Emrise CORP
Form 10-Q
November 14, 2005

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended SEPTEMBER 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	77-0226211
(State or Other Jurisdiction of Incorporation or Organization)	(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 |X| No | |

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes | | No |X|

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

As of November 11, 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

EMRISE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

ASSETS	September 30, 2005	December 31, 2004
Current assets:		
Cash and cash equivalents	$ 3,398	$ 1,057
Accounts receivable, net of allowance for doubtful accounts of $248 and $153, respectively	8,982	5,796
Inventories	10,281	6,491
Deferred tax assets	1,015	352
Prepaid and other current assets	719	417
Total current assets	24,395	14,113
Property, plant and equipment, net	2,269	909
Goodwill	13,683	5,881
Intangible assets, net of accumulated amortization of $174 and $40, respectively	3,018	3,560
Other assets	563	623
	$ 43,928	$ 25,086
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Borrowings under lines of credit	$ 3,514	$ 878
Current portion of long-term debt	530	211
Notes payable to stockholders, current portion	500	500
Accounts payable	3,585	3,398
Income taxes payable	249	572
Accrued expenses	3,346	3,014
Total current liabilities	11,724	8,573
Long-term debt, less current portion	891	985
Notes payable to stockholders, less current portion	1,875	2,250
Deferred income taxes	1,813	1,400
Other liabilities	859	969
Total liabilities	17,162	14,177
Stockholders' equity:		
Common stock, $0.0033 par value Authorized 50,000,000 shares; issued and outstanding 37,498,000 and 24,777,000, respectively	123	82
Additional paid-in capital	42,837	26,746
Accumulated deficit	(15,919)	(16,406)
Accumulated other comprehensive income (loss)	(275)	487
Total stockholders' equity	26,766	10,909
	$ 43,928	$ 25,086

See accompanying notes to condensed consolidated financial statements

EMRISE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net sales	$ 11,177	$ 7,469	$ 28,438	$ 20,093
Cost of sales	6,311	4,239	16,497	11,217
Gross profit	4,866	3,230	11,941	8,876
Operating expenses:				
Selling, general and administrative	3,292	2,465	9,570	6,749
Engineering and product development	600	438	1,736	1,033
Income from operations	974	327	635	1,094
Other income (expense):				
Interest expense	(106)	(115)	(302)	(305)
Interest income	27		136	
Other income (expense)	(91)	(28)	21	(64)
Income before income taxes	804	184	490	725
Income tax expense (benefit)	(12)	26	3	128
Net income	$ 816	$ 158	$ 487	$ 597
Basic earnings per share	$ 0.02	$ 0.01	$ 0.01	$ 0.03
Diluted earnings per share	$ 0.02	$ 0.01	$ 0.01	$ 0.02

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004

Net income	$ 816	$ 158	$ 487	$ 597
Other comprehensive loss:				
Foreign currency translation adjustment	(6)	6	(762)	(58)
Comprehensive income (loss)	$ 810	$ 164	$(275)	$ 539

See accompanying notes to condensed consolidated financial statements.

EMRISE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
NINE MONTHS ENDED SEPTEMBER 30, 2005
(UNAUDITED)
(IN THOUSANDS)

	Common Stock		Additional Paid-In	Accumulate
	Shares	Amount	Capital	Deficit
Balance at December 31, 2004	24,777	$ 82	$ 26,746	$ (16,4
Stock option exercises	104	--	36	
Warrant exercises	113	--	14	
Issuance of common stock and warrants	12,504	41	16,018	
Foreign currency translation adjustment	--	--	--	
Warrants issued for services	--	--	23	
Net income	--	--	--	4
Balance at September 30, 2005	37,498	$ 123	$ 42,837	$ (15,9

See accompanying notes to condensed consolidated financial stateme

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

	Nine Months Ended September	
	2005	2
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 487	$
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	616	

Provision for doubtful accounts	116	
Provision for inventory obsolescence	1,090	
Deferred taxes	(643)	
Changes in operating assets and liabilities, net of businesses acquired:		
Accounts receivable	840	
Inventories	(218)	
Prepaid and other assets	199)	
Accounts payable and accrued expenses	(3,645)	
Cash provided by (used in) operating activities	(1,158)	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net purchases of property, plant and equipment	(212)	
Cash paid for patents	(58)	
Cash paid for acquisition of Pascall, net of cash acquired	(9,509)	
Cash paid for acquisition of RO Associates, net of cash acquired	(4,605)	
Cash paid for acquisition of Larus, net of cash acquired	--	(
Disposal of property, plant and equipment	3	
Cash used in investing activities	(14,381)	(
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net repayments of lines of credit	2,636	
Repayments of long-term debt	(1,253)	
Proceeds from long-term debt	1,052	
Net proceeds from issuance of common stock in offering	16,059	
Proceeds from exercise of stock options and warrants	50	
Cash provided by (used in) financing activities	18,544	
Effect of exchange rate changes on cash	(664)	
Net increase (decrease) in cash and cash equivalents	2,341	
Cash and cash equivalents at beginning of period	1,057	
Cash and cash equivalents at end of period	$ 3,398	$
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 354	$
Income taxes	$ 89	$

See accompanying notes to condensed consolidated financial statements.

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 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, power conversion products, 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 September 30, 2005 and December 31, 2004 and the results of operations and cash flows for the related interim periods ended September 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:

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

	Three Months Ended September 30,		Nine Months Septembe
	2005	2004	2005
Net income (loss):			
As reported	$ 816,000	$ 158,000	$ 487,000
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	(49,000)	(39,000)	(143,000)
Pro forma	$ 767,000	$ 119,000	$ 344,000
Basic earnings per share:			
As reported	$ 0.02	$ 0.01	$ 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	$ 0.02	$ 0.00	$ 0.01
Diluted earnings per share:			
As reported	$ 0.02	$ 0.01	$ 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	$ 0.02	$ 0.00	$ 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 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 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 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 minimize 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 were valued at $3,100,000 as of September 30, 2005 and were marked to market at the end of the period with unrealized gains and losses included in other income and expense.

Emrise Electronics Ltd. in England also has a program that utilizes a forward currency contract denominated in British pounds sterling to offset the risk of intercompany loans to an English 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 minimize the possibility of foreign currency transaction gains or losses. The forward contract expired in September 2005. The Company did not use this forward contract for trading purposes. The forward contract used in this program was 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 grains included in the accompanying consolidated statements of operations totaled $30,000 for the three month period ended September 30, 2005 and $38,000 for the nine months ended September 30, 2005. There was no hedging in the year ended December 31, 2004 in which we reported $2,000 of losses due to currency exchange rates.

SEPTEMBER 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 September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
NUMERATOR:				
Net income	$ 816	$ 158	$ 487	$ 597
Income attributable to common stockholders	$ 816	$ 158	$ 487	$ 597
DENOMINATOR:				
Weighted average number of common shares outstanding during the period	37,456	24,538	37,163	23,833
Incremental shares from assumed exercises of warrants and options	1,040	556	1,195	766
Adjusted weighted average number of outstanding shares	38,496	25,094	38,358	24,599
Basic earnings per share	$ 0.02	$ 0.01	$ 0.01	$ 0.03
Diluted earnings per share	$ 0.02	$ 0.01	$ 0.01	$ 0.02

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 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):

Three Months Ended
September 30,

	2005	2004
Options and warrants to purchase shares of common stock	3,949	1,668
Exercise prices	$1.55 - $3.44	$0.75 - $3.44

	Nine Months Ended September 30,	
	2005	2004
Options and warrants to purchase shares of common stock	3,906	1,091
Exercise prices	$1.55 - $3.44	$0.75 - $3.44

(3) INVENTORIES

Inventories consist of the following (in thousands):

	September 30, 2005	December 31, 2
Raw materials	$ 5,095	$ 3,
Work-in-process	3,065	1,
Finished goods	2,121	1,
	$ 10,281	$ 6,

(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, power conversion products, RF and microwave components and subsystems, and subsystem assemblies. The communications equipment segment also operates in the United States, European and Asian markets and designs, manufactures and distributes network access and transmission products, communications test instruments and network timing and synchronization products.

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

EMRISE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 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. The following is a description of the Company's segment and component structure as of September 30, 2005:

Reporting Units Within Electronic Components Segment:

- Emrise Electronics - Rancho Cucamonga, California: Digitran Division- digital and rotary switches, and electronic subsystem assemblies for defense, aerospace and industrial applications

- Emrise Electronics - Monrovia, California: EEL Circuits Division - printed circuit boards mostly for intercompany use but with a small base of outside customers

- EEL Japan Ltd. - Tokyo, Japan: Reseller of Digitran switches and other third party electronic components

- Emrise Electronics Ltd. ("EEL") - 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

- RO Associates Incorporated ("RO") - Sunnyvale, California: Power conversion products for defense, aerospace and industrial applications

Reporting Units Within Communications Equipment Segment:

- CXR Larus - San Jose, California: Network timing and synchronization devices and network access equipment

- 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 six months ended June 30, 2005 and the inclusion of RO sales in the electronic components segment for the last 31 days of the quarter ended September 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
SEPTEMBER 30, 2005 AND 2004
(UNAUDITED)

	Three Months Ended Sept. 30, 2005	Three Months Ended Sept, 30, 2004	Nine Months Ended Sept. 30, 2005
Sales to external customers:			
Electronic Components	$ 7,262	$ 3,843	$ 17,488
Communications Equipment	3,915	3,626	10,950
	$ 11,177	$ 7,469	$ 28,438
Segment pretax profits (losses):			
Electronic Components	$ 1,246	$ 632	$ 2,423
Communications Equipment	233	75	(57)
	$ 1,479	$ 707	$ 2,366

	September 30, 2005	De
Segment assets:		
Electronic Components	$ 26,156	$
Communications Equipment	15,753	
	$ 41,909	$

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 Sept. 30, 2005	Three Months Ended Sept, 30, 2004	Nine Months Ended Sept. 30, 2005
Income before income taxes			
Total income for reportable segments	$ 1,479	$ 707	$ 2,366
Unallocated amounts:			
General corporate expenses	675	523	1,876
Consolidated income before income taxes	$ 804	$ 184	$ 490

	September 30, 2005
Assets	
Total assets for reportable segments	$ 41,909
Other assets	2,066
Total consolidated assets	$ 43,975

(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.

(6) INCOME TAXES

The effective tax rate for the three and nine-month period ended September 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. Also, the Company recorded a reduction in its valuation allowance of $245,000 in the third quarter of 2005. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which the net operating losses are available or when other temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities and projected future taxable income in making this assessment. Based upon projections for future taxable income, management believes it is more likely than not that the Company will realize the benefits of the deferred tax assets.

(7) CREDIT FACILITIES

On August 25, 2005, the Company, together with two subsidiaries, CXR Larus and Emrise Electronics, acting as guarantors, obtained a credit facility from Wells Fargo Bank, N.A. for the Company's domestic operations. As guarantors, each of CXR Telcom Corporation and Emrise Electronics is jointly and severally liable with the Company for up to $9,000,000. This facility is to be effective through September 1, 2006 and replaced the previous credit facility the Company had with Wells Fargo Bank, N.A. The previous facility was to expire July 1, 2005, but was informally extended for two months. The new credit facility has no prepayment penalty and is subject to an unused commitment fee equal to 0.25% per annum, payable quarterly based on the average daily unused amount of the line of credit described in the following paragraph.

The credit facility provides a $9,000,000 revolving line of credit

secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment. However, borrowings may not exceed $2,000,000 until the bank has completed a collateral examination. Borrowings do not need to be supported by specific receivables or inventory balances unless aggregate borrowings under the line of credit exceed $2,000,000 at any time (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. The formula generally provides that outstanding borrowings under the line of credit may not exceed an aggregate of 80% of eligible accounts receivable, plus 30% of the value of eligible finished goods inventory. The interest rate is variable and is adjusted monthly based on the prime rate. The prime rate at September 30, 2005 was 6.75%. Interest is payable monthly commencing October 1, 2005.

The credit facility is subject to various financial covenants on a consolidated basis. The minimum debt service coverage ratio must be greater than 1.25:1.00 on a trailing four-quarter basis. "Debt service coverage ratio" is defined as net profit after taxes, plus depreciation, plus amortization, plus or minus net distributions, divided by the sum of the current portion of long-term debt plus capitalized lease payments. The current ratio must be not less than 1.50:1.00, determined as of each fiscal quarter end. "Current ratio" is defined as total current assets divided by total current liabilities. Annual net profit after taxes must be greater than $500,000, determined as of each fiscal quarter end on a rolling four-quarter basis; provided that the Company may not sustain net loss after tax in any two consecutive fiscal quarters. Total liabilities divided by tangible net worth of the Company must not at any time be greater than 1.25:1.00, determined as of each fiscal quarter end. Tangible net worth of the Company must not at any time be less than $14,250,000 measured at the end of each quarter. "Total liabilities" is defined as current liabilities plus non-current liabilities, minus subordinated debt. "Tangible net worth" is defined as stockholders' equity plus subordinated debt, minus intangible assets.

As of September 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. As of September 30, 2005, the Company was in compliance with each of the covenants of the credit facility except for the tangible net worth covenant, as to which the Company received a waiver. The bank informally has indicated that it intends to modify the tangible net worth covenant.

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

The credit facility also provides for a term loan of $150,000 secured by equipment, amortizable over 36 months at a variable rate equal to the prime

rate plus 1.5%. The term loan portion of the facility had a balance of $88,000 at September 30, 2005.

Wells Fargo Bank, N.A. has also provided the Company with credit for the purchase of new capital equipment when needed, of which a balance of $130,000 was outstanding at September 30, 2005. The interest rate is equal to the 90-day London InterBank Offered Rate ("LIBOR") rate (4.055% at September 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 September 30, 2005, the Company's foreign subsidiaries had credit facilities, including lines of credit and term loans, with Lloyds TSB Bank PLC ("Lloyds PLC") and Lloyds TSB Commercial Finance Limited ("Lloyds") in England, IFN Finance, a subsidiary of ABN AMRO Holdings, N.V., Banc National de Paris, Societe Generale in France, and Sogelease and Johnan Shinkin Bank in Japan. At September 30, 2005, the balances outstanding under the Company's United Kingdom, France and Japan credit facilities were $3,781,000, $653,000 and $39,000, respectively.

On July 8, 2005, XPS and Pascall obtained a credit facility with 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. $3,701,000 based on the exchange rate in effect on September 30, 2005). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB rate. The Lloyds TSB rate was 4.5% at September 30, 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, on August 26, 2005 Lloyds also provided an unsecured cashflow loan of $1,410,000 and a $264,000 term loan that is secured by equipment and amortized over 36 months.

On August 26, 2005, XCEL Power Systems, a United Kingdom-based subsidiary of the Company, entered into two agreements with Lloyds for (1) an unsecured cashflow loan of 300,000 British pounds sterling (approximately U.S. $544,000 based on the exchange rate in effect on September 30, 2005) and (2) a 150,000 British pounds sterling (approximately U.S. $272,000 based on the

exchange rate in effect on September 30, 2005) term loan, secured by equipment. Both of these loans are structured as overadvances on the previously negotiated 2,100,000 British pounds sterling revolving loan with Lloyds, bringing the maximum aggregate commitment on the revolving loan to 2,550,000 British pounds sterling (approximately U.S. $4,622,000 based on the exchange rate in effect on September 30, 2005).

The unsecured cashflow loan of 300,000 British pounds sterling is payable at a rate of 25,000 British pounds sterling per month, the first payment falling due one month after initial drawdown on the revolving loan. The interest rate is variable and is adjusted monthly based on the base rate of Lloyds PLC

plus 1.9%. The Lloyds PLC base rate at September 30, 2005 was 4.5%. Lloyds has sole discretion to switch the details on this overadvance account if Lloyds determines that the Company will have difficulty in meeting the specific reductions in the overadvance account.

The interest rate on the secured term loan of 150,000 British pounds sterling is variable and is adjusted monthly based on the Lloyds PLC base rate plus 1.9%. Valuations of plant and machinery securing the loan are to be prepared by an independent valuer prior to drawdown and annually on the anniversary of the loan.

On August 26, 2005, EEL Corporation Limited ("EEL Corp"), a United Kingdom-based subsidiary of the Company, entered into an agreement with Lloyds PLC for an unsecured term loan for 500,000 British pounds sterling (approximately U.S. $906,000 based on the exchange rate in effect on September 30, 2005). This loan is repayable in 36 consecutive monthly installments, representing principal and interest. The interest rate is variable and is adjusted daily based on the Lloyds PLC base rate plus 2.5%. The Lloyds PLC base rate at September 30, 2005 was 4.5%. The loan also includes financial covenants. EEL Corp must maintain consolidated profit before taxation and interest paid and payable of no less than 500% of the consolidated interest paid and payable. Additionally, EEL Corp must maintain consolidated profit before taxation, depreciation, amortization of goodwill and other intangibles and interest paid and payable of no less than 300% of the consolidated principal repayments and the consolidated interest paid and payable.

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

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 $1,445,000, based on the exchange rate in effect at September 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 September 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 August 31, 2005, the French T4M rate was 2.067%, and this facility had a balance of $616,000. This facility has no financial performance covenants. In addition, CXR-AJ has term loans with other banks with a balance of $37,000 as of September 30, 2005.

EEL 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 September 30, 2005 was $39,000 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.

(8) RELATED PARTY TRANSACTIONS

On July 13, 2004, the Company issued two promissory notes to the former stockholders of Larus Corporation totaling $3,000,000, in addition to paying cash and issuing shares of common stock (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 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 September 30, 2005, the 30-day LIBOR rate was 3.86%. The total balance of these promissory notes as of September 30, 2005 was $2,375000.

Future maturities of notes payable to stockholders are as follows

Year Ending December 31,	Dollars in Thousands
2005 (3 months)	$ 125
2006	500
2007	500
2008	500
2009	500
Thereafter	250
	$ 2,375

Total interest paid on these notes for the nine months ended September 30, 2005 was $167,000.

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 nine months ended September 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 $546,000 through September 30, 2005 and liquidated damages of $480,000. The Company used a portion of the proceeds from this financing to fund the acquisition of Pascall described 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.

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 timely 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 statement 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 would be, and the liquidated damages paid for the period from June 5, 2005 through June 30, 2005 were, equal to 2% of the amount paid by each investor for the common shares still owned by the investor on each monthly anniversary of the date of the default that occurs prior to the cure of the default, pro rated on a daily basis for periods of default shorter than one month. The maximum aggregate liquidated damages payable to any investor will be equal to 10% of the aggregate amount paid by the investor for the shares of 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) 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.

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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.

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 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 $129,000 of amortization expenses were recorded and charged to administrative expense during the year ended December 31, 2004 and the nine months ended September 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.

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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	4,709
Total assets acquired	9,359
Current liabilities	(531)
Deferred income taxes	(1,400)
Unfavorable lease obligation and other liabilities	(888)
Total liabilities assumed	(2,819)
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 September 30, 2005 is anticipated to be approximately $129,000 per year for each of the next five years.

PASCALL ACQUISITION

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

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

The initial portion of the purchase price was 3,100,000 British pounds

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

On May 6, 2005, the Company submitted to Intelek Properties Limited (which is a subsidiary of Intelek PLC, a London Stock Exchange public limited company, and is the former parent of PEHL), the Company's calculation of the value of the net assets of Pascall as of the closing date, which the Company believed slightly exceeded 2,520,000 British pounds sterling. Ultimately, the parties determined that the value of the net assets of Pascall at the closing date was 2,650,000 British pounds sterling. As a result, the Company paid to Intelek Properties Limited 130,000 British pounds sterling (approximately U.S. $236,000 based on the exchange rate in effect at June 30, 2005) on August 1, 2005 to satisfy this obligation. The purchase price is also subject to downward adjustments for any payments that may be made to EEL under indemnity, tax or warranty provisions of the Purchase Agreement.

EEL loaned to PEHL and Pascall at the closing 1,600,000 British pounds sterling (approximately U.S. $3,082,000 based on the exchange rate in effect on March 18, 2005) in accordance with the terms of a Loan Agreement entered into by those entities at the closing. The loaned funds were used to immediately repay outstanding intercompany debt owed by PEHL and Pascall to the seller.

The Company and Intelek PLC have agreed to guarantee payment when due of all amounts payable by EEL and Intelek Properties Limited, respectively, under the Purchase Agreement. The Company and EEL agreed to seek to replace the guaranty that Intelek Properties Limited has given to Pascall's landlord with a guaranty by the Company, and EEL 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, EEL, 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. EEL 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.

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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.............	5,348
Total assets acquired.......................	12,911
Current liabilities.........................	(2,875)
Other liabilities...........................	(80)
Total liabilities assumed...................	(2,955)
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 supply 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 $5,298,000 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 by December 31, 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.

RO ASSOCIATES ACQUISITION

On September 2, 2005, Emrise Electronics entered into a stock purchase agreement dated effective as of August 31, 2005 to acquire RO Associates Incorporated, a California corporation ("RO"). Effective September 28, 2005, Emrise Electronics entered into an amendment to the stock purchase agreement.

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

RO is based in Sunnyvale, California and designs and manufactures power conversion products for telecom, industrial, commercial, and military applications. As a result of the acquisition, Emrise Electronics acquired all of the assets and liabilities of RO, including the intellectual property, cash, accounts receivable and inventories owned by RO. Emrise Electronics intends to use these acquired assets for the same purpose for which they were used by RO.

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

In determining the purchase price for RO, Emrise Electronics considered the historical and expected earnings and cash flow of RO, as well as the value of companies of a size and in an industry similar to RO, comparable transactions and the market for such companies generally. The purchase price represented a premium of approximately $2,275,000 over the $2,340,000 recorded net worth of the assets of RO. In determining this premium, Emrise Electronics considered the synergistic and strategic advantages provided by having a United States-based power conversion manufacturer and the value of the goodwill, customer relationships and technology of RO. Goodwill associated with the RO acquisition totaled approximately $1,291,000. Emrise intends to commission a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. Emrise has estimated that RO's technology is valued at approximately $484,000, its trademarks are valued at $300,000 and its

customer relationships are valued at $200,000. The valuation of the identified intangible assets is expected to be completed in December 2005 and could result in changes to the value of these identified intangible assets and corresponding changes to the value of goodwill. However, Emrise does not believe these changes will be material to Emrise's consolidated financial position or results of operations.

In connection with the execution of the stock purchase agreement, Emrise Electronics executed a lease agreement with Caspian Associates for the lease of 25,700 square feet of a 30,700 square feet building located at 246 Caspian Drive, Sunnyvale, California. The lease provides for a two-year term, commencing on September 1, 2005 and ending on August 31, 2007, at a base rent of $9,210 per month. Additionally, the lease provides for an extension of the lease term for an additional three years, to August 31, 2010, if RO achieves net sales of at least $14,500,000 and cumulative gross profit of at least $3,987,500. If RO achieves the net sales and cumulative gross profit targets, the monthly base rent for the facility will be increased to the fair market value as of the first day of the next calendar month. The facility will continue to be used for the design, manufacture and sale of power conversion products.

In connection with the stock purchase agreement, Emrise Electronics also executed an employment agreement with Richard Okada, effective as of September 1, 2005, to serve as president of RO. Mr. Okada will receive an annual base salary of $115,000 for the two-year term of the employment agreement. In addition, Mr. Okada is entitled to receive an incentive bonus based upon performance criteria to be determined in the future. In connection with Mr. Okada's employment agreement, Emrise granted Mr. Okada an incentive stock option under Emrise's 2000 Stock Option Plan to purchase up to 50,000 shares of Emrise's common stock at an exercise price of $1.35 per share. This option vests 50% on September 1, 2006 and 50% on September 1, 2007. The option expires on August 31, 2015.

The following table summarizes the unaudited assets and liabilities assumed in connection with this acquisition, including $48,000 in acquisition costs:

	DOLLARS IN THOUSANDS
Current assets	$ 3,269
Property, plant and equipment	329
Intangibles, including goodwill	2,275
Other assets	66
Total assets acquired	5,939
Current liabilities	(931)
Other liabilities	(393)
Total liabilities assumed	(1,324)

Net assets acquired	$ 4,615

PRO FORMA RESULTS OF OPERATIONS

The following table summarizes, on an unaudited pro forma basis, the combined results of operations of the Company, Larus Corporation, Pascall and RO, as though the Larus Corporation, Pascall and RO 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).

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	Three Months Ended September 30,		Nine M Ended Sept
	2005	2004	2005
Revenues	$ 11,887	$ 12,098	$ 35,043
Net income	$ 691	$ 586	$ 431
Earnings per share of common stock			
Basic	$ 0.02	$ 0.02	$ 0.01
Diluted	$ 0.02	$ 0.02	$ 0.01

(11) ACCRUED EXPENSES

Accrued expenses were as follows (in thousands):

	September 30, 2005	December 31, 2004
Accrued salaries	$ 720	$ 805
Accrued payroll taxes and benefits	692	491
Advance payments from customers	50	77
Other accrued expenses	1,884	1,641
Total accrued expenses	$ 3,346	$ 3,014

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:

- the projected growth or contraction in the electronic components and communications equipment markets in which we operate;
- our business strategy for expanding, maintaining or contracting our presence in these markets;
- our ability to efficiently and effectively integrate and operate the businesses of our newly-acquired subsidiaries, Pascall Electronics Limited ("Pascall") and RO Associates Incorporated ("RO");
- our ability to identify, fund and integrate additional businesses;
- anticipated trends in our financial condition and results of operations; and
- 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.

OVERVIEW

Through our three wholly-owned operating subsidiaries, Emrise Electronics Corporation ("Emrise Electronics"), 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
  - -- 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 61.5% and 58.5% of our total net sales during the nine months ended September 30, 2005 and 2004, respectively. Sales of communications equipment and related services, primarily to private customer premises and public carrier customers, were 38.5% and 41.5% of our total net sales during the nine months ended September 30, 2005 and 2004, respectively.

Sales of our electronic components segment increased $5,785,000 (49.4%) for the nine months ended September 30, 2005 as compared to the nine months ended September 30, 2004. Excluding sales of $8,209,000 from our new subsidiaries, Pascall and RO, which we acquired as of March 18, 2005 and August 31, 2005, respectively, our electronic components segment sales declined $2,424,000 (20.7%) for the nine months ended September 30, 2005 as compared to the nine months ended September 30, 2004, primarily due to a $2,239,000 (32.2%) decrease in net sales of power supplies manufactured by our XCEL Power Systems, Ltd. subsidiary that was primarily due to the customer's delay of delivery requirements for the Eurofighter Typhoon aircraft.

We achieved a $2,560,000 (30.5%) sales increase in our communications equipment segment for the nine months ended September 30, 2005 as compared to the nine months ended September 30, 2004. This was primarily due to increased demand for our test equipment, network access equipment and synchronous timing devices. However, sales of our European network access products declined to $3,848,000 during the nine months ended September 30, 2005 from $4,391,000 during the prior nine-month period, which decline partially offset the total increases in sales of this segment. The decline primarily was due to lower sales volume caused by delay in the award of contracts by the French military for products under previous contracts.

We have reduced costs at CXR Larus by 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 nine months ended September 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 nine months ended September 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 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 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, Emrise Electronics Ltd. ("EEL") purchased all of the outstanding capital stock of Pascall Electronic (Holdings) Limited ("PEHL"), the parent holding company of Pascall, using funds loaned to EEL 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 EEL 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 EEL under indemnity, tax or warranty provisions of the purchase agreement.

EEL loaned to Pascall and PEHL at the closing 1,600,000 British pounds sterling (approximately U.S. $3,082,000 based on the exchange rate in effect on March 18, 2005) 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.

We and Intelek PLC have agreed to guarantee payment when due of all amounts payable by EEL and Intelek Properties Limited, respectively, under the PEHL purchase agreement. Emrise and EEL have agreed to seek to replace the guaranty that Intelek Properties Limited has given to Pascall's landlord with a guaranty from us, and EEL 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, EEL, 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. EEL 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 have consolidated 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.

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	5,348
Total assets acquired.......................	12,911
Current liabilities.........................	(2,875)
Other liabilities...........................	(80)
Total liabilities assumed...................	(2,955)

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.

On September 2, 2005, we entered into a stock purchase agreement dated effective as of August 31, 2005 to acquire RO. We amended the agreement on September 28, 2005.

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

RO is based in Sunnyvale, California and designs and manufactures power conversion products for telecom, industrial, commercial and military applications. As a result of the acquisition, we acquired all of the assets and liabilities of RO, including the intellectual property, cash, accounts receivable and inventories owned by RO. We intend to use these acquired assets for the same purpose for which they were used by RO.

The purchase price consisted of $2,400,000 in cash paid at closing and an additional $600,000 in cash payable in two equal installments on October 6, 2005 and March 31, 2006. The acquisition purchase price was funded with cash on-hand. The purchase price is subject to adjustment based on the value of the shareholders' equity, accounts receivable, accounts payable, cash on hand and net inventory of RO, as determined by the consolidated, unaudited balance sheet as of August 31, 2005, prepared in accordance with accounting principles generally accepted in the United States of America. In addition, concurrently with the closing of the acquisition of RO, we paid in full all then existing credit facilities of RO in the aggregate amount of $1,602,060.

In determining the purchase price for RO, we considered the historical and expected earnings and cash flow of RO, as well as the value of companies of a size and in an industry similar to RO, comparable transactions and the market for such companies generally. The purchase price represented a premium of approximately $2,275,000 over the $2,340,000 net worth of the assets of RO. In determining this premium, Emrise Electronics considered the synergistic and strategic advantages provided by having a United States-based power converted manufacturer and the value of the goodwill, customer relationships and technology of RO. Goodwill associated with the RO acquisition totaled approximately $1,291,000. We intend to commission a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. We have estimated that RO's technology is valued at approximately $484,000, its trademarks are valued at $300,000 and its customer relationships are valued at $200,000. The valuation of the identified intangible assets is expected to be completed in December 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 consolidated financial position or results of operations.

In connection with the execution of the stock purchase agreement, we executed a lease agreement with Caspian Associates for the lease of 25,700 square feet of a 30,700 square feet building located at 245 Caspian Drive, Sunnyvale, California. The lease provides for a two-year term, commencing on September 1, 2005 and ending on August 31, 2007, at a base rent of $9,210 per month. Additionally, the lease provides for an extension of the lease term for an additional three years, to August 31, 2010 if RO achieves net sales of at

least $14,500,000 and cumulative gross profit of at least $3,987,500. If RO achieves the net sale and cumulative gross profit targets, the monthly base rent for the facility will be increased to the fair market value as of the first day of the next calendar month. The facility will continue to be used for the design, manufacture and sale of power conversion products.

In connection with the stock purchase agreement, we also executed an employment agreement with Richard Okada, effective as of September 1, 2005, to serve as president of RO. Mr. Okada will receive an annual base salary of $115,000 for the two-year term of the employment agreement. In addition, Mr. Okada is entitled to receive an incentive bonus based upon performance criteria to be determined in the future. In connection with Mr. Okada's employment agreement, Emrise granted Mr. Okada an incentive stock option under Emrise's 2000 Stock Option Plan to purchase up to 50,000 shares of Emrise's common stock at an exercise price of $1.35 per share. This option vests 50% on September 1, 2006 and 50% on September 1, 2007. The option expires on August 31, 2015.

The following table summarizes the unaudited assets and liabilities assumed in connection with the acquisition, including $48,000 in acquisition costs.

	Dollars in Thousands
Current assets..............................	$ 3,269
Property, plant and equipment...............	329
Intangibles, including goodwill	2,275
Other assets	66
Total assets acquired.......................	5,939
Current liabilities.........................	(931)
Other liabilities...........................	(393)
Total liabilities assumed...................	(1,324)
Net assets acquired.........................	$ 4,615

The following table summarizes, on an unaudited pro forma basis, the combined results of operations of Emrise, Larus Corporation, Pascall and RO, as though the Laurus Corporation, Pascall and RO 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 September 30,		Six Mo Ended Sept
	2005	2004	2005

Revenues	$ 11,887	$ 12,098	$ 35,043
Net income	$ 691	$ 586	$ 431
Earnings per share of common stock			
Basic	$ 0.02	$ 0.02	$ 0.01
Diluted	$ 0.02	$ 0.02	$ 0.01

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.

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 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 1.8% and 5.7% of net sales during the nine months ended September 30, 2005 and the year ended December 31, 2004, respectively.

RO generates a portion of its revenue from royalties. Royalty income is recognized when the technology rights have transferred to the licensee. For agreements that provide the licensees the right to manufacture and sell our proprietary products, we recognize initial license fee revenue upon delivery of the product technology. We recognize guaranteed minimum license royalties as revenue as they become due. Per unit royalties that exceed the guaranteed minimum are recognized as earned when reported.

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 61.0% of our net revenues, 50.3% of our assets and 53.2% of our total liabilities as of and for the nine months ended September 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.

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 $275,000 and gain of $487,000 that were included as part of accumulated other comprehensive income (loss) within our balance sheet at September 30, 2005 and December 31, 2004, respectively. During the nine months ended September 30, 2005 and the year ended December 31, 2004, we included translation adjustments of losses of approximately $762,000 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 September 30, 2005 and December 31, 2004, the reported goodwill totaled $13,683,000 and $5,881,000, respectively (net of accumulated amortization of $1,073,000 and $1,084,000, respectively). During the nine months ended September 30, 2005 and the year ended December 31, 2004, we did not record any impairment losses related to goodwill and other intangible assets.

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 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 $129,000 of amortization expenses were recorded and charged to administrative expense during the year ended December 31, 2004 and the nine months ended September 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 $5,298,000 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 December 31, 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.

Our Emrise Electronics subsidiary acquired RO Associates Incorporated effective August 31, 2005. In determining the purchase price for RO, Emrise Electronics considered the historical and expected earnings and cash flow of RO, as well as the value of companies of a size and in an industry similar to RO, comparable transactions and the market for such companies generally. The purchase price represented a premium of approximately $2,275,000 over the $2,340,000 net worth of the assets of RO. In determining this premium, Emrise Electronics considered the synergistic and strategic advantages provided by having a United States-based power converted manufacturer and the value of the goodwill, customer relationships and technology of RO. Goodwill associated with the RO acquisition totaled approximately $1,290,000. We intend to commission a

valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. We have estimated that RO's technology is valued at approximately $484,000, its trademarks are valued at $300,000 and its customer relationships are valued at $200,000. The valuation of the identified intangible assets is expected to be completed in December 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 consolidated financial position or results of operations.

RESULTS OF OPERATIONS

The tables presented below, which compare our results of operations for the three and nine months ended September 30, 2005 to our results of operations for the three and nine months ended September 30, 2004, present the results for each period, the changes 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:

- The first two data columns show the absolute results for each period presented.

- 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.

- The last two columns show the results for each period as a percentage of net sales.

THREE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO THREE MONTHS ENDED SEPTEMB

	THREE MONTHS ENDED September 30, 2005	THREE MONTHS ENDED September 30, 2004	DOLLAR VARIANCE FAVORABLE (UNFAVORABLE)	PERC VAR FAVO (UNFAV
	(DOLLARS IN THOUSANDS)			
Net sales				
Electronic components	$ 7,262	$ 3,843	$ 3,419	
Communications equipment	3,915	3,626	289	
Total net sales	11,177	7,469	3,708	
Cost of sales				
Electronic components	4,183	2,284	(1,899)	
Communications equipment	2,128	1,955	(173)	

Total cost of sales	6,311	4,239	(2,072)
Gross profit			
Electronic components	3,079	1,559	1,520
Communications equipment	1,787	1,671	116
Total gross profit	4,866	3,230	1,636
Selling, general and administrative expenses	3,292	2,465	(827)
Engineering and product development	600	438	(162)
Operating income	974	327	647
Interest expense	(106)	(115)	9
Interest income	27	--	27
Other expense	(91)	(28)	(63)
Income before income tax expense	804	184	620
Income tax expense (benefit)	(12)	26	38
Net income	$ 816	$ 158	$ 658

NET SALES. The $3,708,000 (49.6%) increase in total net sales for the three months ended September 30, 2005 as compared to the three months ended September 30, 2004 resulted from the combination of a $3,419,000 (89.0%) increase in net sales of our electronic components and a $289,000 (8.0%) 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 $2,743,000 (146.0%) increase in net sales of power supplies primarily due to the inclusion of $3,442,000 of power supplies and RF components sold by Pascall and $344,000 sold by RO, which subsidiaries we acquired on March 18, 2005 and August 31, 2005, respectively. Without Pascall and RO, sales of power supplies by XCEL Power Systems, Ltd. would have declined by $818,000, primarily due to the delay of delivery requirements for the Eurofighter Typhoon aircraft. We had $718,000 of sales of RF components and RF subsystems assemblies for the three months ended September 30, 2005 as compared to none in the prior year period due to the acquisition of Pascall in March 2005. Sales of switches decreased $165,000 (11.4%) to $1,281,000 for the three months ended September 30, 2005 from $1,446,000 for the prior year period due to a deferral of certain orders to the fourth quarter and lower orders for spares by the defense supply agency.

COMMUNICATIONS EQUIPMENT. The $289,000 (8.0%) increase in net sales of our communications equipment segment resulted primarily from an increase of $394,000 (73.2%) of net sales of test instruments and a $317,000 (62.2%) increase in sales of synchronous timing devices due to an increased number of units sold. These increases were partially offset by a $473,000 (19.9%) decline

in net sales of network access equipment and transmission products due to lower unit sales volume. Sales of network access products produced by CXR-AJ in France held steady with no change. 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 2005. We also anticipate that sales of our network timing and synchronization products will show growth as we build our business with telecommunications carrier companies during the remainder of 2005 and beyond.

GROSS PROFIT. Gross profit as a percentage of total net sales increased to 43.5% for the three months ended September 30, 2005 from 43.2% for the prior year period. In dollar terms, gross profit increased by $1,636,000 (50.7%) to $4,866,000 for the three months ended September 30, 2005 as compared to $3,230,000 for the prior year period.

Electronic Components. The $1,520,000 (97.5%) increase in gross profit for our electronic components segment was primarily due to the inclusion of Pascall's results, which contributed $1,103,000 in gross profit for the three months ended September 30, 2005, and the inclusion of $633,000 of gross profit contributed by RO primarily as a result of $550,000 of licensing revenue. Gross profit for our switch sales declined by $209,000 (26.1%) to $592,000 for the three months ended September 30, 2005 as compared to $801,000 for the prior year period due to lower sales volume, changes in product mix and delays of production into the fourth quarter.

Communications Equipment. The $116,000 (6.9%) increase in gross profit for our communications equipment segment was primarily due to the increased sales of test instruments during the three months ended September 30, 2005. Gross profit for test instruments increased $206,000 (55.0%) to $579,000 as compared to $373,000 in the prior year period. This increase was slightly reduced by minor decreases in gross profit on network access equipment and network timing devices.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. The $827,000 (33.5%) increase in selling, general and administrative expenses for the three months ended September 30, 2005 as compared to the three months ended September 30, 2004 primarily was due to:

- a $114,000 (70.8%) increase in sales commissions primarily due to the inclusion of sales commissions due to the RO and Pascall acquisitions;

- a $329,000 (150.2%) increase in other selling and marketing expenses primarily due to the inclusion of selling expenses as a result of the Pascall acquisition;

- a $379,000 (24.4%) increase in administrative expenses primarily due to the inclusion of $218,000 and $43,000 of administrative costs for Pascall and RO, respectively, and an increase of $54,000 in corporate legal expenses and a $77,000 increase in accounting and auditing expenses at our United States operations to $96,000 and $132,000, respectively.

Despite the increase in selling, general and administrative expenses in dollar terms, our selling general and administrative expenses declined to 29.5% of our net sales for the three months ended September 30, 2005 as compared to 33.0% 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, Pascall and RO 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

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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 new product development activities. The $162,000 (37.0%) increase in these expenses resulted primarily from an increase of $43,000 in expenses attributable to CXR Larus network timing devices, a $95,000 increase in engineering expenses related to new products for our Pascall acquisition and a $31,000 increase attributable to our RO acquisition. We expect this higher level of expense to continue throughout the remainder of 2005 as we continue to develop our new family of rotary switches, pursue long-term opportunities in the timing and synchronization market and continue to develop our power supply and RF component products.

INTEREST EXPENSE AND OTHER INCOME. Interest expense of $106,000 declined slightly for the three months ended September 30, 2005. We recorded reduced interest expenses related to our Wells Fargo Bank loan due to the zero balance on the revolving credit line. In addition, we recorded $27,000 of interest income in the three months ended September 30, 2005, which was earned on the remaining proceeds of the January 2005 private placement. We did not have interest income during the three months ended September 30, 2004. Other expense of $91,000 for the three months ended September 30, 2005 included a United States-based currency hedging loss of $87,000.

INCOME TAX EXPENSE. Income tax benefit for the three months ended September 30, 2005 was $12,000, compared to an expense of $26,000 for the three months ended September 30, 2004. We have net tax loss carryforwards for United States income tax purposes and relieved $245,000 of our tax asset valuation allowance. This was partially offset with foreign tax provisions of $233,000.

NET INCOME. The net income for the three months ended September 30, 2005 increased by $658,000 (416.5%) to $816,000 as compared to net income of $158,000 for the three months ended September 30, 2004. The increase was primarily due to $313,000 of net income from Pascall and $439,000 of net income from RO that included $550,000 of royalty revenue. Improved sales of test instruments at CXR Larus provided a $277,000 increase in operating income. 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 indicated above.

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NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO NINE MONTHS ENDED SEPTEMBE

	NINE MONTHS ENDED September 30,		DOLLAR VARIANCE	PERC VAR
			FAVORABLE	FAVO
	2005	2004	(UNFAVORABLE)	(UNFAV
	(DOLLARS IN THOUSANDS)			
Net sales				
Electronic components	$ 17,488	$ 11,703	$ 5,785	
Communications equipment	10,950	8,390	2,560	
Total net sales	28,438	20,093	8,345	
Cost of sales				
Electronic components	10,634	6,809	(3,825)	
Communications equipment	5,863	4,408	(1,455)	
Total cost of sales	16,497	11,217	(5,280)	
Gross profit				
Electronic components	6,854	4,894	1,960	
Communications equipment	5,087	3,982	1,105	
Total gross profit	11,941	8,876	3,065	
Selling, general and administrative expenses	9,570	6,749	(2,821)	
Engineering and product development expenses	1,736	1,033	(703)	
Operating income	635	1,094	(459)	
Interest expense	(302)	(305)	3	
Interest income	136	--	136	
Other income and expense	21	(64)	85	
Income before income tax expense	490	725	(235)	
Income tax expense	3	128	125	
Net income	$ 487	$ 597	(110)	

NET SALES. The $8,345.000 (41.5%) increase in total net sales for the nine months ended September 30, 2005 as compared to the nine months ended September 30, 2004 resulted from the combination of a $5,785,000 (49.4%) increase in net sales of our electronic components and a $2,560,000 (30.5%) 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 nine months ended September 30, 2005 of Pascall's $7,314,000 sales of power supplies and RF components and RO's $894,000 sales of power conversion products and licensing. This increase was offset by a $2,239,000 (32.2%) 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 deliveries for the Eurofighter Typhoon aircraft. Sales of switches increased $135,000 (1.9%) to $4,629,000 for the nine months ended September 30, 2005 from $4,541,000 for the prior year period due to slightly higher sales volume.

We first reported sales of RF components during the three months ended March 31, 2005 due to the Pascall acquisition. We acquired RO on August 31, 2005. Excluding sales by Pascall from March 18, 2005 through September 30, 2005 and sales by RO for September 2005, our electronic components segment sales declined by $2,424,000 or (20.7%) for the nine months ended September 30, 2005

as compared to the nine months ended September 30, 2004. We currently anticipate that our sales of electronic components will increase in the fourth quarter of 2005, and throughout 2006 based upon informal indications we have received from various customers and based upon recent increases in our backlog.

COMMUNICATIONS EQUIPMENT. The $2,560,000 increase in net sales of our communications equipment segment resulted primarily from the inclusion in our results for the nine months ended September 30, 2005 of $4,418,000 of net sales of network timing and synchronization products attributable to our acquisition of Larus Corporation that occurred on July 13, 2004 as compared to such sales of $1,468,000 for the period from July 13, 2004 to September 30, 2004. This increase was partially offset by a $543,000 (12.4%) decline in net sales of network access equipment and transmission products manufactured by CXR-AJ, which was primarily due to delays in French military communications infrastructure programs that utilize our products. Communications test equipment net sales increased $257,000 (14.6%) to $2,012,000 for the nine months ended September 30, 2005 as compared to $1,755,000 for the prior year period, primarily due to increased sales to an agency of the Homeland Defense Department. We anticipate that sales of our communications test equipment will continue to improve throughout the remainder of 2005. We also anticipate that sales of our network access products both in France and more importantly in the United States will grow as new sales channels and our stronger marketing presence becomes effective and we work to utilize our two new United States-based distributors we established relationships with during the 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 carrier companies.

GROSS PROFIT. Gross profit as a percentage of total net sales decreased to 42.0% from 44.2% for the prior year period. In dollar terms, gross profit increased by $3,065,000 (34.5%) to $11,941,000 for the nine months ended September 30, 2005 as compared to $8,876,000 for the prior year period.

ELECTRONIC COMPONENTS. The $1,960,000 (40.0%) increase in gross profit for our electronic components segment was primarily due to the inclusion in our results for the nine months ended September 30, 2005 of $2,136,000 of gross profit from Pascall and $633,000 of gross profit from RO. Partially offsetting these increases was a $535,000 reduction in gross profit from switches primarily due to product mix and reduced sales volume and a $340,000 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 delays. 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 and increased backlog. EEL Japan Ltd. increased its gross profit by $160,000 (40.2%) to $558,000 from $398,000 in the prior year due to increased sales of higher margin switches.

COMMUNICATIONS EQUIPMENT. The $1,105,000 (27.7%) increase in gross profit for our communications equipment segment was primarily due to the inclusion of CXR Larus' $1,866,000 of gross profit during the nine months ended September 30, 2005 attributable to net sales of network access and network timing and synchronization products as compared to $595,000 in the period from July 13, 2004 to September 30, 2004. Gross profit for test instruments virtually remained unchanged at $1,253,000.

The 1.0 percentage point decrease in this segment's gross profit as a percentage of total net sales was primarily the result of the larger sales 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. We plan to have our timing and other network access products

built for us under a signed contract with Hitachi OMD and thereby increase gross margins over our in-house manufacturing.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. The $2,821,000 (41.8%) increase in selling, general and administrative expenses for the nine months September 30, 2005 as compared to the nine months ended September 30, 2004 was primarily due to:

- a $284,000 (78.2%) increase in sales commissions primarily due to the inclusion of $126,000, $119,000 and $42,000 of sales commission expenses of CXR Larus, Pascall and RO, respectively;

- a $1,340,000 (62.8%) increase in other selling and marketing expenses primarily due to an increase of $737,000 and inclusion of $664,000 of selling expenses of our Larus division and Pascall, respectively, attendance at tradeshows and increased advertising and marketing of our electronic components;

- a $1,198,000 (28.2%) increase in administrative expenses primarily due to the inclusion of $376,000 and $472,000 of administrative costs for our Larus division and Pascall, respectively;

- $74,000 in severance costs we recorded to administrative expense to reflect a consolidation of CXR Larus' operations;

- 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

- an increase of $149,000 in United States corporate legal expenses and a $168,000 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, Pascall and RO acquisitions, increased investments in new products, sales and marketing expenses for our new low profile rotary and digital switches, increased activity in searching for and analyzing potential acquisitions, expansion of our investor relations program and increased corporate governance activities in response to the Sarbanes-Oxley Act of 2002 and rules and regulations of the Securities and Exchange Commission. However we continue to seek efficiencies 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. Our selling, general and administrative expenses remained almost constant as a percentage of net sales at 33.7% as compared to 33.6% in the prior period.

ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES. Engineering and product development expenses consist primarily of new product development engineering activities. The $703,000 (68.1%) increase in these expenses resulted primarily from the inclusion of $381,000 of expenses attributable to our Larus division

and a $194,000 increase in engineering expenses attributable to Pascall. Also, expenses related to development of our new low profile rotary switches increased $70,000 (19.9%) to $422,000 for the nine months ended September 30, 2005 as compared to $352,000 for the prior year period. We expect this higher level of expense to continue throughout the remainder of 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 nine months ended September 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.

INTEREST EXPENSE AND OTHER INCOME. Interest expense decreased slightly by $3,000 (1.0%) to $302,000 for the nine months ended September 30, 2005 as compared to $305,000 for the nine months ended September 30, 2004. In addition, we recorded $136,000 of interest income in the nine months ended September 30, 2005, which was earned on the proceeds of the January 2005 private placement. We did not have interest income during the nine months ended September 30, 2004. Other income of $21,000 for the nine months ended September 30, 2005 primarily resulted from a $100,000 gain due to the sale of our T-Com product line. The T-Com technology and tangible assets had no carrying value.

INCOME TAX EXPENSE. Income tax expense for the nine months ended September 30, 2005 was $3,000, compared to $128,000 for the nine months ended September 30, 2004 due to lower pretax income. We relieved our tax asset valuation allowance by $245,000, which was offset by our foreign tax provision of $248,000.

NET INCOME (LOSS). Net income for the nine months ended September 30, 2005 decreased by $110,000 to $487,000 as compared to $597,000 for the nine months ended September 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 CXR Larus 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 indicated above.

LIQUIDITY AND CAPITAL RESOURCES

During the nine months ended September 30, 2005, 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 nine months ended September 30, 2005, we continued to rely on our foreign credit facilities. In addition, we raised approximately $16,018,000 in net proceeds through a private placement of equity securities in January 2005 as described below to support our acquisition program. As of September 30, 2005, we had working capital of $12,671,000, which represented a $7,131,000 (128.7%) 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 and RO. At September 30, 2005 and December 31, 2004, we had accumulated deficits of $15,919,000 and $16,406,000, respectively, and cash and cash equivalents of $3,398,000 and $1,057,000, respectively.

Accounts receivable increased $3,186,000 (55.0%) during the nine months ended September 30, 2005 from $5,796,000 as of December 31, 2004 to $9,297,000 as of September 30, 2005. Sales attributable to the Pascall and RO acquisitions contributed $2,303,000 and $793,000, respectively, to accounts receivable at September 30, 2005. Without the acquisition of Pascall, our receivables would have increased by $90,000 (1.6%) during the nine months ended September 30, 2005, primarily due to increased receivables from higher test instrument sales. 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 64 days for the nine months ended September 30, 2005. Our customers include many Fortune 100 companies in the United States and similarly large companies in Europe and Asia. Because of the financial strength of our customer base, we have virtually eliminated our bad debt reserves.

Inventory balances increased $3,790,000 (58.4%) during the nine months ended September 30, 2005, from $6,491,000 at December 31, 2004 to $10,281,000 at September 30, 2005. Inventory represented 23.4% and 25.9% of our total assets as of September 30, 2005 and December 31, 2004, respectively. Included in the September 30, 2005 amount is $2,015,000 and $2,221,000 of inventory attributable to Pascall and RO, respectively. Excluding the effect of this inclusion, inventory would have decreased by $446,000 (6.9%) and would have represented 19.6% of total assets (excluding the $6,929,000 and $6,250,000 000 of total assets related to Pascall and RO, respectively) at September 30, 2005. Inventory turnover, which is a ratio that indicates how many times our inventory is sold and replaced over a specified period, decreased to 2.14 times (excluding Pascall and RO, turnover would have increased to 2.44 times) for the nine months ended September 30, 2005 as compared to 2.48 times for the year ended December 31, 2004.

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, which was negatively impacted by the telecommunications downturn of 2002 and 2003. We also have contracted with offshore manufacturers for production of test equipment at lower prices than our previous cost for in-house manufacturing. We have also contracted with Hitachi to outsource the manufacture of our network timing devices beginning approximately in the second quarter of 2006. We merged Larus Corporation with and into CXR Telcom Corporation at the end of 2004 and integrated their operations.

Cash used in our operating activities totaled $1,158,000 for the nine months ended September 30, 2005 as compared to cash provided by operating activities of $1,579,000 for the nine months ended September 30, 2004. This $2,737,000 decrease in operating cash flows primarily resulted from payments made as planned reductions of accounts payable and accrued expenses.

Cash used in our investing activities totaled $14,381,000 for the nine months ended September 30, 2005 as compared to $1,923,000 for the nine months ended September 30, 2004. Included in the results for the nine months ended September 30, 2005 are net cash of $9,509,000 and $4,605,000 used to acquire Pascall and RO, respectively. Also we acquired $212,000 of property, plant and equipment purchases for production equipment and computer equipment.

Cash provided by our financing activities totaled $18,544,000 for the nine months ended September 30, 2005 as compared to $373,000 of cash used in our financing activities for the nine months ended September 30, 2004. The change is primarily due to the net proceeds of $16,059,000 from the issuance of common stock in the January 2005 private placement.

On September 1, 2005, we obtained a credit facility from Wells Fargo Bank, N.A. for our domestic operations which replaced the prior credit facility entered into on June 1, 2004 with Wells Fargo Bank, N.A. The new credit facility has no prepayment penalty and is subject to an unused commitment fee equal to 0.25% per annum, payable quarterly based on the average daily unused amount of the line of credit described in the following paragraph.

The credit facility provides a $9,000,000 revolving line of credit secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment. Borrowings do not need to be supported by specific receivables or inventory balances unless aggregate borrowings under the line of credit 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 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 September 30, 2005 was 6.75%.

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 $88,000 at September 30, 2005.

Wells Fargo Bank, N.A. has also provided us with credit for the purchase of new capital equipment when needed, of which a balance of $130,000 was outstanding at September 30, 2005. The interest rate is equal to the 90-day London InterBank Offered Rate ("LIBOR") rate (4.055% at September 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 September 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. As of September 30, 2005, we were in compliance with each of those covenants except for the tangible net worth covenant, as to which we received a waiver The bank has informally indicated it intends to modify the tangible net worth covenant. The credit facility is subject to various financial covenants. The minimum debt service coverage ratio of the Company must be not less than 1.25:1.00 on a rolling four-quarter basis. "Debt service coverage ratio" is defined as net profit after taxes plus depreciation, plus or minus net distributions divided by the sum of the current portion of long term debt plus capitalized lease payments. The current ration of the Company 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 profit after taxes as of the Company must be not less than $500,000, determined as of each fiscal quarter end on a rolling four quarter basis; provided that we may not sustain net loss after tax in any two consecutive fiscal quarters. Total liabilities divided by tangible net worth of the Company must not at any time be greater than 1.25:1.00, determined as for each fiscal quarter end. Tangible net worth of the Company must not at any time be less than $14,250,000 measured at the end of each quarter. "Total liabilities" is defined as current liabilities plus no-current liabilities, minus subordinated debt. "Tangible net worth" is defined as stockholders' equity plus subordinated debt, minus intangible assets.

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

The credit facility will expire on September 1, 2006.

As of September 30, 2005, our foreign subsidiaries had credit facilities, including lines of credit and term loans, with Lloyds TSB Bank and Lloyds TSB Commercial Finance, 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 September 30, 2005, the balances outstanding under our United Kingdom, France and Japan credit facilities were $3,781,000, $653,000 and $39,000, respectively.

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On June 28, 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. $3,701,000 based on the exchange rate in effect on September 30, 2005). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB rate. The Lloyds TSB rate was 4.5% at September 30, 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, on August 26, 2005 Lloyds also provided an unsecured cashflow loan of $1,410,000 and a $264,000 term loan that is secured by equipment and amortized over 36 months.

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

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 $1,445,000, based on the exchange rate in effect at September 30, 2005 for the conversion of euros into United States dollars. CSR-AJ also had $39,000 of term loans with several French banks outstanding at 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 August 31, 2005, the French T4M rate was 2.067% and this facility had a balance of $616,000. This facility has no financial performance covenants. In addition, CXR-AJ has term loans with other banks with a balance of $37,000 as of September 320, 2005.

EEL 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 September 30, 2005 was $39,000 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.

Our backlog was $25,098,000 as of September 30, 2005 as compared to $7,307,000 as of September 30, 2004. The increase in backlog was primarily due to the addition of $8,840,000 of backlog for Pascall and $613,000 for RO. Without Pascall and RO, our backlog as of September 30, 2005 would have been $15.6 million, representing a $10.7 million (139%) increase. Our backlog as of September 30, 2005 was 96.3% related to our electronic components business, which business tends to provide us with long lead-times for our manufacturing processes due to the custom nature of the products, and 3.7% 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 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 $1,026,000 through September 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 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 Emrise Electronics 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 accordingly we paid $237,000 to Intelek on August 1, 2005 to compensate for an upward adjustment of Pascall's net worth. We have guaranteed obligations of Emrise Electronics 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.

We used another portion of the proceeds from the January 2005 private placement to partially fund the acquisition of RO described above under the heading "Overview." We used $4,002,000 of cash to acquire RO including paying down RO's bank debt of $1,602,000. In addition, we agreed to make two deferred payments of $300,000 each, the first of which we paid in October 2005, and the second of which is due in March 2006. Offsetting these amounts was $35,000 received from the former RO shareholders to compensate for balance sheet adjustments.

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.

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 of our common 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.

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.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which is a revision of SFAS No. 123. SFAS No. 123(R) supersedes APB Opinion No. 25, and amends SFAS No. 95, "Statement of Cash Flows." Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) generally requires share-based payments to employees, including grants of employee stock options and purchases under employee stock purchase plans, to be recognized in the statement of operations based on their fair values. Pro forma disclosure of fair value recognition will no longer be an alternative. SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods:

- o Modified prospective method: Compensation cost is recognized beginning with the effective date of adoption (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted after the effective date of adoption and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of adoption that remain unvested on the date of adoption.

- o Modified retrospective method: Includes the requirements of the modified prospective method described above, but also permits restatement using amounts previously disclosed under the pro forma provisions of SFAS No. 123 either for (a) all prior periods presented or (b) prior interim periods of the year of adoption.

On April 14, 2005, the Commission announced that the SFAS No. 123(R) effective transition date will be extended to annual periods beginning after June 15, 2005. We are required to adopt this new standard on June 1, 2006, with early adoption permitted.

SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under current accounting rules. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Total cash flow will remain unchanged from what would have been reported under prior accounting rules.

As permitted by SFAS No. 123, we currently account for share-based payments to employees using APB Opinion No. 25's intrinsic value method. As a consequence, we generally recognize no compensation cost for employee stock options under our employee stock option plans. Although the adoption of SFAS No. 123(R)'s fair value method will have no adverse effect on our balance sheet or total cash flows, it will affect our net income and diluted earnings per share. The actual effects of adopting SFAS No. 123(R) will depend on numerous factors, including the amounts of share-based payments granted in the future, the valuation model we use to value future share-based payments to employees and estimated forfeiture rates. See Note 1 to our condensed consolidated financial statements for the effect on reported net income and earnings per share that would have occurred if we had accounted for our employee stock options using the fair value recognition provisions of SFAS No. 123.

On December 16, 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions." SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 is effective for nonmonetary asset exchanges beginning in our second quarter of fiscal 2006. We do not believe our adoption of SFAS No. 153 will have a material effect on our consolidated financial position, results of operations or cash flows.

On June 7, 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. However, SFAS No. 154 does not change the transition provisions of any existing accounting pronouncements. We do not believe our adoption of SFAS No. 154 will have a material effect on our consolidated financial position, results of operations or cash flows.

On June 29, 2005, the FASB ratified the EITF's Issue No. 05-06, "Determining the Amortization Period for Leasehold Improvements." Issue No. 05-06 provides that the amortization period used for leasehold improvements acquired in a business combination or purchased after the inception of a lease shall be the shorter of (a) the useful life of the assets or (b) a term that includes required lease periods and renewals that are reasonably assured upon the acquisition or the purchase. The provisions of Issue No. 05-06 are effective on a prospective basis for leasehold improvements purchased or acquired beginning in our second quarter of fiscal 2006. We do not believe the adoption of Issue No. 05-06 will have a material effect on our consolidated financial

position, results of operations or cash flows.

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 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 acquisition of Pascall located in England.

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 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 Ltd. also has a program that utilizes a forward currency contract denominated in British pounds sterling to offset the risk of intercompany loans to an English subsidiary. Under this program, increases or decreases in the current portion of intercompany debt due to Emrise Electronics

Ltd. are offset by gains or losses on the forward contract, to mitigate the possibility of foreign currency transaction gains or losses. The forward contract expired in September 2005. We do not use this forward contract for trading purposes. The forward contract used in this program was 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 $115,000 for the nine months ended September 30, 2005. There was no hedging in the year ended December 31, 2004.

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 nine months ended September 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 considered 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 modify the items and returned the items to Pascall on July 7, 2005 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). Grant Thornton LLP met with our audit committee on August 18, 2005 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 have sought and plan to continue to seek 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 and believe we have therefore corrected the material weakness.

As of September 30, 2005 the products included in the bill and hold matter were no longer at our facility as they had all been processed and shipped back to the customer. Therefore, we recognized in the third quarter the revenue and income we had deferred during the second quarter.

Our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of September 30, 2005, 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")) are effective to ensure that information required to be disclosed by us

in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, including to ensure that Information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding whether or not disclosure is required.

During the quarter ended September 30, 2005, except as described above with regard to our review of SAB 104, 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.

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.

None.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

Exhibit
Number Description

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2.1	Stock Purchase Agreement dated September 2, 2005 between Emrise Electronics Corporation, a New Jersey corporation, Robert H. Okada, as Trustee of the Robert H. Okada Trust Agreement dated February 11, 1992, and Sharon Vavro, an individual (1)
2.2	Amendment No. 1 dated effective as of September 28, 2005 to Stock Purchase Agreement dated September 2, 2005 between Emrise Electronics Corporation, a New Jersey corporation, Robert H. Okada, as Trustee of the Robert H. Okada Trust Agreement dated February 11, 1992, and Sharon Vavro, an individual (2)
10.1	Credit Agreement between Emrise Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (3)
10.2	Revolving Line of Credit Note between Emrise Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (3)
10.3	Security Agreement between Emrise Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (3)
10.4	Continuing Security Agreement between Emrise Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (3)
10.5	Continuing Guaranty between CXR Telcom Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (3)
10.6	Continuing Guaranty between Emrise Electronics Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (3)
10.7	Agreement and Acknowledgment of Security Interest by and among Wells Fargo Bank, National Association, Emrise Corporation and Noel C. McDermott and Warren P. Yost dated as of August 25, 2005 (3)
10.8	Debt Purchase Agreement between Lloyds TSB Commercial Finance Limited and Pascall Electronics Limited dated June 28, 2005(3)
10.9	Debt Purchase Agreement between Lloyds TSB Commercial Finance Limited and XCEL Power Systems Limited dated June 28, 2005 (3)
10.10	Loan Agreement between Lloyds TSB Commercial Finance Limited and XCEL Power Systems Limited dated June 28, 2005 (3)
10.11	Business Loan Agreement between Lloyds TSB Bank PLC and XCEL Corporation Limited dated June 30, 2005 (3)
10.12	Guaranty and Indemnity between XCEL Power Systems Limited, Pascall Electronics Limited, Pascall Electronic (Holdings) Limited, Belix Wound Components Limited and Lloyds TSB Commercial Finance Limited dated June 21, 2005 (3)

Exhibit Number	Description
10.13	Deed of Guaranty and Indemnity between XCEL Corporation Limited and Lloyds TSB Commercial Finance Limited dated June 21, 2005 (3)
10.14	Deed of Guarantee and Indemnity between Pascall Electronics Limited and Lloyds TSB Commercial Finance Limited dated June 21, 2005
10.15	Deed of Guarantee and Indemnity between XCEL Corporation Limited and Lloyds TSB Commercial Finance Limited dated June 21, 2005
10.16	Deed of Priorities between Lloyds TSB Commercial Finance Limited and Lloyds TSB Bank PLC and Pascall Electronics Limited dated June 28, 2005
10.17	Deed of Priorities between Lloyds TSB Commercial Finance Limited and Lloyds TSB Bank PLC and XCEL Power Systems Limited dated June 28, 2005 (3)
10.18	All Assets Debenture given by XCEL Power Systems Limited in favor of Lloyds TSB Commercial Finance Limited dated June 28, 2005 (3)
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 (3)
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 (3)

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(1) Filed as an exhibit to our Form 8-K for September 2, 2005 and incorporated herein by reference.

(2) Filed as an exhibit to Amendment No. 1 to the our current report on Form 8-K for September 2, 2005 and incorporated herein by reference.

(3) Filed with this report.

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: November 14, 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)

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EXHIBITS ATTACHED TO THIS REPORT

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