Emrise CORP
Form 10-K/A
December 15, 2006

==

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

AMENDMENT NO. 1
TO
FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTIONS 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended DECEMBER 31, 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)

Registrant's telephone number, including area code: (909) 987-9220

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
COMMON STOCK, $0.0033 PAR VALUE	NYSE ARCA

Securities registered pursuant to Section 12(g) of the Act:
NONE
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the

registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [ ] No [X]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). 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]

The aggregate market value of the voting common equity held by nonaffiliates of the registrant, computed by reference to the $1.03 closing sale price of such stock on June 30, 2006, the last business day the registrant's most recently completed second fiscal quarter, was approximately $37,981,000. The registrant has no non-voting common equity.

The number of shares of the registrant's common stock, $0.0033 par value, outstanding as of December 14, 2006 was 38,081,750.

DOCUMENTS INCORPORATED BY REFERENCE: None.

TABLE OF CONTENTS

PART I

Item 1. Business....

Item 1A. Risk Factors....

Item 1B. Unresolved Staff Comments....

Item 2. Properties....

Item 3. Legal Proceedings....

Item 4. Submission of Matters to a Vote of Security Holders....

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase Securities....

Item 6. Selected Financial Data....

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk....

Item 8. Financial Statements and Supplementary Data....

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure..

Item 9A. Controls and Procedures....................

Item 9B. Other Information....................

PART III

Item 10. Directors and Executive Officers of the Registrant....................

Item 11. Executive Compensation....................

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder

Item 13. Certain Relationships and Related Transactions....................

Item 14. Principal Accountant Fees and Services....................

PART IV

Item 15. Exhibits and Financial Statement Schedules....................

Index to Financial Statements and Financial Statement Schedule....................

Signatures ....

Exhibits Attached to This Report....................

PART I

ITEM 1. BUSINESS.

OVERVIEW

We are a leading supplier of timing and synchronization systems, rotary and digital switches, electronic power supplies and radio frequency, or RF, devices. We sell our products to communications service providers, defense and aerospace contractors and industrial customers. We are a multinational company operating out of facilities located in the United States, United Kingdom, France and Japan. As of November 30, 2006, we had approximately 300 employees.

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

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

In March 2005, EMRISE Electronics Ltd. ("EEL"), a United Kingdom-based subsidiary of EMRISE Electronics, acquired Pascall Electronic (Holdings) Limited

("PEHL") and its wholly-owned subsidiary, Pascall Electronics Limited ("Pascall"). Pascall is based in the United Kingdom and manufactures a range of custom proprietary power systems and radio frequency ("RF") devices.

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

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

- Electronic Components
  - digital and rotary switches
  - electronic power supplies
  - RF and microwave devices
- Communications Equipment
  - network access and transmission products
  - communication timing and synchronization products
  - communications test instruments

Our sales are primarily in North America, Europe and Asia. Sales to customers in the electronic components segment, primarily to defense and aerospace customers, defense contractors and industrial customers were approximately 62.6%, 51.1%, and 63.4% of our total net sales during 2005, 2004 and 2003, respectively. Sales of communications equipment and related services, primarily to private customer premises and public carrier customers, were approximately 37.4%, 48.9% and 36.6% of our total net sales during 2005, 2004 and 2003, respectively.

Our objective in our electronic components business is to become the supplier of choice for harsh environment, high reliability digital and rotary switches, custom and standard power supplies and RF and microwave products and subsystems. Our objective in our communications equipment business is to become a leader in quality, cost effective solutions to meet the requirements of communications equipment customers. We believe that we can achieve these objectives through customer-oriented product development, superior product solutions, and excellence in local market service and support.

INDUSTRY OVERVIEW

ELECTRONIC COMPONENTS

The electronic components industry comprises three basic segments, which are active components, passive components and electromechanical components. We compete in the active and electromechanical segments of this industry. These segments can be further segmented by industry into telecommunications, aerospace, defense, commercial, industrial and other

environments, each of which places constraints that define performance and permitted use of differing grades of components.

We are active only in the industry segments that are characterized by harsh environment, high reliability, low volume, high margin and long lead-times, namely the aerospace, defense and industrial segments. To support the myriad customers that rely on digital and rotary switches and electronic power supplies and RF devices, we believe that our electronic components must offer high levels of reliability and in many cases must be tailored to the size, appearance, functionality and pricing needs of each particular customer.

The defense market, which is a predominant market for our electronic components, makes use of sophisticated electronic assemblies in diverse applications that involve both original equipment and retrofit of existing equipment.

The Digitran division of EMRISE Electronics ("Digitran"), which EMRISE Electronics acquired from Becton Dickinson in 1985, has been manufacturing digital switches since the 1960s. XCEL Power Systems, Ltd. ("XPS"), a second-tier subsidiary of EMRISE Electronics, has been manufacturing electronic power supplies since 1989. Pascall was formed in 1977.

COMMUNICATIONS EQUIPMENT

Over the past decade, telecommunications and data communications infrastructures have undergone significant growth and have become a critical part of the global business and economic infrastructure that has been driven by the following:

- a surge in demand for broadband access used to conduct e-commerce activities and transmit growing volumes of data, voice and video information;

- the adoption of Internet protocol, or IP, which is a protocol developed to enable the transmission of information as packets of data from a source to a recipient using dynamically changing routes, with the data being reassembled at the recipient's location into the original information format; and

- an apparent worldwide trend toward deregulation of the communications industry, which has enabled a large number of new communications service providers to enter the market.

This rapid growth has been succeeded by a period of consolidation. Private and corporate communications providers and other businesses that rely heavily on information technology continue to devote significant resources to the purchase of network access and transmission equipment, such as high-speed DSL and fiber optic modems, through which data and voice information may be transmitted.

To support the rapidly changing needs of telecommunications companies and information technology dependent businesses, we believe that network access and transmission products and communications test instruments must offer high levels of functional integration, automation and flexibility to operate across a variety of network protocols, technologies and architectures. Because the competition for subscribers for high-speed bandwidth access is intense, the

quality and reliability of network service has become critical to telecommunications companies due to the expense, loss of customers and negative publicity resulting from poor service. Quality and reliability of network service are also important to information technology dependent businesses that rely on broadband high-speed data links for a variety of purposes.

Technicians who use service verification test equipment in the field or in central or branch offices assist businesses in verifying and repairing service problems effectively and, thus, increase the quality and reliability of their networks. We believe that as broadband services are deployed further and as competition for telecommunications subscribers and e-commerce customers proliferates, telecommunications companies and other information technology-reliant businesses will increasingly depend on new and improved integrated access transmission devices and advanced field and central or branch office testing and monitoring solutions.

OUR SOLUTION

We have developed a range of electronic components, including digital and rotary switches, custom and standard electronic power supplies and RF devices, used primarily by aerospace, defense and industrial customers.

We have developed and we manufacture and market various network access and transmission devices used by businesses and other users to efficiently transmit data, voice and video information to destinations within and outside of their respective networks.

We have developed and we manufacture and market a select range of test instruments used by operators of telecommunications networks for the installation, maintenance and optimization of communications networks.

We have developed and we manufacture and market a range of communication timing and synchronization products used by operators of public and private telecommunications networks to provide a consistent source of timing alignment, or synchronization, for digital networks.

Our extensive knowledge and understanding of our customers' needs, together with the broad capabilities of our network access and transmission products, test instrumentation products and our sophisticated electronic components, enable us to provide the following features and benefits to our customers:

DEVELOPMENT OF NEW SWITCH TECHNOLOGY. We have complemented our long-established range of digital switch products with a new range of space-saving rotary switches we refer to as VLP(R), which are very low profile switches. These products have been specifically designed to target harsh environment and aerospace applications where space is at a premium, providing a substantial advantage over larger, heavier switches offered by our competitors. We have secured one patent and a number of other patents are pending relating to this technology.

PROVISION OF RF DEVICES. We have developed and provide a range of RF devices that meet the requirements of defense, aerospace and industrial applications.

DEVELOPMENT AND PROVISION OF COMMUNICATION TIMING AND SYNCHRONIZATION

EQUIPMENT. We have extended the existing range of communication timing and synchronization products with a new range of equipment designed specifically to target the telephone company market in addition to private networks.

PROVISION OF MORE EFFICIENT AND COST-EFFECTIVE POWER SYSTEMS. We have developed and we provide custom and standard high and low voltage power systems that are highly integrated within the application hardware, which minimizes cost, space and complexity and maximizes overall system reliability and efficiency. We believe that our ability to partner with major international defense contractors and to provide power systems solutions based on both standard modules and custom designs provides us with an important competitive advantage.

BROAD RANGE OF NETWORK ACCESS AND TRANSMISSION PRODUCTS FOR A WIDE RANGE OF APPLICATIONS. We have developed a broad range of professional grade network access and transmission products capable of connecting to a wide range of remote monitoring devices and equipment. Many of these products are designed to operate in extended temperatures and harsh environments and meet specific requirements such as data speeds, data interfaces, power inputs, operating temperatures, data formats and power consumption. In addition, our desktop and rack mount transmission product lines allow us to serve both central site data communications needs and remote access and transmission sites on both the enterprise-wide and single location level.

COMPREHENSIVE CONNECTIVITY. Our network access and transmission products and communications test instruments are the result of significant product research and engineering and are designed to connect to a broad range of operation configurations and to connect over a wide range of prevailing transmission conditions. Our products incorporate a wide range of standard international connectivity protocols as well as proprietary protocols.

CUSTOMER-DRIVEN FEATURES. Most of our digital and rotary switches and each of our power supplies are highly tailored to our customers' needs. We manufacture digital and rotary switches for insertion into new equipment as well as for retrofit into existing equipment. Our engineers continually interact with our customers during the design process to ensure that our electronic components are the best available solution for them. For example, based on specifications from our customers, we delivered a compact multiple output power supply to allow BAE Systems to produce a single-heads up display suitable for fitting on a large range of commercial and military aircraft.

HANDHELD DESIGN OF FIELD TEST EQUIPMENT. The compact, lightweight design of these products enables field technicians to access problems and verify line operation quickly.

CUSTOMER RELATIONS. Our electronic components business currently enjoys a preferred supplier status with many key accounts, which means that we work in close association with the customer to develop custom products specifically addressing their needs. Our electronic components also are considered qualified products with many key accounts, which mean that our products are designed into equipment specifications of many of our customers for the duration of their production of their equipment.

LONG-TERM RELATIONSHIPS. Market procurement methods encourage long-term relationships between electronic components suppliers and customers, with customers committing to a single source of supply because of the high cost

involved in qualifying a product or its alternative for use. For example, a large proportion of XPS' and Digitran's products are qualified products that have been involved in many hours of flight trials.

OUR STRATEGY

Our objectives are to become the supplier of choice for harsh environment switches, RF devices and custom and standard power supplies in the aerospace, defense and industrial markets, in addition to being a leading provider of network access and transmission products and timing and synchronization systems for a broad range of applications within the global communications industry. The following are the key elements of our strategy to achieve these objectives:

FOCUS ON OUR ELECTRONIC COMPONENTS BUSINESS. We plan to continue to grow our electronic components business by marketing our electronic devices in their established market niches and identifying opportunities to broaden our customer base.

EXPAND OUR COMMUNICATION TIMING AND SYNCHRONIZATION PRODUCTS AND CONTINUE TO FOCUS ON NETWORK ACCESS AND TRANSMISSION PRODUCTS. We plan to build upon our existing strong base businesses in the communications equipment market introducing additional new products, especially new communication timing and synchronization products, utilizing our broader reach with CXR Larus to address new markets.

CONTINUE TO INVEST IN RESEARCH AND DEVELOPMENT TO ADDRESS HIGH GROWTH MARKET OPPORTUNITIES. We plan to continue investing in markets and technologies that we believe offer substantial growth prospects. We believe that the expertise we have developed in creating our existing products will permit us to enhance these products, develop new products and respond to emerging technologies in a cost-effective and timely manner.

LEVERAGE EXISTING CUSTOMER BASE. We believe that many of our existing customers will continue to purchase network access and transmission products, communication timing and synchronization products and test instrument products and services. We intend to aggressively market new and enhanced products and services to our existing customers. We also believe that our existing customer base represents an important source of references and referrals for new customers in new markets.

PURSUE FOLLOW-ON SALES OPPORTUNITIES. We plan to continue to increase the functionality of our communications equipment products, enabling products to be upgraded by the downloading of software or the addition of hardware to an existing unit, allowing customers to protect their investment in their already deployed equipment and generating follow-on sales opportunities as we develop new capabilities in the future. We plan to continue to approach our existing digital switch customers to determine whether they need our proprietary and patented rotary switches that we do not currently manufacture for them.

SEEK COMPETITIVE WORLD-CLASS MANUFACTURING FOR SELECTED PRODUCTS. Toward the end of 2002, we cut costs by using Asian manufacturing sources for selected communications equipment products and subassemblies. We have now located a Tier 1 manufacturer in the U.S. whose cost structure is more competitive than the Asian manufacturing source.

SEEK ALTERNATIVE MARKET OPPORTUNITIES. We plan to expand our focus and efforts to identify and capture more new customers, such as private network utilities and transit customers, for our network access and transmission products.

DEVELOP AND ExPAND STRATEGIC RELATIONSHIPS. We plan to continue to develop our strategic relationships with network access and transmission manufacturers in order to enhance our product development activities and leverage shared technologies and marketing efforts to build recognition of our brands. In particular, in Europe, we intend to continue to expand our relationships with offshore vendors as a reseller of their products to enhance our position and reputation.

PURSUE TECHNOLOGY TRANSFER AND LICENSING. We plan to continue our established practice of purchasing or licensing core technologies where this reduces time and cost to market.

DEVELOP CUSTOMER-FOCUSED SOLUTIONS. We design, develop, and manufacture many products and provide services that are tailored to the specific needs of our customers with an emphasis on ease of use. We intend to continue to adapt our core communications technologies to deliver focused products that improve our customers' ability to manage increasingly large and complex networks.

EXTEND OUR GLOBAL PRESENCE. Our customers' needs evolve through industry expansion and consolidation as well as with the deployment of new technologies and services. To support our customers more effectively, we intend to further augment our sales, marketing and customer support organizations.

PRODUCTS AND SERVICES

Our products and services currently are divided into the following two main business segments:

- Electronic Components
  - digital and rotary switches
  - electronic power supplies
  - RF and microwave devices
- Communications Equipment
  - network access and transmission products
  - communication timing and synchronization products
  - communications test instruments

During 2005, 2004 and 2003, our total net sales were approximately $41,270,000, $29,637,000 and $25,519,000, respectively, and the percentages of total net sales contributed by each product group within our two main business segments were as follows:

Segment and Product Type	Year Ended December 2005	2004
Electronic Components		
Digital and Rotary Switches	15.9%	18.6%
Electronic Power Supplies	34.1%	26.9%
RF Components	7.5%	--
Subsystem Assemblies	--	0.8%
Other Products and Services	4.7%	5.2%
	62.2%	51.5%
Communications Equipment		
Network Access and Transmission Products	21.4%	27.9%
Communication Timing and Synchronization Products	6.4%	4.4%
Communications Test Instruments	7.2%	12.8%
Other Products and Services	2.8%	3.4%
	37.8%	48.5%
Totals	100.0%	100.0%

BACKLOG

Our business is generally not seasonal, with the exception that purchases of our communications equipment by public telecommunications carriers tend to be lower than average during the first quarter of each year because capital equipment budgets typically are not approved until late in the first quarter. At December 31, 2005, our backlog of firm, unshipped orders was approximately $22,150,000. Our backlog was related approximately 97.4% to our electronic components business, which tends to provide us with long lead-times for our manufacturing processes due to the custom nature of the products, and approximately 2.6% to our communications equipment business, the majority of which portion relates to our network access and transmission and communications timing and synchronization and test equipment products. Of these backlog orders, we anticipate fulfilling approximately 70% of our electronic components orders and 100% of our communications equipment orders within the current fiscal year. However, we cannot assure you that we will be successful in fulfilling these orders in a timely manner or that we will ultimately recognize as revenue the amounts reflected as backlog.

WARRANTIES

Generally, our electronic components, network access and transmission products and communication timing and synchronization products carry a one-year limited parts and labor warranty and our communications test instruments and European network access and transmission products carry a two-year limited parts and labor warranty. Products returned under warranty typically are tested and repaired or replaced at our option. Historically, product returns have not had a material effect on our operations or financial condition. However, we cannot assure you that this will continue to be the case or that disputes over components or other materials or workmanship will not arise in the future.

OUR ELECTRONIC COMPONENTS BUSINESS

Our electronic components segment includes digital and rotary switches, electronic power supplies and RF devices. During the years ended December 31, 2005, 2004 and 2003, this segment accounted for approximately 62.2%, 51.5% and 63.4%, respectively, of our total net sales.

DIGITAL AND ROTARY SWITCHES

The Digitran division of EMRISE Electronics manufactures, assembles and sells digital and rotary switch products serving aerospace, defense and industrial applications. Digital and rotary switches are manually operated electromechanical devices used for routing electronic signals. Thumbwheel, push button, lever-actuated and rotary modules, together with assemblies comprised of multiple modules, are manufactured in many different model families. Digitran also offers a variety of custom keypads.

Our switches may be ordered with different combinations of a variety of features and options, including night vision compatibility, harsh environment sealing, RF shielding, various mounting methods, various electrical interfaces, various packaging and presentation to suit each application.

ELECTRONIC POWER SUPPLIES

XPS and Pascall, based in England, and RO based in the U.S., manufacture a range of high and low voltage, high specification, high reliability custom and standard power conversion products designed for hostile environments and supplied to an international customer base, predominantly in the military and commercial aerospace, military vehicle and telecommunications markets.

Power conversion units supplied by XPS and Pascall range from 10VA to 1.5 KVA power ratings, low voltage (1V) to high voltage (20KV+), and convert alternating current, or AC, to direct current, or DC, convert DC to AC and convert DC to AC. Units can be manufactured to satisfy input requirements determined by military, commercial aerospace, telecommunications or industrial businesses, and sophisticated built-in test equipment, or BITE, and control circuitry often is included. Operating environments for our units are diverse and range from fighter aircraft to roadside cabinets.

RF COMPONENTS

Pascall designs, develops, manufactures and markets a range of RF and microwave amplifiers, multiplexers, components, subsystems and systems for applications such as defense, aerospace, communications, air traffic control and radar.

OUR COMMUNICATIONS EQUIPMENT BUSINESS

Our communications equipment business comprises network access and transmission products, communication timing and synchronization products, and communications test equipment. During the years ended December 31, 2005, 2004 and 2003, the sale of communications equipment products and related services accounted for approximately 37.8%, 48.5% and 36.6%, respectively, of our total net sales. These products are configured in a variety of models designed to perform analog and digital measurements or to transmit data at speeds varying from low-speed voice grade transmission to high-speed broadband access.

NETWORK ACCESS AND TRANSMISSION PRODUCTS

CXR Larus and CXR-AJ design, develop, manufacture and market a broad range of network access and transmission products, including multiplexers, for fiber, copper and microwave infrastructure, which combine to provide users with

8

a complete solution for voice and data transmission. Typical applications include secure encryption for point-of-sale and videoconferencing extension of local area networks, the consolidation of voice or data sources into a single carrier, modular routers, interface converters and voice and data transmission.

COMMUNICATION TIMING AND SYNCHRONIZATION PRODUCTS

CXR Larus designs, develops, manufactures and markets a series of communication timing and synchronization products that provide a consistent source of timing alignment, or synchronization, for digital communication networks. When the principal network timing source is lost, a CXR Larus communication timing system can provide an alternative source of reference synchronization until the principal source can be restored. This is called operating in the "holdover" state. The various levels of accuracy in holdover mode are referred to as "stratum levels." Stratum 1 is the most precise, followed by Stratum 2, Stratum 3E, Stratum 3, and finally Stratum 4. Stratum 4 has no holdover mode and is the least precise. All CXR Larus communication timing products offer Stratum 3E stability, or better, and all are available with options that meet or exceed Stratum 1.

Our range of communication timing and synchronization products include the StarSyncs(TM) 5850, a GPS timing source, the StarSyncs(TM) 5800, an economical timing system designed for small installations and the StarClock(TM) 200, specifically designed for central office applications.

COMMUNICATIONS TEST INSTRUMENTS

CXR Larus manufactures the CXR HALCYON 700 series of products, which we believe provide performance and value in integrated installation, maintenance and testing of communications services. These test instruments are modular, rugged, lightweight, hand-held products used predominantly by telephone companies and private network operators to pre-qualify facilities for services, verify proper operation of newly installed services and diagnose problems. The unique modular nature of our CXR HALCYON 700 series test equipment provides an easy configuration and upgrade path for testing of the specific services offered by the various national and international service providers.

CUSTOMERS

ELECTRONIC COMPONENTS

We sell our electronic components primarily to original equipment manufacturers, or OEMs, in the electronics industry, including manufacturers of aerospace and defense systems and industrial instruments. During 2005, our top five electronic components customers in terms of revenues were Rockwell Collins, Inc., BAE Systems, Raytheon Systems, Advance Navigation and Positioning Corporation and Selex Airborne Systems. Sales to Rockwell Collins, Inc. represented approximately 10% of our total net sales during 2005. No other customer represented 10% or more of our total net sales for that period. Sales to BAE Systems companies represented 15% and 13% of total net sales in 2004 and 2003, respectively.

COMMUNICATIONS EQUIPMENT

We market our network access and transmission products, communication

timing and synchronization products and communications test instruments primarily to public, private and corporate telecommunications service providers and end users. Typically, communications service providers use a variety of network equipment and software to originate, transport and terminate communications sessions. Communications service providers rely on our products and services as elements of the communications infrastructure and to configure test and manage network elements and the traffic that runs across them. Also, our products help to ensure smooth operation of the network and increase the reliability of services to customers.

The major communications service providers to whom we market these products and services include telephone companies, inter-exchange carriers, incumbent local exchange carriers, competitive local exchange carriers, Internet service providers, integrated communications providers, cable service providers, international post, telephone and telegraph companies, banks, brokerage firms, government agencies and other service providers. During 2005, our top five communications test instruments, network access and transmission products and communication timing and synchronization products customers in terms of our net sales were Harris Corporation, Siemens, Thalis Avioniques, Power and Telephone and Hitron Technology. None of our communications equipment customers represented 10% or more of our revenues during 2005.

Because we currently derive some of our revenues from sales to telephone companies and other telecommunications service providers, we have experienced and will continue to experience for the foreseeable future an effect on our quarterly operating results due to the budgeting cycles of telephone companies. Telephone companies generally obtain approval for their annual budgets during the first quarter of each calendar year. If a telephone company's annual budget is not approved early in the calendar year or is insufficient to cover its desired purchases for the entire calendar year, we are unable to sell products to the telephone company during the period of the delay or shortfall.

SALES, MARKETING AND CUSTOMER SUPPORT

ELECTRONIC COMPONENTS

We market and sell our electronic components through Digitran, XPS, Pascall, and XCEL Japan, Ltd., a wholly-owned subsidiary of EMRISE Electronics based in Japan. In some European countries and the Pacific Rim, these products are sold through a combination of direct sales and through third-party distributors.

We sell our electronic components primarily to OEMs in the electronics industry, including manufacturers of aerospace and military systems and industrial instruments. Our efforts to market our electronic components generally are limited in scope since we rely on sales to a broad base of historical customers with whom we have long-term business dealings.

XCEL Japan, Ltd. resells Digitran's digital and rotary switches and keypad products and some third-party-sourced components primarily into Japan and also into other highly industrialized Asian countries. Marketing of our electronic components is primarily through referrals from our existing customers, with sales either direct or via a small number of selected independent sales representatives.

We rely on long-term orders and repeat business from our existing

customers. We also approach our existing customers and their competitors to discuss opportunities for us to provide them with subsystem assemblies that typically incorporate our own products. Each of our components businesses has an extensive installed base: Digitran's history spans over 40 years in the electronic components industry, XPS, 50 years and RO 40 years. Major OEMs have designed many of our switches, power supplies and RF devices into their established product specifications. These factors have frequently resulted in customers seeking us out to manufacture for them unique subsystem assemblies as well as special variations of our standard digital switches.

COMMUNICATIONS EQUIPMENT

Our sales and marketing staff consist primarily of engineers and technical professionals. Our staff undergo extensive training and ongoing professional development and education. We believe that the skill level of our sales and marketing staff has been instrumental in building long-standing customer relationships. In addition, our frequent dialogue with our customers provides us with valuable input on systems and features they desire in future products. We believe that our consultative sales approach and our product and market knowledge differentiate our sales forces from those of our competitors.

Our local sales forces are highly knowledgeable about their respective markets, customer operations and strategies and regulatory environments. In addition, the familiarity of members of our sales force with local languages and customs enables them to build close relationships with our customers.

We provide repair and training services to enable our customers to improve performance of their networks. We also offer on-line support services to supplement our on-site application engineering support. Customers can also access information regarding our products remotely through our domestic, European and Japanese technical assistance centers.

We sell many of our communications equipment products to large telecommunications service providers as well as through distributors, resellers and value added resellers. Telecommunications service providers generally commit significant resources to an evaluation of our and our competitors' products and require each vendor to expend substantial time, effort and money educating them about the value of the vendor's solutions. Consequently, sales to this type of customer generally require an extensive sales effort throughout the prospective customer's organization and final approval by an executive officer or other senior level employee. The result is lengthy sales and approval cycles, which make sales forecasting difficult. In addition, even after a large telecommunications service provider has approved our product for purchase, their future purchases are uncertain because while we generally enter into long-term supply agreements with those parties, these agreements do not require specific levels of purchases.

Delays associated with potential customers' internal approval and contracting procedures, procurement practices, testing and acceptance processes are common and may cause potential sales of our communications products and test equipment to be delayed or foregone. As a result of these and related factors, the sales cycle of new products for large customers typically ranges from six to twelve months or more. In addition to the latter case, we also have some distribution channels that generally are box stocking distributors with significant independent sales forces selling our products to final customers, integrators and other resellers on a regional and nationwide basis. We perform

product applications training for the distributor and reseller workforce and funnel many of the leads we generate to the distribution channels for their follow-up and closure.

COMPETITION

ELECTRONIC COMPONENTS

The market for our components is highly fragmented and composed of a diverse group of OEMs, including Power One, Interpoint/Grenson, Martek and Celab Ltd. for power supplies and Esterline (Janco), Greyhill, Inc., Omron Electronics, Transico Inc. and C&K Components Inc. for digital and rotary switches and Elisera, AML and American Microwave Corporation for RF and microwave devices. We believe that the principal competitive factors affecting our components business include:

- capability and quality of product offerings;
- status as qualified products; and
- compliance with government and industry standards.

We have made substantial investments in machinery and equipment in our digital and rotary switch and power supply operations. In addition, Digitran's long history in the electronic components industry and the fact that major OEMs have designed many of our digital switches into their product specifications have acted as barriers to entry for other potential competitors and aided us in establishing and maintaining both distribution channels and customers for our products by making us a sole source supplier for approximately 30% to 50% of the digital switches that we sell and have caused some customers to seek us out to manufacture for them unique as well as our standard digital and rotary switches.

Some of our competitors have greater sales, marketing, technological, research and financial resources than we do. Our competitors' advantage with regard to these resources may reduce our ability to obtain or maintain market share for our products in cases where our competitors are better able than we are to satisfy the above competitive factors.

COMMUNICATIONS EQUIPMENT

The markets for our communications equipment and services are fragmented and intensely competitive, both inside and outside the United States, and are subject to rapid technological change, evolving industry standards and regulatory developments. We believe that the principal competitive factors affecting our communications equipment business include:

- quality of product offerings;
- adaptability to evolving technologies and standards;
- ability to address and adapt to individual customer requirements;
- price and financing terms;
- strength of distribution channels;

- ease of installation, integration and use of products;
- system reliability and performance; and
- compliance with government and industry standards.

Our principal competitors for our communications equipment include Symmetricom and Oscilloquartz, for communication timing and synchronization products, RAD, Zhone/Paradyne and Patton Electronics Corporation, for network access and transmission products, and TTC Corporation (a subsidiary of JDS Uniphase), Ameritec Corporation, Fluke, Sunrise Telecom, Inc. and Electrodata, Inc., for communications test instruments.

The design of many of our data transmission products enables us to offer numerous product combinations to our customers and to serve both central site data communications needs and remote access and transmission sites on both the enterprise-wide and single location level. We believe that this design flexibility helps us to excel at many of the above competitive factors by enabling us to offer quality products that meet and are adaptable to evolving customer requirements, technologies and government and industry standards.

We currently derive a significant portion of our revenues from sales to telephone companies. We believe we derive a competitive advantage from efforts we expended to establish many of our communications equipment products as customer-approved products for telephone companies and for other key customers in the United States and abroad. Our products' approved status facilitates the ability of our customers to order additional products from us as their needs arise without the long delays that might otherwise be needed to obtain the approval of our customers' upper management or governing body prior to each purchase.

Some of our competitors have greater sales, marketing, technological, research and financial resources than we do. Our competitors' advantage with regard to these resources may reduce our ability to obtain or maintain market share for our products in cases where our competitors are better able than we are to satisfy the above competitive factors.

MANUFACTURING, ASSEMBLY AND QUALITY ASSURANCE

Our network access and transmission products, communication timing and synchronization products and communications test instruments generally are assembled from outsourced subassemblies, with final assembly, configuration and quality testing performed in house.

Manufacturing of our electronic components, including injection molding, fabrication, machining, printed circuit board manufacturing and assembly, and quality testing is done in house due to the specialized nature and small and varied batch sizes involved. Although many of our electronic devices incorporate standard designs and specifications, products are nevertheless built to customer order. This approach, which avoids the need to maintain a finished goods inventory, is possible because long lead-times for delivery often are available. Typically, our electronic components segment produces products in one- to 300-piece batches, with a ten- to thirty-week lead-time. The lead-time is predominantly to source sub-component piece parts such as electronic components, mechanical components and services. Typical build time is six to

eight weeks from receipt of external components.

We operate seven manufacturing and assembly facilities worldwide. All of these facilities except the RO Associates facility, which is being submitted for accreditation, are certified as ISO 9001- or 9002-compliant. We manufacture our network access and transmission products at CXR-AJ's facilities in France and at CXR Larus' facility in San Jose, California. We manufacture RF devices and custom power supplies at Pascall's facility in Ryde, Isle of Wight, England. We manufacture standard power supplies at RO's facility in Sunnyvale, California. We manufacture all of our test equipment and communication timing and synchronization products at the San Jose facility. We manufacture all of our digital and rotary switches in our Rancho Cucamonga, California facility. We manufacture our custom electronic power supplies in Ashford, Kent, England and Ryde, Isle of Wight, England.

The purchased components we use to build our products are generally available from a number of suppliers. We rely on a number of limited-source suppliers for specific components and parts. We do not have long-term supply agreements with these vendors. In general, we make advance purchases of some components to ensure an adequate supply, particularly for products that require lead-times of up to nine months to manufacture. If we were required to locate new suppliers or additional sources of supply, we could experience a disruption in our operations or incur additional costs in procuring required materials.

We intend to increase the use of outsource manufacturing for our communications equipment products. We believe that outsourcing will lower our manufacturing costs, in particular our components and labor costs, provide us with more flexibility to scale our operations to meet changing demand, and allow us to focus our engineering resources on new product development and product enhancements.

PRODUCT DEVELOPMENT AND ENGINEERING

We believe that our continued success depends on our ability to anticipate and respond to changes in the electronics hardware industry and anticipate and satisfy our customers' preferences and requirements. We continually review and evaluate technological and regulatory changes affecting the electronics hardware industry and seek to offer products and capabilities that solve customers' operational challenges and improve their efficiency.

For the years ended December 31, 2005, 2004 and 2003, our engineering and product development costs were approximately $2,621,000, $1,521,000 and $951,000, respectively.

Our product development costs during the past three years were related to development of new communications test equipment and voice, data and video transmission equipment, communication timing and synchronization products, development of a new line of rotary switches at our Digitran facility and the development of RF and microwave devices at Pascall. We have continued incurring engineering costs applicable to the development of new digital and rotary switches since 2001. Current research expenditures in the communications equipment segment are directed principally toward enhancements to the current test instrument product line, the expansion of our range of network access and transmission products and the development and expansion of our range of Network Equipment Building System, or NEBS, qualified communication timing and synchronization systems. These expenditures are intended to improve market share

and gross profit margins, although we cannot assure you that we will achieve these improvements.

We strive to take advantage of the latest computer-aided engineering and engineering design automation workstation tools to design, simulate and test advanced product features or product enhancements. Our use of these tools helps us to speed product development while maintaining high standards of quality and reliability for our products. Our use of these tools also allows us to efficiently offer custom designs for OEM customers whose needs require the integration of our electronic components with their own products.

INTELLECTUAL PROPERTY

We regard our software, hardware and manufacturing processes as proprietary and rely on a combination of patent, copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. We have secured a U.S. and foreign patent for a rotary switch product and we filed patent applications, and intend to file additional patent applications in the future, for various other products with the U.S. Patent and Trademark Office and in the European Union, Japan, Canada and Brazil. We seek to protect our software, documentation and other written materials under trade secret and copyright laws, which afford some limited protection. The laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States. Our research and development and manufacturing process typically involves the use and development of a variety of forms of intellectual property and proprietary technology. In addition, we incorporate technology and software that we license from third party sources into our products. These licenses generally involve a one-time fee and no time limit. We believe that alternative technologies for this licensed technology are available both domestically and internationally.

We may receive in the future notices from holders of patents that raise issues as to possible infringement by our products. As the number of network access, transmission and communication timing and synchronization instruments increases and the functionality of these products further overlaps, we believe that we may become subject to allegations of infringement given the nature of the telecommunications and information technology industries and the high

incidence of these kinds of claims. Questions of infringement and the validity of patents in the fields of telecommunications and information technology involve highly technical and subjective analyses. These kinds of proceedings are time consuming and expensive to defend or resolve, result in substantial diversion of management resources, cause product shipment delays or could force us to enter into royalty or license agreements rather than dispute the merits of the proceeding initiated against us.

GOVERNMENT REGULATION AND INDUSTRY STANDARDS AND PROTOCOLS

We design our products to comply with a significant number of industry standards and regulations, some of which are evolving as new technologies are deployed. In the United States, our products must comply with various regulations defined by the United States Federal Communications Commission, or FCC, and Underwriters Laboratories as well as industry standards such as NEBS established by Telcordia Technologies, Inc., formerly Bellcore, and those developed by the American National Standards Institute. Internationally, our products must comply with standards established by the European Committee for

Electrotechnical Standardization, the European Committee for Standardization, the European Telecommunications Standards Institute and telecommunications authorities in various countries, as well as with recommendations of the International Telecommunications Union. The failure of our products to comply, or delays in compliance, with the various existing and evolving standards could negatively affect our ability to sell our products.

Our product lines are subject to statutes governing safety and environmental protection. We believe that we are in substantial compliance with these statutes and are not aware of any proposed or pending safety or environmental rule or regulation that, if adopted, would have a material affect on our business or financial condition.

EMPLOYEES

As of November 30, 2006, we employed approximately 300 persons in our various divisions and subsidiaries. None of our employees are represented by labor unions, and there have not been any work stoppages at any of our facilities. We believe that our relationship with our employees is good.

ITEM 1A. RISK FACTORS.

RISK FACTORS

THE FOLLOWING SUMMARIZES MATERIAL RISKS THAT INVESTORS SHOULD CAREFULLY CONSIDER BEFORE DECIDING TO BUY OR MAINTAIN AN INVESTMENT IN OUR COMMON STOCK. ANY OF THE FOLLOWING RISKS, IF THEY ACTUALLY OCCUR, WOULD LIKELY HARM OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS. AS A RESULT, THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE, AND INVESTORS COULD LOSE THE MONEY THEY PAID TO BUY OUR COMMON STOCK.

OUR LACK OF LONG-TERM PURCHASE ORDERS OR COMMITMENTS MAY ADVERSELY AFFECT OUR BUSINESS IF DEMAND IS REDUCED.

During 2005, the sale of electronic components accounted for approximately 62.6% of our total net sales, and the sale of communications equipment and related services accounted for approximately 37.8% of our total net sales. In many cases we have long-term contracts with our electronic components and communications equipment customers that cover the general terms and conditions of our relationships with them but that do not include long-term purchase orders or commitments. Rather, our customers issue purchase orders requesting the quantities of communications equipment they desire to purchase

from us, and if we are able and willing to fill those orders, then we fill them under the terms of the contracts. Accordingly, we cannot rely on long-term purchase orders or commitments to protect us from the negative financial effects of reduced demand for our products that could result from a general economic downturn, from changes in the electronic components and communications equipment industries, including the entry of new competitors into the market, from the introduction by others of new or improved technology, from an unanticipated shift in the needs of our customers, or from other causes.

THE UNPREDICTABILITY OF OUR QUARTERLY OPERATING RESULTS MAY CAUSE THE PRICE OF OUR COMMON STOCK TO FLUCTUATE OR DECLINE.

Our quarterly operating results have varied significantly in the past

and will likely continue to do so in the future due to a variety of factors, many of which are beyond our control. Our operating results from our communications segment tend to be less stable and predictable than our operating results from our electronic components segment.

The cyclical nature of the telecommunications business due to the budgetary cycle of telephone companies has had and will continue to have for the foreseeable future an effect on our quarterly operating results. Telephone companies generally obtain approval for their annual budgets during the first quarter of each calendar year. If a telephone company's annual budget is not approved early in the calendar year or is insufficient to cover its desired purchases for the entire calendar year, we are unable to sell products to the telephone company during the period of the delay or shortfall.

Our electronic components sales are often made in conjunction with military contracts. The timing of required deliveries under these contracts can be delayed based on issues related to the overall military contract, which can cause delays in our shipment schedules and revenue recognition.

Quarter to quarter fluctuations may also result from the uneven pace of technological innovation, the development of products responding to these technological innovations by us and our competitors, our customers' acceptance of these products and innovations, the varied degree of price, product and technological competition and our customers' and competitors' responses to these changes.

Due to these factors and other factors, including changes in general economic conditions, we believe that period-to-period comparisons of our operating results will not necessarily be meaningful in predicting future performance. If our operating results do not meet the expectations of investors, our stock price may fluctuate or decline.

MANY OF OUR COMPETITORS HAVE GREATER RESOURCES THAN US. IN ORDER TO COMPETE SUCCESSFULLY, WE MUST KEEP PACE WITH OUR COMPETITORS IN ANTICIPATING AND RESPONDING TO THE RAPID CHANGES INVOLVING THE ELECTRONIC COMPONENTS AND COMMUNICATIONS EQUIPMENT INDUSTRIES.

Our future success will depend upon our ability to enhance our current products and services and to develop and introduce new products and services that keep pace with technological developments, respond to the growth in the electronic components and communications equipment markets in which we compete, encompass evolving customer requirements, provide a broad range of products and achieve market acceptance of our products. Many of our existing and potential competitors have larger technical staffs, more established and larger marketing and sales organizations and significantly greater financial resources than we do. Our lack of resources relative to our competitors may cause us to fail to anticipate or respond adequately to technological developments and customer requirements or to experience significant delays in developing or introducing new products and services. These failures or delays could reduce our competitiveness, revenues, profit margins or market share.

WE RELY HEAVILY ON OUR MANAGEMENT, AND THE LOSS OF THEIR SERVICES COULD ADVERSELY AFFECT OUR BUSINESS.

Our success is highly dependent upon the continued services of key members of our management, including Carmine T. Oliva, our Chairman of the

Board, President, and Chief Executive Officer, Acting Chief Financial Officer and Secretary, and Graham Jefferies, our Executive Vice President and Chief Operating Officer. Mr. Oliva co-founded EMRISE Electronics and has developed personal contacts and other skills that we rely upon in connection with our financing, acquisition and general business strategies. Mr. Jefferies is a long-time employee of EMRISE who we have relied upon in connection with our United Kingdom acquisitions and who fulfills significant operational responsibilities in connection with our foreign and domestic operations. The loss of Mr. Oliva, Mr. Jefferies, or one or more other key members of management could adversely affect us. Although we have entered into employment agreements with each of our executive officers, those agreements are of limited duration and are subject to early termination by the officers under some circumstances. We maintain key-man life insurance on Mr. Oliva and Mr. Jefferies. However, we cannot assure you that we will be able to maintain this insurance in effect or that the coverage will be sufficient to compensate us for the loss of the services of Mr. Oliva or Mr. Jefferies.

IF WE ARE UNABLE TO SUCCESSFULLY IDENTIFY OR MAKE STRATEGIC ACQUISITIONS, OUR LONG-TERM COMPETITIVE POSITIONING MAY SUFFER.

Our business strategy includes growth through acquisitions that we believe will improve our competitive capabilities or provide additional market penetration or business opportunities in areas that are consistent with our business plan. Identifying and pursuing strategic acquisitions and integrating acquired products and businesses requires a significant amount of management time and skill. Acquisitions may also require us to expend a substantial amount of cash or other resources, not only as a result of the direct expenses involved in the acquisition transaction, but also as a result of ongoing research and development activities that may be required to maintain or enhance the long-term competitiveness of acquired products, particularly those products marketed to the rapidly evolving telecommunications industry. If we are unable to make strategic acquisitions due to our inability to identify appropriate targets, or to manage the difficulties or costs involved in the acquisitions, our long-term competitive positioning may suffer.

IF WE ARE UNABLE TO FULFILL BACKLOG ORDERS DUE TO CIRCUMSTANCES INVOLVING US OR ONE OR MORE OF OUR SUPPLIERS OR CUSTOMERS, OUR ANTICIPATED RESULTS OF OPERATIONS WILL SUFFER.

As of December 31, 2005, we had $22,150,000 in backlog orders for our products. Backlog orders represent 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. Our backlog orders are due in large part to the long lead-times associated with our electronic components products, which products generally are custom built to order. We cannot assure you that we will be successful in fulfilling orders and commitments in a timely manner or that we will ultimately recognize as revenue the amounts reflected as backlog. Factors that could affect our ability to fulfill backlog orders include difficulty we may experience in obtaining components from suppliers, whether due to obsolescence, production difficulties on the part of suppliers or other causes, or customer-induced delays and product holds. Our anticipated results of operations will suffer to the extent we are unable to fulfill backlog orders within the timeframes we establish, particularly if delays in fulfilling backlog orders cause our customers to reduce or cancel their orders.

IF OUR PRODUCTS FAIL TO COMPLY WITH EVOLVING GOVERNMENT AND INDUSTRY STANDARDS AND REGULATIONS, WE MAY HAVE DIFFICULTY SELLING OUR PRODUCTS.

We design our products to comply with a significant number of industry standards and regulations, some of which are evolving as new technologies are deployed. In the United States, our communications equipment products must comply with various regulations defined by the FCC and Underwriters Laboratories as well as industry standards established by Telcordia Technologies, Inc. and the American National Standards Institute, among others. Internationally, our communications equipment products must comply with standards established by the European Committee for Electrotechnical Standardization, the European Committee for Standardization, the European Telecommunications Standards Institute, telecommunications authorities in various countries as well as with recommendations of the International Telecommunications Union, among others. The failure of our products to comply, or delays in compliance, with the various existing and evolving standards could negatively affect our ability to sell our products.

OUR BUSINESS COULD SUFFER IF WE ARE UNABLE TO OBTAIN COMPONENTS OF OUR PRODUCTS FROM OUTSIDE SUPPLIERS.

The major components of our products include circuit boards, microprocessors, chipsets and memory components. Most of these components are available from multiple sources. However, we currently obtain some components used in our products from single or limited sources. Some modem chipsets used in our data communications equipment products have been in short supply and are frequently on allocation by semiconductor manufacturers. We have, from time to time, experienced difficulty in obtaining some components. We do not have guaranteed supply arrangements with any of our suppliers, and there can be no assurance that our suppliers will continue to meet our requirements. Further, disruption in transportation services as a result of enhanced security measures in response to terrorism threats or attacks may cause some increases in costs and timing for both our receipt of components and shipment of products to our customers. If our existing suppliers are unable to meet our requirements, we could be required to alter product designs to use alternative components or, if alterations are not feasible, we could be required to eliminate products from our product line.

Shortages of components could not only limit our product line and production capacity but also could result in higher costs due to the higher costs of components in short supply or the need to use higher cost substitute components. Significant increases in the prices of components could adversely affect our results of operations because our products compete on price and, therefore, we may not be able to adjust product pricing to reflect the increases in component costs. Also, an extended interruption in the supply of components or a reduction in their quality or reliability would adversely affect our financial condition and results of operations by impairing our ability to timely deliver quality products to our customers. Delays in deliveries due to shortages of components or other factors may result in cancellation by our customers of all or part of their orders. Although customers who purchase from us products, such as many of our digital switches and all of our custom power supplies, that are not readily available from other sources would be less likely than other customers of ours to cancel their orders due to production delays, we cannot assure you that cancellations would not occur.

FINANCIAL STATEMENTS OF OUR FOREIGN SUBSIDIARIES ARE PREPARED USING THE RELEVANT FOREIGN CURRENCY THAT MUST BE CONVERTED INTO UNITED STATES DOLLARS FOR INCLUSION IN OUR CONSOLIDATED FINANCIAL STATEMENTS. AS A RESULT, EXCHANGE RATE FLUCTUATIONS MAY ADVERSELY AFFECT OUR REPORTED RESULTS OF OPERATIONS.

We have established and acquired international subsidiaries in the

United Kingdom, France and Japan 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 affect our consolidated financial statements. Our exposure to fluctuations in currency exchange rates has increased as a result of the growth of our international subsidiaries. Sales of our products and services to customers located outside of the United States accounted for approximately 49.7% of our net sales for 2005. We use derivatives to manage foreign currency rate risk for certain sales shipped from the United Kingdom. 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 gains included in other income and expense in our consolidated statements of operations totaled $123,000 for 2005.

BECAUSE WE BELIEVE THAT PROPRIETARY RIGHTS ARE MATERIAL TO OUR SUCCESS, MISAPPROPRIATION OF THESE RIGHTS COULD ADVERSELY AFFECT OUR FINANCIAL CONDITION.

Our future success will be highly dependent on proprietary technology, particularly in our communications equipment business. However, we do not hold any patents and we currently rely on a combination of contractual rights, copyrights, trademarks and trade secrets to protect our proprietary rights. Our management believes that because of the rapid pace of technological change in the industries in which we operate, the legal intellectual property protection for our products is a less significant factor in our success than the knowledge, abilities and experience of our employees, the frequency of our product enhancements, the effectiveness of our marketing activities and the timeliness and quality of our support services. Consequently, we rely to a great extent on trade secret protection for much of our technology. However, there can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors or customers will not independently develop comparable or superior technologies or obtain unauthorized access to our proprietary technology. Our financial condition would be adversely affected if we were to lose our competitive position due to our inability to adequately protect our proprietary rights as our technology evolves.

OUR COMMON STOCK PRICE HAS BEEN VOLATILE, WHICH COULD RESULT IN SUBSTANTIAL LOSSES FOR INVESTORS PURCHASING SHARES OF OUR COMMON STOCK AND IN LITIGATION AGAINST US.

The market prices of securities of technology-based companies currently are highly volatile. The market price of our common stock has fluctuated significantly in the past. During 2005, the high and low closing sale prices of a share of our common stock were $2.34 and $0.91, respectively. Between January 1, 2006 and November 30, 2006, the high and low closing sale prices of a share of our common stock were $1.46 and $0.66, respectively. The market price of our common stock may continue to fluctuate in response to the following factors, many of which are beyond our control:

o changes in market valuations of similar companies and stock market price and volume fluctuations generally;

- economic conditions specific to the electronic components or communications equipment industries;
- announcements by us or our competitors of new or enhanced products, technologies or services or significant contracts, acquisitions, strategic relationships, joint ventures or capital commitments;
- delays in our introduction of new products or technological innovations or problems in the functioning of these new products or innovations;

- third parties' infringement of our intellectual property rights;
- changes in our pricing policies or the pricing policies of our competitors;
- foreign currency translations gains or losses;
- regulatory developments;
- fluctuations in our quarterly or annual operating results;
- additions or departures of key personnel; and
- future sales of our common stock or other securities.

The price at which you purchase shares of common stock may not be indicative of the price of our stock that will prevail in the trading market. You may be unable to sell your shares of common stock at or above your purchase price, which may result in substantial losses to you. Moreover, in the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

FUTURE SALES OF SHARES OF OUR COMMON STOCK BY OUR STOCKHOLDERS COULD CAUSE OUR STOCK PRICE TO DECLINE.

We cannot predict the effect, if any, that market sales of shares of our common stock or the availability of shares of common stock for sale will have on the market price prevailing from time to time. As of November 30, 2006, we had outstanding 38,081,750 shares of common stock and options and warrants to purchase an aggregate of 6,126,633 shares of common stock. A substantial number of these outstanding shares of common stock and shares of common stock underlying the options and warrants are registered for issuance or public resale under existing registration statements. Sales of shares of our common stock in the public market, or the perception that those sales may occur, could cause the trading price of our common stock to decrease or to be lower than it might be in the absence of those shares or perceptions.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

Not applicable.

ITEM 2. PROPERTIES.

As of November 30, 2006, we leased or owned approximately 174,000 square feet of administrative, engineering, production, storage and shipping space. All of this space was leased other than the Abondant, France facility, which is owned.

BUSINESS UNIT	LOCATION	FU LEASE E
EMRISE Corporation (corporate headquarters)	Rancho Cucamonga, California	Administratio Expires Octob
EMRISE Electronics Corporation/Digitran (electronic components)	Rancho Cucamonga, California	Administratio Manufacturing Expires Novem
	Monrovia, California	Expires Febru
XCEL Power Systems, Ltd. and EEL (electronic components)	Ashford, Kent, England	Administratio Manufacturing
XCEL Japan, Ltd. (electronic components)	Tokyo, Japan	Sales; Expires Decem
RO (power supplies)	Sunnyvale, California	Administrativ Manufacturing Expires Augus
Pascall Electronics Limited (RF devices and custom power supplies)	Ryde, Isle of Wight, England	Administratio Manufacturing Expires May 2
CXR-AJ (network access and transmission products)	Paris, France	Administratio Expires April
CXR-AJ (network access and transmission products)	Abondant, France	Administratio Manufacturing Facility is o
CXR Larus (network access and transmission products, communications test instruments, communication timing and synchronization products)	San Jose, California	Administratio Manufacturing Expires June renewable

We believe the listed facilities are adequate for our current business operations.

ITEM 3. LEGAL PROCEEDINGS.

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

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

On December 21, 2005, we held our 2005 annual meeting of stockholders. The total number of outstanding votable shares was 37,497,750. Our stockholders were asked to consider and vote upon the following two proposals:

(1) Re-election of Carmine T. Oliva as a Class III director to serve a three-year term.

(2) Ratification of the selection of Grant Thornton LLP as our independent registered public accounting firm to audit our consolidated financial statements for 2005.

Results of the vote were as follows:

Proposal	For	Against	Abstain	Withheld
(1)	29,792,773	--	--	107,752
(2)	29,850,830	5,750	43,945	--

As a result, Mr. Oliva was re-elected to serve as a Class III member of our board of directors. Robert Runyon, who also served as a Class III member of our board of directors, declined to stand for re-election and therefore left his position on our board effective as of the meeting. Laurence P. Finnegan and Otis W. Baskin continued to serve on our board of directors following the meeting. The selection of our independent registered public accounting firm to audit our consolidated financial statements for 2005 was ratified.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Our common stock has traded on NYSE Arca, Inc. since March 8, 2006, under the symbol "ERI." For the period from August 10, 2005 through March 7, 2006, our common stock traded on the Archipelago Exchange(SM) (ArcaEx(R)), a facility of the Pacific Exchange(R), under the symbol "ERI." For the period from January 1, 2004 through August 9, 2005, our common stock traded on the OTC Bulletin Board under the symbol "EMRI." The table below shows, for each fiscal quarter indicated, the high and low sales prices on the Pacific Exchange and the high and low closing bid prices on the OTC Bulletin Board, as the case may be, for shares of our common stock. The prices shown reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

	High	Low
Year Ended December 31, 2004		
First Quarter..	$1.18	$0.87

Second Quarter	1.28	0.76
Third Quarter	0.82	0.52
Fourth Quarter	1.68	0.60
Year Ended December 31, 2005		
First Quarter	$1.82	$1.46
Second Quarter	1.51	1.08
Third Quarter	1.98	0.91
Fourth Quarter	2.34	1.14

As of November 30, 2006, we had outstanding 38,081,750 shares of common stock outstanding held of record by approximately 3,000 stockholders. These holders of record include depositories that hold shares of stock for brokerage firms which, in turn, hold shares of stock for numerous beneficial owners. On November 30, 2006, the closing sale price of our common stock on NYSE Arca was $1.01 per share.

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.

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.

In August 2005, we issued 35,000 shares of common stock to our former investor relations consultant upon exercise of a warrant at a per share exercise price of $0.39.

In August 2005, we issued 78,042 shares of common stock to a former employee upon net exercise of a warrant to purchase up to 120,000 shares of common stock at a per share exercise price of $0.50.

In November 2005, we issued 50,000 shares of common stock to a financial advisor upon exercise of a warrant at a per share exercise price of $0.75 and 2,500 shares upon the exercise of employee stock options at a per share exercise price of $1.00.

Exemption from the registration provisions of the Securities Act of 1933 for the transactions described above is claimed under Section 4(2) of the Securities Act of 1933, among others, on the basis that such transactions did not involve any public offering and the purchasers were accredited or sophisticated with access to the kind of information registration would provide. In each case, appropriate investment representations were obtained, stock certificates were issued with restricted stock legends, and stop transfer orders were placed with our transfer agent.

ITEM 6. SELECTED FINANCIAL DATA.

The selected consolidated financial data presented below for each of the five years in the period ended December 31, 2005 have been derived from audited financial statements which for the most recent three years appear elsewhere herein. The data presented below should be read in conjunction with

such financial statements, including the related notes thereto and the other information included herein. The historical results are not necessarily indicative of results to be expected for any future periods.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME DATA:	YEARS ENDED DECEMBER 31,			
	2005 (RESTATED)	2004 (RESTATED)	2003	20
	(IN THOUSANDS, EXCEPT PER SHARE AM			
Net sales	$ 41,270	$ 29,637	$ 25,519	$ 22,
Cost of sales	23,714	16,089	14,835	14,
Gross profit	17,556	13,548	10,684	8,
Selling, general and administrative expenses	13,707	10,212	7,812	7,
Engineering and product development expenses	2,621	1,521	951	1,
Income (loss) from operations	1,228	1,815	1,921	(
Total other expense	(54)	(439)	(474)	(
Income (loss) from continuing operations before income taxes	1,174	1,376	1,447	(
Income tax (benefit) expense	(267)	49	286	
Income (loss) from continuing operations	1,441	1,327	1,161	(
Discontinued operations:				
Gain from operations of discontinued segment	--	--	--	
Net income (loss)	1,441	1,327	1,161	(
Foreign currency translation adjustment	(1,357)	379	705	
Total comprehensive income (loss)	$ 84	$ 1,706	$ 1,866	$ (
Basic earnings (loss) per share from continuing operations	$ 0.04	$ 0.06	$ 0.05	$ (0
Diluted earnings (loss) per share from continuing operations	$ 0.04	$ 0.05	$ 0.05	$ (0
Basic and diluted earnings per share from discontinued operations	$ --	$ --	$ --	$
Basic earnings (loss) per share	$ 0.04	$ 0.06	$ 0.05	$ (0
Diluted earnings (loss) per share	$ 0.04	$ 0.05	$ 0.05	$ (0
Weighted average shares outstanding, basic	37,253	24,063	22,567	21,
Weighted average shares outstanding, diluted	38,386	24,839	23,811	21,

	YEARS ENDED DECEMBER 31,			
	2005	2004 (RESTATED)	2003	200

BALANCE SHEET DATA:		(IN THOUSANDS)		
Cash and cash equivalents.....................	$ 4,371	$ 1,057	$ 1,174	$
Working capital...............................	12,958	5,357	5,696	3,
Total assets..................................	44,461	25,144	17,169	16,
Long-term debt, net of current portion.........	2,492	3,208	819	
Stockholders' equity..........................	27,013	10,757	7,916	5,
Convertible redeemable preferred stock.........	--	--	--	

No cash dividends on our common stock were declared during any of the periods presented above. Various factors materially affect the comparability of the information presented in the above table. These factors relate primarily to the acquisition of Larus Corporation in July 2004, the acquisition of Pascall in March 2005 and changes in foreign currency conversion rates that may affect the consistency of the generally accepted accounting principles that we use. The year ended December 31, 2004 includes five months of Larus Corporation activity. The year ended December 31, 2005 includes nine and one-half months of Pascall activity and five months of RO activity. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview."

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

THE FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES AND THE OTHER FINANCIAL INFORMATION INCLUDED ELSEWHERE IN THIS REPORT. THIS REPORT AND THE FOLLOWING DISCUSSION CONTAIN FORWARD-LOOKING STATEMENTS REGARDING THE ELECTRONIC COMPONENTS AND COMMUNICATIONS EQUIPMENT INDUSTRIES AND OUR EXPECTATIONS REGARDING OUR FUTURE PERFORMANCE, LIQUIDITY AND CAPITAL RESOURCES. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE EXPRESSED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF ANY NUMBER OF FACTORS, INCLUDING THOSE SET FORTH UNDER "RISK FACTORS" AND UNDER OTHER CAPTIONS CONTAINED ELSEWHERE IN THIS REPORT.

OVERVIEW

GENERAL

Through our three wholly-owned operating subsidiaries, EMRISE Electronics, CXR Larus and 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:

- Electronic Components
  - digital and rotary switches
  - electronic power supplies
  - RF and microwave devices

- Communications Equipment
  - network access and transmission products
  - communication timing and synchronization products

-- communications test instruments

Sales to customers in the electronic components segment, primarily to aerospace customers, defense contractors and industrial customers, were approximately 62.2%, 51.5% and 63.4% of our total net sales during 2005, 2004 and 2003, respectively. Sales of communications equipment and related services, primarily to private customer premises and public carrier customers, were approximately 37.8%, 48.5% and 36.6% of our total net sales during 2005, 2004 and 2003, respectively.

Sales of our electronic components segment increased $10,425,000 (68.3%) for 2005. Without the addition of the sales of $11,157,000 and $1,925,000, respectively, by our new subsidiaries, Pascall, which we acquired March 18, 2005 and RO, which we acquired on September 1, 2005, our electronic components segment sales would have declined $2,657,000 (17.4%) for 2005 as compared to 2004, primarily due to the lower shipments of our power supplies due to delays in the shipping schedule for the Eurofighter Typhoon aircraft program that resumed shipments in the second quarter of 2006.

We achieved a $1,208,000 (8.4%) sales increase in our communications equipment segment for 2005. We acquired the Larus division of CXR Larus in July 2004. Without the addition of the $2,947,000 of sales made by the Larus division during the first half of 2005, our communications equipment segment sales would have declined $1,739,000 (12.1%) for 2005 as compared to 2004. This was primarily due to a low demand for our test equipment by the major United States telecommunications companies, a delay in continued shipments on a long-term United States government infrastructure program due to customer technical issues, and delays in French military program orders that had been expected in early 2005.

We continue to reduce costs at CXR Larus by reducing its work force and increasing our sourcing of test equipment components from offshore manufacturers that produce components for lower prices than we previously paid to our former suppliers. Outsourcing of manufacturing to Asia was a primary reason we were able to increase our gross margin from approximately 34% in 2002 to approximately 62% in 2005 in our CXR Larus test equipment business, which resulted in an annual cost reductions of approximately $1,372,000 during 2004. During 2005, we began working toward establishing a similar arrangement for the manufacture of our communication timing and synchronization products by Hitachi OMD, 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 $327,000 on an annual basis and downsizing our administrative office in Paris, France.

LARUS CORPORATION ACQUISITION

In July 2004, we acquired Larus Corporation. Larus Corporation was a San Jose, California-based manufacturer and seller of telecommunications products that had one wholly-owned subsidiary, Vista Labs, Incorporated, or Vista, which provided engineering services to Larus Corporation. The basic purchase terms of the acquisition are described below. We consolidated the results of operations of Larus Corporation beginning from the date of acquisition, July 13, 2004. CXR Larus' United States-based sales and marketing staff, have secured relationships with two new major United States-based distributors, Power and Tel and Graybar, during 2005. We consolidated our CXR Larus subsidiary's operations into Larus Corporation's facility, which resulted

in annual savings in rent and facilities expense of approximately $250,000 beginning in the third quarter of 2004. Subsequent to March 31, 2005, we implemented further administrative, engineering and sales cost savings through staffing reductions of approximately $700,000 on an annual basis as compared to our costs in the three months ended March 31, 2005. These staffing reductions related to eliminating redundancies in our electronic components segment personnel (including nine sales, marketing and administrative positions, one engineering director and the former CXR president) that occurred as a result of our acquisition of Larus Corporation.

We paid $6,539,500 to acquire the outstanding common stock of Larus Corporation. As a result, we acquired assets that included intellectual property, cash, accounts receivable and inventories owned by each of Larus Corporation and Vista. The purchase price for the acquisition consisted of $1,000,000 in cash, the issuance of 1,213,592 shares of our common stock with a fair value of $1,000,000, $887,500 in the form of two short-term, zero interest promissory notes that were repaid in 2004, $3,000,000 in the form of two subordinated secured promissory notes, warrants to purchase up to an aggregate of 150,000 shares of our common stock at $1.30 per share and approximately $580,000 of acquisition costs. The number of shares of our common stock issued as part of the purchase price was calculated based on the $0.824 per share average closing price of our common stock for the five trading days preceding the transaction. The warrants to purchase 150,000 shares of common stock were valued at $72,526 using a Black-Scholes formula that included a volatility of 107.19%, an interest rate of 3.25%, a life of three years and no assumed dividend.

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

In determining the purchase price for Larus Corporation, we 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, we considered our potential ability to refine various Larus Corporation products and to use our marketing resources and status as a qualified supplier to qualify and market those products for sale to large telecommunications companies. We believe 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. We also believe 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.

PASCALL ACQUISITION

On March 18, 2005, our subsidiary, EMRISE Electronics Ltd. ("EEL"), purchased all of the outstanding capital stock of PEHL, the parent holding company of Pascall, using funds loaned to EEL by EMRISE. The purchase price for the acquisition totaled $9,669,000, subject to adjustments as described below,

and included a $9,054,000 cash payment to PEHL's former parent and approximately $615,000 in acquisition costs. In connection with the purchase, EEL loaned $3,082,000 to PEHL and Pascall, 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 and was subject to adjustment on a pound for pound basis to the extent that the value of the net assets of Pascall as of the closing date was greater or less than 2,520,000 British pounds sterling. On May 6, 2005, we submitted to Intelek Properties Limited (which is a subsidiary of Intelek PLC, a London Stock Exchange public limited company, and is the former parent of PEHL), our calculation of the value of the net assets of Pascall as of the closing date, which we believed slightly exceeded 2,520,000 British pounds sterling. Ultimately, the parties determined that the value of the net assets of Pascall at the closing date was 2,650,000 British pounds sterling. As a result, we paid to Intelek Properties Limited 130,000 British pounds sterling (approximately U.S. $236,000 based on the exchange rate then in effect) on August 1, 2005 to satisfy this obligation. The purchase price is also subject to downward adjustments for any payments that may be made to EEL under indemnity, tax or warranty provisions of the purchase agreement.

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

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 underwrite the guarantee 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 recent history and sales projections, we expect Pascall to provide a positive contribution to our earnings per share. 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 and anticipate that we will be able to generate further future savings as we continue to integrate the businesses.

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	5,534
Total assets acquired	13,097
Current liabilities	(2,863)
Other liabilities	(80)
Total liabilities assumed	(2,943)
Net assets acquired	$ 10,154

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.

RO ACQUISITION

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

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

$1,602,000.

In determining the purchase price for RO, EMRISE Electronics considered the historical and expected earnings and cash flow of RO, as well as the value of companies of a size and in an industry similar to RO, comparable transactions and the market for such companies generally. The purchase price represented a premium of approximately $2,275,000 over the $2,340,000 recorded net worth of the assets of RO. In determining this premium, EMRISE Electronics considered the synergistic and strategic advantages provided by having a United States-based power conversion manufacturer and the value of the goodwill, customer relationships and technology of RO. Goodwill associated with the RO acquisition totaled approximately $1,376,000. EMRISE commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible asset. The valuation study of RO's intangibles was completed in June 2006. We initially estimated the intangibles to be valued as follows:

technology, $484,000, trademarks, $300,000 and customer relationships, $200,000. The valuation study resulted in the following valuations: technology, $500,000, trademarks, $350,000 and customer relationships, $350,000. The intangibles were adjusted to the appraised values in the second quarter of 2006. The technology and customer relationships are being amortized over 10 years on their appraise values and the trademarks are not being amortized due to the inability to determine an estimated life.

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 provided 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 provided 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. Otherwise, the rent will remain unchanged unless and until the targets are met. The property was sold on November 1, 2006. As a result of the sale, the lease agreement was amended to remove the financial targets. Also, beginning on March 1, 2007, the lease coverts to a month-to-month tenancy whereupon either party may provide the other with 30 days' notice to terminate the lease. The current lease obligation is $12,280 per month, which is more than the original $9,210 because a sublessor terminated its sublease.

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 is a general partner of Caspian Associates. Mr. Okada will receive an annual base salary of $115,000 for the two-year tern 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 RO acquisition, including $65,000 in acquisition

costs:

	Dollars in Thousands
Current assets	$ 3,213
Property, plant and equipment	329
Intangibles, including goodwill	2,360
Other assets	66
Total assets acquired	5,968
Current liabilities	(943)
Other liabilities	(393)
Total liabilities assumed	(1,336)
Net assets acquired	$ 4,632

PRO FORMA RESULTS OF OPERATIONS

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 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).

	Year Ended December 31,	
	2005 (restated)	2004 (restated)
Revenues	$ 47,933	$ 52,767
Net income	$ 1,324	$ 2,072
Basic earnings per share of common stock	$ 0.04	$ 0.06
Diluted earnings per share of common stock	$ 0.03	$ 0.06

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of those financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of net sales and expenses for each period. The following represents a summary of our critical accounting

policies, defined as those policies that we believe are the most important to the portrayal of our financial condition and results of operations and that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

REVENUE RECOGNITION

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

We recognize revenues from domestic sales of our electronic components and communications equipment at the point of shipment of those products. Product returns are infrequent and require prior authorization because our sales are final and we quality test our products prior to shipment to ensure they meet the specifications of the binding purchase orders under which they are shipped. Normally, when a 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 communication timing and synchronization products carry a one-year limited parts and labor warranty and our communications test instruments and European network access and transmission products carry a two-year limited parts and labor warranty. Products returned under warranty are tested and repaired or replaced at our option. Historically, warranty repairs have not been material. We do not offer customer discounts, rebates or price protection on these products.

Revenues from services such as repairs and modifications are recognized when the service has been completed and invoiced. For repairs that involve shipment of a repaired product, we recognize repair revenues when the product is shipped back to the customer. Service revenues represented approximately 2.6%, 5.7% and 3.1% of net sales during 2005, 2004 and 2003, respectively.

INVENTORY VALUATION

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

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

FOREIGN CURRENCY TRANSLATION

We have foreign subsidiaries that together accounted for approximately 61.7% of our net revenues, 47.3% of our assets and 53.1% of our total liabilities as of and for the year ended December 31, 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 included either within our statement of operations or as a separate part of our net equity under the caption "accumulated other comprehensive income (loss)."

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

considered the functional currency. However, management must also consider any dependency of the subsidiary upon the parent and the nature of the subsidiary's operations.

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

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

Based on our assessment of the factors discussed above, we consider the functional currency of each of our international subsidiaries as each subsidiary's local currency. Accordingly, we had cumulative translation losses of $870,000 and gains of $487,000 that were included as part of accumulated other comprehensive income within our balance sheets at December 31, 2005 and 2004, respectively. During the years ended December 31, 2005 and 2004, we included translation adjustments of losses of approximately $1,357,000 and gains of $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 gain or loss for 2005 and 2004. The magnitude of these gains or losses depends upon movements in the exchange rates of the foreign currencies in which we transact business as compared to the value of the United States dollar. These currencies include the euro, the British pound sterling and the Japanese yen. Any future translation gains or losses could be significantly higher or lower than those we recorded for these periods.

A $6,296,000 loan payable from EEL to EMRISE was outstanding as of December 31, 2005. This loan is not expected to be outstanding indefinitely. Therefore, exchange rate losses and gains on this loan are recorded in cumulative translation gains or losses in the equity section of the balance sheet.

INTANGIBLES, INCLUDING GOODWILL

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

In assessing potential impairment of goodwill, we consider these factors as well as forecasted financial performance of the acquired businesses. If forecasts are not met, we may have to record additional impairment charges not previously recognized. In assessing the recoverability of our goodwill and other intangibles, we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of those respective assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets that were not previously recorded. If that were the case, we would have to record an expense in order to reduce the carrying value of our goodwill. On January 1, 2002, we adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," and were required to analyze our goodwill for

impairment issues by June 30, 2002, and then at least annually after that date or more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. At December 31, 2005, the reported goodwill totaled $12,066,000. During 2005, we did not record any impairment losses related to goodwill and other intangible assets.

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

In conjunction with our March 2005 acquisition of Pascall, we selected a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. We considered whether the acquisition included various types of identifiable intangible assets, including trade names, trademarks, covenants not to compete, patents, customers, workforce, technology and software. The Pascall trade name and trademark are valued at $500,000 and are not amortized. The covenants not to compete that were obtained from Pascall's former affiliates are valued at $200,000 amortizable over three years in light of public statements made by those affiliates indicating that they were strategically 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. The backlog was valued at $200,000 amortizable over two years. Total amortization expense of $310,000 was charged to administrative expense in 2005. We believe that no other identifiable intangible assets of significant value were acquired. No patents were acquired. We did not ascribe any value to Pascall's customer base because EEL already was selling to Pascall's key customers prior to the acquisition. 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 estimated that the goodwill associated with the Pascall acquisition totaled $4,634,000. 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 and backlog are being amortized over their respective three-year and two-year durations.

In conjunction with our acquisition of RO, we commissioned a valuation firm to determine what portion of the purchase price should be allocated to identifiable intangible assets. The valuation study of RO's intangibles was completed in June 2006. We initially estimated the intangibles to be valued as follows: technology, $484,000, trademarks, $300,000 and customer relationships,

$200,000. The valuation study resulted in the following valuations: technology, $500,000, trademarks, $350,000 and customer relationships, $350,000. The intangibles were adjusted to the appraised values in the second quarter of 2006. The technology and customer relationships are being amortized over 10 years on their appraise values and the trademarks are not being amortized due to the inability to determine an estimated life.

RESULTS OF OPERATIONS

The tables presented below, which compare our results of operations from one period to another, present the results for each period, the change in those results from one period to another in both dollars and percentage change, and the results for each period as a percentage of net sales. The columns present the following:

- The first two data columns in each table 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 in each table show the results for each period as a percentage of net sales.

YEAR ENDED DECEMBER 31, 2005 (RESTATED) COMPARED TO YEAR ENDED DECEMBER 31, 2004

	YEAR ENDED DECEMBER 31, 2005 (RESTATED)	YEAR ENDED DECEMBER 31, 2004 (RESTATED)	DOLLAR VARIANCE FAVORABLE (UNFAVORABLE)	PERCENTAGE VARIANCE FAVORABLE (UNFAVORABLE
			(DOLLARS IN THOUSANDS)	
Net sales				
Electronic components	$ 25,687	$ 15,262	$ 10,425	68.3%
Communications equipment	15,583	14,375	1,208	8.4%
Total net sales	41,270	29,637	11,633	39.3%
Cost of sales				
Electronic components	15,527	9,024	(6,503)	(72.1)%
Communications equipment	8,187	7,065	(1,122)	(15.9)%
Total cost of sales	23,714	16,089	(7,625)	(47.4)%

Gross profit				
Electronic components	10,160	6,238	3,922	62.9%
Communications equipment	7,396	7,310	86	1.2%
Total gross profit	17,556	13,548	4,008	29.6%
Selling, general and administrative expenses	13,707	10,212	(3,495)	34.2%
Engineering and product development ...	2,621	1,521	(1,100)	(72.3)%
Operating income	1,228	1,815	(587)	(32.3)%
Interest expense	(455)	(433)	(22)	(5.1)%
Interest income	153	--	153	--
Other income and expense	248	(6)	254	4,233.3%
Income before income tax expense	1,174	1,376	(202)	(14.7)%
Income tax expense	(267)	49	316	644.9%
Net income	$ 1,441	$ 1,327	$ 114	8.6%

NET SALES. The $11,633,000 (39.3%) increase in total net sales for 2005 as compared to 2004 resulted from the combination of a $10,425,000 (68.3%) increase in net sales of our electronic components and a $1,208,000 (8.4%) 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 2005 results of Pascall's $11,157,000 sales of power supplies and RF components and RO's $1,925,000 sales of power conversion products and licensing. This increase occurred despite a $2,939,000 (32.0%) decrease in sales at XPS primarily related to reduced sales of power supplies due to the delay of deliveries for the Eurofighter Typhoon aircraft. Sales of switches manufactured by Digitran increased $1,021,000 (18.5%) to $6,545,000 for 2005 from $5,524,000 for the prior year period due to sales of new rotary switches and other new programs for our digital switches.

We first reported sales of RF devices during the three months ended March 31, 2005 due to the Pascall acquisition. We acquired RO on August 31, 2005. If we excluded sales by Pascall from March 18, 2005 through December 31, 2005 and sales by RO for September through December 31, 2005, our electronic components segment sales would have declined by $2,657,000 or (17.4%) for 2005. We currently anticipate that our sales of electronic components will increase in 2006, based upon informal indications we have received from various customers and based upon recent increases in our backlog, especially including orders relating to the Eurofighter Typhoon aircraft.

COMMUNICATIONS EQUIPMENT. The $1,208,000 increase in net sales of our communications equipment segment resulted primarily from the inclusion in our 2005 results of the full year of $5,974,000 of net sales of communication timing and synchronization products attributable to our acquisition of Larus Corporation that occurred on July 13, 2004 as compared to sales of $3,424,000 for the period from July 13, 2004 to December 31, 2004. This increase occurred despite a $869,000 (24.6%) decline in net sales of test instruments primarily due to delays and non-receipt of expected orders from large carriers. Sales of

network access equipment produced by CXR-AJ in France decreased by $380,000 (6.2%) to $5,759,000 in 2005 as compared to $6,139,000 in 2004 due to lower sales volume in military markets. We do not anticipate that sales of our communications test equipment will improve in 2006. We anticipate that sales of our network access products both in France and more importantly in the United States will grow as new sales channels and our stronger marketing presence becomes effective and we work to utilize our two new United States-based distributors we established relationships with during 2005.

GROSS PROFIT. Gross profit as a percentage of total net sales decreased to 42.5% from 45.7% for the prior year period. In dollar terms, gross profit increased by $4,008,000 (29.6%) to $17,556,000 for 2005 as compared to $13,548,000 for 2004.

ELECTRONIC COMPONENTS. The $3,922,000 (62.9%) increase in gross profit for our electronic components segment was primarily due to the inclusion in our results for 2005 of $3,484,000 of gross profit from Pascall and $788,000 of gross profit from RO. Partially offsetting these increases was a $244,000 reduction in gross profit from switches primarily due to product mix and a $399,000 decrease in gross profit on power supplies produced by XPS as a direct result of reduced sales volume due to contract delivery delays for the Eurofighter Typhoon aircraft. We expect overall sales of power supplies in 2006 to exceed overall sales of power supplies in 2005 based upon informal indications we have received from various customers and increased backlog. XCEL Japan Ltd. increased its gross profit by $346,000 (62.0%) to $904,000 from $558,000 in the prior year due to increased sales of higher margin military switches.

COMMUNICATIONS EQUIPMENT. This segment had a slight $86,000 decrease in gross profits. CXR Larus contributed $2,755,000 of gross profit for 2005 relating to net sales of network access and communication timing and synchronization products as compared to $1,782,000 for the period from July 13, 2004 to December 31, 2004. Gross profit for test instruments decreased $805,000 (30.4%) to $1,845,000 in 2005 as compared to $2,650,000 in 2004 due to lower

volume. Due to reduced overhead costs, CXR-AJ recorded a relatively low $84,000 decrease in gross profit despite a $359,000 decline in sales, resulting in a gross margin for CXR-AJ of 42.0% in 2005 as compared to a gross margin for CXR-AJ of 41.0% in 2004. We plan to have our timing and other network access products built for us under a signed contract with Hitachi OMD and thereby expect to increase gross margins over our in-house manufacturing.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Our selling, general and administrative expenses increased in dollar terms but decreased as a percentage of net sales to 33.2% in 2005 from 34.5% in 2004. The $3,495,000 (34.2%) increase in selling, general and administrative expenses for 2005 as compared to 2004 resulted from:

- a $359,000 (54.8%) increase in sales commissions due to the increase or inclusion of $85,000, $243,000 and $73,000 of sales commission expenses of CXR Larus, Pascall and RO, respectively, partially offset by reductions in commission expenses of $22,000 for test instruments and $22,000 for our French-produced network access products;

- a $1,505,000 (48.5%) increase in other selling and marketing

expenses primarily due to an increase of $694,000 and the inclusion of $924,000 and $71,000 of selling expenses of our Larus division, Pascall and RO, respectively, attendance at tradeshows and increased advertising and marketing of our electronic components. These increases were partially offset by decreases in these expenses of $71,000 for test instruments and $118,000 at CXR-AJ;

- a $1,622,000 (25.1%) increase in administrative expenses primarily due to the increase or inclusion of $337,000 and $775,000 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 XPS's operations in Ashford, England; and

- an increase of $144,000 in United States corporate legal expenses and a $282,000 increase in our domestic accounting and auditing expenses plus an increase of $227,000 in consulting fees relating to internal control documentation in response to the Sarbanes-Oxley Act of 2002.

We anticipate that selling, general and administrative expenses for 2006 will exceed those expenses for 2005 due to costs associated with the reaudit of our consolidated financial statements for the years ending December 31, 2003, 2004 and 2005, integrating Pascall and RO, increased 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 ("Commission"). However we continue to seek efficiencies and cost savings at all operations.

37

ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES. Engineering and product development expenses consist primarily of new product development engineering activities. The $1,100,000 (72.3%) increase in these expenses resulted primarily from the increase of $443,000 of expenses attributable to our Larus division and a $513,000 increase in engineering expenses attributable to Pascall. Also, expenses related to development of our new low profile rotary switches increased $58,000 (12.0%) to $540,000 for 2005 as compared to $482,000 for 2004. We expect this higher level of expense to continue through 2006 as we continue to develop our new family of rotary switches and pursue long term opportunities for a new timing and synchronization product. During 2005, we eliminated one of our two engineering directors at CXR Larus, which is helping to offset approximately $75,000 of our increased engineering expenses on an annual basis.

INTEREST EXPENSE AND OTHER INCOME. Interest expense increased by $22,000 (5.1%) to $455,000 for 2005 as compared to $433,000 for 2004. In addition, we recorded $153,000 of interest income in 2005, which we earned on the proceeds of the January 5, 2005 private placement. We did not have interest income during 2004. Other income of $248,000 for 2005 primarily resulted from a $100,000 gain due to the sale of our T-Com product line and $123,000 of a net

currency exchange gain. The T-Com technology and tangible assets had no carrying value.

INCOME TAX EXPENSE. Income tax benefit for 2005 was $267,000, compared to an expense of $49,000 for 2004 primarily because we reduced our tax asset valuation allowance by $555,000 and recorded a federal tax benefit of $150,000 that was offset by our foreign tax provision of $408,000 and a state tax provision of $30,000.

NET INCOME. Net income for 2005 increased by $114,000 to $1,441,000 as compared to $1,327,000 for 2004. The increase was primarily due to an increase in gross profit in our electronic components segment resulting from our acquisitions of Pascall and RO. 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.

38

YEAR ENDED DECEMBER 31, 2004 (RESTATED) COMPARED TO YEAR ENDED DECEMBER 31,

	YEAR ENDED DECEMBER 31, 2004 (RESTATED)	YEAR ENDED DECEMBER 31, 2003	DOLLAR VARIANCE FAVORABLE (UNFAVORABLE)	PERCENTAGE VARIANCE FAVORABLE (UNFAVORABLE
			(DOLLARS IN THOUSANDS)	
Net sales				
Electronic components	$ 15,262	$ 16,168	$ (906)	(5.6)%
Communications equipment	14,375	9,351	5,024	53.7%
Total net sales	29,637	25,519	4,118	16.1%
Cost of sales				
Electronic components	9,024	9,530	506	5.3%
Communications equipment	7,065	5,305	(1,760)	(33.2)%
Total cost of sales	16,089	14,835	(1,254)	(8.5)%
Gross profit				
Electronic components	6,238	6,638	(400)	(6.0)%
Communications equipment	7,310	4,046	3,264	80.7%
Total gross profit	13,548	10,684	2,864	26.8%
Selling, general and administrative expenses	10,212	7,812	2,400	30.7%
Engineering and product development expenses	1,521	951	570	(59.9)%
Operating income	1,815	1,921	(106)	(5.5)%

Interest expense	(433)	(416)	(17)	(4.1)%
Other expense	(6)	(58)	52	89.7%
Income before income tax expense	1,376	1,447	(71)	(4.9)%
Income tax expense	49	286	(237)	82.9%
Net income	$ 1,327	$ 1,161	$ 166	14.3%

NET SALES. The $4,118,000 (16.1%) increase in total net sales for 2004 as compared to 2003 resulted from the combination of a $906,000 (5.6%) decrease in net sales of our electronic components and a $5,024,000 (53.7%) increase in net sales of our communications equipment products and services.

ELECTRONIC COMPONENTS. The decrease in net sales of our electronic components segment resulted from:

- a $2,012,000 (20.1%) decrease in net sales of power supplies and subassemblies by XPS that we believe was primarily due to deferral of orders for the Eurofighter Typhoon aircraft; and

- a $67,000 (23.1%) decrease in sales of electronic subsystem assemblies produced by Digitran, which we believe was primarily due to a delay in the United States government's transfer of a contract from one prime contractor to another.

These decreases were only partially offset by the following:

- a $217,000 (4.1%) increase in net sales of switches manufactured by Digitran, which was primarily a result of an increase in the volume of orders for spare parts that we believe was mainly due to increased military activities;

- an increase from $1,000 in 2003 to $28,000 in 2004 in net sales of a new standard rotary switch and then patent pending VLP(TM) rotary switches that were introduced by Digitran in 2004; and

- a $956,000 (164.3%) increase in net revenue from service and miscellaneous other electronic component products primarily due to increased service business volume at XPS.

COMMUNICATIONS EQUIPMENT. The increase in net sales of our communications equipment products and services resulted from:

- a $2,112,000 (34.4%) increase in net sales of network access and transmission equipment, which primarily consisted of $1,952,000 in sales made by CXR Larus as a direct result of our acquisition of Larus Corporation in July 2004;

- $1,298,000 of net sales of communication timing and synchronization products by CXR Larus from July through December 2004, prior to which time we did not have a similar product line; and

- a $1,384,000 (64.5%) increase in net sales of our CXR HALCYON

704 series field test equipment, which was primarily due to a $1,800,000 order we received and delivered in the fourth quarter of 2004 for a project that had been under development since 2002.

These increases were partially offset by the curtailment during 2004 of orders for CXR Larus test equipment by another large customer who shifted its focus to fiber and HDSL services.

GROSS PROFIT. The four percentage point increase in gross profit as a percentage of total net sales and the $2,864,000 (26.8%) increase in total gross profit in 2004 as compared to 2003 resulted from gross profit decreases in our electronic components segment that were more than offset by gross profit increases in our communications equipment segment.

ELECTRONIC COMPONENTS. The $400,000 (6.0%) decrease in gross profit for our electronic components segment was primarily due to the large reduction in sales of power supplies described above.

COMMUNICATIONS EQUIPMENT. The $3,264,000 (80.7%) increase in gross profit for our communications equipment segment and the 8.8% increase in this segment's gross profit as a percentage of total net sales were primarily the result of the addition of Larus Corporation's $1,782,000 gross profit resulting from net sales of communication timing and synchronization products for July through December 2004 and a $1,423,000 increase in gross profit at CXR Larus as a result of a large increase in high gross margin sales of CXR Halcyon communications test equipment. Excluding the addition of Larus Corporation sales, gross profit for network access equipment increased approximately $60,000 (2.1%).

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. The $2,400,000 (30.7%) increase in selling, general and administrative expenses in 2004 as compared to 2003 resulted primarily from:

- $994,000 in selling, general and administrative expenses generated by Larus Corporation following its acquisition in July 2004;

- a $73,000 (12.0%) increase in sales expense at CXR Larus mostly related to commissions for the large orders they obtained during 2004;
- a $110,000 (53.9%) increase in selling expense at Digitran related to support for our new line of rotary switches;
- a $56,000 (19.6%) increase in selling expense at XPS to improve marketing of power supplies;
- a $99,000 (110.0%) increase in corporate legal fees and $67,000 (35.9%) increase in auditing fees partially due to requirements of the Sarbanes-Oxley Act of 2002;
- a $126,000 (91.3%) increase in deferred compensation;
- a $68,000 (42.5%) increase in stockholder relations and investor relations expenses; and

- a $180,000 (18.3%) increase in corporate salaries, bonus and expenses partially due to foreign currency exchange rate fluctuation.

Some of the reasons for higher administrative expenses were increased acquisition activities, costs of changing our name to EMRISE Corporation and complying with the requirements of the Sarbanes-Oxley Act of 2002 and related rules, and increased investor relations activities.

ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES. Engineering and product development expenses consist primarily of research and product development activities. The $570,000 (59.9%) increase in these expenses resulted from:

- the inclusion of $200,000 of these expenses from Larus Corporation;
- an $80,000 (65.6%) increase in these expenses at CXR Larus relating to test instruments;
- a $53,000 (91.1%) increase in these expenses at CXR-AJ for network access equipment; and
- a $237,000 (96.7%) increase in expenses at Digitran for the new line of rotary switches.

INTEREST EXPENSE. Although our bank interest expense declined $58,000 (13.9%) due to our new credit line with Wells Fargo Bank, N.A., this benefit was more than offset by the $75,000 interest we paid on the notes we issued to acquire Larus Corporation.

INCOME TAX EXPENSE. Income tax expense for 2004 was $49,000 as compared to $286,000 in 2003. The 2004 tax provision was composed of $177,000 net foreign income taxes and $76,000 current federal and state taxes. These amounts were offset with a $160,000 reduction of the valuation allowance applied against the deferred tax asset. The release of the allowance was based on our recent and expected U.S. based earnings and the probability that a portion of our tax net operating loss carryforwards may be utilized.

NET INCOME. Net income increased by $166,000 (14.3%) to $1,327,000 in 2004 from $1,161,000 in 2003. Our 2004 net income was helped by the contribution of $628,000 of operating earnings from Larus Corporation, a $1,259,000 increase in operating earnings by CXR Larus due to improved test instrument sales and an improvement of $319,000 in operating earnings at CXR-AJ due to increased network access sales. These improvements were partially offset by lower operating

earnings at our electronics components segment due to higher operating expenses at Digitran and lower gross margin at XPS due to a lower sales volume of power supplies. These changes resulted in our net income before taxes in 2004 of $1,376,000, $71,000 less than 2003 net income before tax of $1,447,000. Our income tax provision in 2004 was $49,000 as compared to $286,000 in 2003.

LIQUIDITY AND CAPITAL RESOURCES

During 2005, we funded our operations primarily through revenue generated from our operations and through our previous lines of credit with

Wells Fargo Bank, N.A. and various foreign banks. During 2005, we continued to rely on our foreign credit facilities. In addition, we raised approximately $16,060,000 in net proceeds through a private placement of equity securities in January 2005 as described below to support our acquisition program. As of December 31, 2005, we had working capital of $12,958,000, which represented a $7,601,000 (141.9%) increase from working capital of $5,357,000 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 December 31, 2005 and 2004, we had accumulated deficits of $15,118,000 and $16,559,000, respectively, and cash and cash equivalents of $4,371,000 and $1,057,000, respectively.

Accounts receivable increased $3,617,000 (62.4%) during 2005 from $5,796,000 as of December 31, 2004 to $9,413,000 as of December 31, 2005. Sales attributable to the Pascall and RO acquisitions contributed $11,157,000 and $1,925,000, respectively, to accounts receivable at December 31, 2005. Without the acquisitions of Pascall and RO, our receivables would have decreased by $374,000 (6.5%) during 2005, primarily due to increased receivables for switches and test instruments. Days sales outstanding, which is a measure of our average accounts receivable collection period, increased from 61 days for 2004 to 67 days for 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 incur few bad debts.

Inventory balances increased $3,728,000 (56.9%) during 2005, from $6,549,000 at December 31, 2004 to $10,277,000 at December 31, 2005. Inventory represented 23.1% and 26.0% of our total assets as of December 31, 2005 and December 31, 2004, respectively. Included in the December 31, 2005 amount is $1,591,000 and $2,325,000 of inventory attributable to Pascall and RO, respectively. Excluding the effect of this inclusion, inventory would have increased by $469,000 (7.2%) and would have represented 22.6% of total assets (excluding the $10,410,000 and $5,872,000 of total assets related to Pascall and RO, respectively) at December 31, 2005. Inventory turnover, which is a ratio that indicates how many times our inventory is sold and replaced over a specified period, increased to 2.8 times for 2005 as compared to 2.6 times for 2004.

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

Cash provided by our operating activities totaled $1,140,000 for 2005 as compared to cash provided by operating activities of $3,884,000 for 2004. This $2,744,000 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 $15,044,000 for 2005 as compared to $2,208,000 for 2004. Included in the results for 2005 are net cash of $10,154,000 and $4,623,000 used to acquire Pascall and RO, respectively. Also we acquired $287,000 of property, plant and equipment purchases for production equipment and computer equipment.

Cash provided by our financing activities totaled $18,050,000 for 2005 as compared to $2,164,000 of cash used in our financing activities for 2004. The change is primarily due to the net proceeds of $16,060,000 from the issuance of common stock in the January 2005 private placement.

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

	Decem
	2005
Line of credit with a U.S. commercial lender........................	$ --
Lines of credit with foreign banks.................................	3,283,000
	$ 3,283,000

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

As of December 31, 2005, we had no outstanding balance owing under our revolving credit line with Wells Fargo Bank, and had $2,000,000 of availability on the non-formula based portion of the credit line. As of December 31, 2005, we were in compliance with each of the covenants of the credit facility.

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

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

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

funding date, the penalty is equal to 2% of the maximum line amount and/or prepayment amount; and if the termination or prepayment occurs at any time after the second anniversary of the initial funding date and prior to the maturity date, the penalty is equal to 1% of the maximum line amount and/or prepayment amount . The credit facility is subject to an unused line fee equal to 0.25% per annum, payable monthly based on the average daily unused amount of the line of credit described in the following paragraph. The credit facility is also subject to a minimum monthly interest charge of $8,500 with respect to the revolving line of credit.

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

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

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

The credit facility also provides for a term loan of $200,000 secured by accounts receivable, other rights to payment and general intangibles,

inventories and equipment, amortizable over 36 months at a variable rate equal to the prime rate plus 1%.

As of December 31, 2005, our foreign subsidiaries had credit facilities, including lines of credit and term loans, with Lloyds TSB Bank PLC ("Lloyds TSB") and Lloyds TSB Commercial Finance Limited ("Lloyds") in England, IFN Finance, a subsidiary of ABN AMRO Holdings, N.V., Banc National de Paris, Societe Generale in France, and Sogelease and Johnan Shinkin Bank in Japan. At December 31, 2005, the balances outstanding under our United Kingdom, France and Japan credit facilities were $3,006,000, $1,090,000 and $32,000, respectively.

On July 8, 2005, XPS and Pascall obtained a 24-month credit facility with Lloyds, which facility expires July 31, 2007. At the same time, the credit facility of Venture Finance PLC, a subsidiary of ABN AMRO Holdings, N.V., was terminated and paid off. The Lloyds facility provides a revolving loan secured by receivables, with a maximum availability of 2,100,000 British pounds sterling (approximately U.S. $3,613,000 based on the exchange rate in effect on December 31, 2005). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB base rate. The Lloyds TSB base rate was 4.5% at December 31, 2005.

The financial covenants include a 50% cap on combined export gross sales of XPS and Pascall and days sales outstanding of less than 65 days, and the funding balance is capped at 125% of XPS and Pascall combined gross sales.

On August 26, 2005, XPS entered into an agreement with Lloyds for an unsecured cashflow loan of 300,000 British pounds sterling (approximately U.S. $516,000 based on the exchange rate in effect on December 31, 2005 payable over 12 months). The loan is structured as an overadvance on the previously negotiated 2,100,000 British pounds sterling revolving loan with Lloyds, bringing the maximum aggregate commitment on the revolving loan to 2,400,000 British pounds sterling (approximately U.S. $4,129,000 based on the exchange rate in effect on December 31, 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 TSB plus 1.9%. The Lloyds TSB base rate at December 31, 2005 was 4.5%. Lloyds TSB has sole discretion to switch the details on this overadvance account if Lloyds determines that the Company will have difficulty in meeting the specific reductions in the overadvance account.

On August 26, 2005, EEL entered into an agreement with Lloyds TSB for an unsecured term loan for 500,000 British pounds sterling (approximately U.S. $860,000 based on the exchange rate in effect on December 31, 2005). This loan is repayable in 36 consecutive monthly installments of principal and interest. The interest rate is variable and is adjusted daily based on the Lloyds TSB base rate plus 2.5%. The Lloyds TSB base rate at December 31, 2005 was 4.5%. The loan also includes financial covenants. EEL must maintain consolidated profit before taxation and interest paid and payable of no less than 500% of the consolidated interest paid and payable. Additionally, EEL must maintain consolidated profit before taxation, depreciation, amortization of goodwill and other intangibles and interest paid and payable of no less than 300% of the consolidated principal repayments and the consolidated interest paid and payable.

In the event of a default, Lloyds TSB may make the loan, including any

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

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 $1,421,000 based on the exchange rate in effect at December 31, 2005 for the conversion of euros into United States dollars. CXR-AJ also had $34,000 of term loans with two French banks outstanding as of December 31, 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 December 31, 2005, the French T4M rate was 2.26%, and this facility had a balance of $1,056,000. This facility has no financial performance covenants.

XCEL Japan Ltd ("XJL"), obtained a term loan on November 29, 2002 from Johnan Shinkin Bank. The loan is amortizable 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 December 31, 2005 was $32,000 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 $22,150,000 as of December 31, 2005 as compared to $7,720,000 as of December 31, 2004. The increase in backlog was primarily due to the addition of $7,183,000 of backlog for Pascall and $695,000 for RO. Without Pascall and RO, our backlog as of December 31, 2005 would have been $14,272,000, representing a $5,975,000 (77.4%) increase. Our backlog as of December 31, 2005

was 97.4% related to our electronic components business, which business tends to provide us with long lead-times for our manufacturing processes due to the custom nature of the products, and 2.6% related to our communications equipment business, which business tends to deliver standard products from stock as orders are received. The amount of backlog orders represents revenue that we anticipate recognizing in the future, as evidenced by purchase orders and other purchase commitments received from customers, but on which work has not yet been initiated or with respect to which work is currently in progress. However, there can be no assurance that we will be successful in fulfilling such orders and commitments in a timely manner or that we will ultimately recognize as revenue the amounts reflected as backlog.

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

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

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

On May 5, 2006, our audit committee concluded that our financial statements for the years ended December 31, 2005 and 2004 and the interim periods during 2005 and 2004 should no longer be relied upon. The audit committee reached this conclusion after having discussions with our former

independent registered public accountants and management as part of an investigation conducted by the audit committee in response to an inquiry by the staff of the Securities and Exchange Commission's Division of Enforcement. As a result of the audit committee's conclusion regarding our financial statements, on May 9, 2006, the registration statement was no longer effective. This event triggered the liquidated damages provision contained in the registration rights agreement. During the months of June through November 2006, we paid to the remaining investors liquidated damages equal to $44,064 per month for a total of $220,320.

We used a portion of the proceeds from the January 2005 private placement to fund the acquisition of Pascall. In connection with the Pascall acquisition, we loaned to EMRISE Electronics approximately $10,100,000 in cash that was used to acquire Pascall and to repay Pascall's existing intercompany debt. As described above, the Pascall purchase price is subject to upward or

downward adjustment, and accordingly we paid $237,000 to Intelek on August 1, 2005 to compensate for an upward adjustment of Pascall's net worth. We have guaranteed obligations of EMRISE Electronics in connection with the Pascall acquisition and have agreed to indemnify Pascall's former parent in connection with obligations under Pascall's facilities lease.

We used another portion of the proceeds from the January 2005 private placement to partially fund the acquisition of RO. We used $4,002,000 of cash to acquire RO, including paying down RO's bank debt of $1,602,000. In addition, we agreed to make two deferred payments of $300,000 each, the first of which we paid in October 2005, and the second of which was due on March 31, 2006. Offsetting these amounts was $35,000 received from the former RO shareholders to compensate for balance sheet adjustments.

The following table outlines payments due from us or our subsidiaries under our lines of credit and other significant contractual obligations over the next five years, exclusive of interest. All dollars are in thousands. The symbol "P" represents the prime rate, the symbol "B" represents the lender's base rate and the symbol "L" represents the 30-day LIBOR.

CONTRACTUAL OBLIGATIONS AT DECEMBER 31, 2005	PAYMENTS DUE BY PERIOD (IN THOUSANDS) 2006	2007	2008	2009	2010	THE
Line of Credit (Domestic)	$ --	$ --	$ --	$ --	$ --	$
Average Interest Rate	P+0.5%					
Line of Credit (U.K.)	$ 2,227	$ --	$ --	$ --	$ --	$
Average Interest Rate	B+2%					
Overdraft (France)	$ 1,056	$ --	$ --	$ --	$ --	$
Average Interest Rate	%					
Term Loan From Stockholders (Domestic)	$ 500	$ 500	$ 500	$ 500	$ 250	$
Average Interest Rate	P+1.5%, L+5.0%					
Capital Equipment Loan (U.S.)	$ 26	$ 26	$ 26	$ 26	$ 19	$
Average Interest Rate	L+4%					
Term Loans (U.S.)	$ 50	$ 25	$ --	$ --	$ --	$
Average Interest Rate	P+1.5%					
Term Loan (U.K.)	$ 292	$ 292	$ 195	$ --	$ --	$
Average Interest Rate	B+2%					
Term Loans (France)	$ 10	$ 10	$ 10	$ 5	$ --	$
Average Interest Rate	1.2%-5.6%					
Term Loan (Japan)	$ 17	$ 15	$ --	$ --	$ --	$
Average Interest Rate	3.25%					
Capitalized Lease Obligations	$ 116	$ 56	$ 25	$ 6	$ --	$
Operating Leases	$ 1,202	$ 1,140	$ 745	$ 551	$ 430	$
	$ 5,496	$ 2,064	$ 1,501	$ 1,088	$ 699	$

We intend to grow our business through both internal growth and further

acquisitions that we identify as being potentially both synergistic and accretive of our earnings. Any additional acquisitions would likely be funded through the use of cash and/or a combination of cash and notes.

We believe that current and future available capital resources, revenues generated from operations, and other existing sources of liquidity, including the credit facilities we currently have and expect to have with Wells Fargo Business Credit, 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:

- 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.

- 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 adopted this new standard on January 1, 2006 using the modified prospective method.

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. However, we estimate that we will record expenses relating to currently outstanding stock options of $103,000 in 2006 and $30,000 in 2007.

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 Emerging Issues Task Force 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.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Exchange Rate Sensitivity

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 affect our consolidated financial statements. Our exposure to fluctuations in currency exchange rates has increased as a result of the growth or acquisition of our international subsidiaries. However, because historically the majority of our currency exposure has related to financial statement translation rather than to particular transactions, prior to 2005 we had not entered into forward currency contracts or hedging arrangements in an effort to mitigate our currency exposure. For further information regarding our exchange rate sensitivity, see Item 7 of this report under the heading "Critical Accounting Policies - Foreign Currency Translation."

Interest Rate Sensitivity

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.

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.

We also utilized a forward currency contract denominated in British pounds sterling to offset the risk of intercompany loans to a United Kingdom subsidiary. Under this program, increases or decreases in the current portion of intercompany debt due from EEL 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 gains included in other income and expense in the accompanying consolidated statements of operations totaled $40,000 for 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.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Reference is made to the financial statements included in this report, which begin at page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

On April 13, 2006, we notified Grant Thornton LLP ("GT"), the independent registered public accounting firm that was engaged as our principal accountant to audit our consolidated financial statements, that we intended to engage new certifying accountants and thereby were terminating our relationship with GT.

Our decision to change accountants was approved by our audit committee and board of directors. The reason for the change was to allow us to engage an

alternative firm that we believe has adequate resources and experience to provide us with the auditing and tax services we require, on a more cost-effective basis.

The audit reports of GT on our consolidated financial statements and consolidated financial statement schedules as of and for the years ended December 31, 2005 and 2004 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles.

During the years ended December 31, 2005 and 2004 and the subsequent interim period through April 13, 2006, there were no disagreements with GT on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures which disagreements, if not resolved to GT's satisfaction, would have caused GT to make reference to the subject matter of the disagreement in connection with its opinion.

During the years ended December 31, 2005 and 2004 and the subsequent interim period through April 13, 2006, there were no reportable events as described in Item 304(a)(1)(v) of Regulation S-K under the Securities Act of 1933, as amended, except as described below.

- On April 5, 2005, in connection with its audit of our consolidated financial statements for the year ended December 31, 2004, GT advised our audit committee and management of two matters that GT considered to be "material weaknesses" as that term is defined under standards established by the Public Company Accounting Oversight Board (United States), or PCAOB. A material weakness is a control deficiency or combination of control deficiencies that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The first matter related to our need for additional staff with expertise in preparing required disclosures in the notes to the financial statements, and our need to develop greater internal resources for researching and evaluating the appropriateness of complex accounting principles and for evaluating the effects of new accounting pronouncements on us. Our growth during and since 2004 as a result of our acquisitions of Larus Corporation, PEHL and RO and the increased complexity surrounding our financing arrangements are major contributors to the need for additional resources in financial reporting. The second matter related to segregation of duties relating to cash disbursements. Both our assistant controller and accounts payable clerk had access to initiate the payment of invoices and print electronically signed checks. Both individuals had the ability to record transactions in the accounting system. The lack of segregation of these two functions - check-writing ability and the recording of disbursement transactions in our accounting system - represented a material weakness in the cash disbursements cycle. We considered these matters in connection with the preparation of the December 31, 2004 consolidated financial statements and also determined that no prior period financial statements were materially affected by such matters. In response to the observations made by GT, on April 7, 2005, we engaged financial consultants who are certified public accountants with the requisite background and experience to prepare required disclosures in the notes to our financial statements and to provide greater internal resources for researching and evaluating the appropriateness of complex accounting principles and for evaluating the effects that

new accounting pronouncements may have on us. In addition, we recognize that the risk of an unauthorized disbursement exists without proper segregation of duties between check-writing and record keeping. However, every month we review the listing of checks produced and research any check number that is missing or questionable. We believe this type of detective control would identify unauthorized disbursements. Additionally, on May 6, 2005, we limited the system access for those individuals performing this review such that there are appropriate mitigating controls over the incompatible duties with regard to our disbursements. We believe these steps addressed the matters raised by GT.

- On August 15, 2005, in connection with its review of our condensed consolidated financial statements for the quarter ended June 30, 2005, GT advised our management of a matter that GT considered to be a material weakness. GT 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). GT 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 No. 104. Our audit committee and management have undertaken an extensive review of SAB No. 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 No. 104 as it relates to control procedures over bill and hold matters and believe we have therefore remediated the material weakness.

- On March 28, 2006, in connection with its audit of our consolidated financial statements for the year ended December 31, 2005, GT advised our management and audit committee of two matters that GT considered to be material weaknesses. GT indicated that in the area of accounting and financial reporting, it believes we have insufficient accounting resources to enable us to identify and evaluate complex accounting and reporting matters. In addition, GT recommended that we establish procedures to ensure that our Chief Financial Officer can more closely monitor information submitted to our corporate headquarters by our subsidiary controllers and oversee accounting for reserves and other areas that involving significant judgment at all company locations. GT also recommended that we establish procedures to ensure that personnel familiar with accounting principles generally accepted in the United States and with Commission disclosure requirements thoroughly evaluate activities and transactions at all company locations in order to determine that we are timely making all required disclosures. To remediate this material weakness in the area of accounting and financial reporting, we intend to seek additional guidance from our financial consultants, who are certified public accountants with the requisite background and experience, and from our newly appointed Director of Financial Controls for Europe, to assist us in identifying and evaluating complex accounting and reporting matters. In addition,

we intend to increase the frequency at which our Chief Financial Officer and our Director of Financial Controls for Europe visit and hold conference calls with accounting personnel and managers at each of our company locations. Also, we intend to define internal processes for identifying and disclosing non-routine and other transactions as required by Commission disclosure requirements and for researching and determining proper accounting treatment for those transactions. We plan to assign individuals with appropriate knowledge and skills to perform these processes and plan to provide those individuals with adequate technical resources to help ensure timely disclosure of the transactions and proper application of accounting principles generally

accepted in the United States. We plan to develop procedures to document all non-routine transactions each quarter, including support for the final accounting treatment, and require the assigned individuals to review the documentation with our Chief Financial Officer and/or Director of Financial Controls for Europe prior to finalizing our quarterly and annual financial statements. GT also indicated that we need to improve our controls over inventory reserves. GT noted that some items that were in our inventory reserve earlier in 2005 were not present in the year-end reserve, although those items remained in inventory at year end. Current accounting guidance would have required us to include in our year-end reserve all items that were included in the inventory reserve earlier in 2005, despite the fact that we no longer viewed those items as slow moving. Our failure to continue to include those items in the inventory reserve resulted in a material audit adjustment. In addition, GT determined that inventory reserves in our CXR-AJ location were understated at year-end, resulting in an additional audit adjustment. To remediate this material weakness with regard to our controls over inventory reserves, we will adjust the procedures we use to compute inventory reserves to ensure that items that are included in inventory reserves are not removed from inventory reserves until a sale or disposal of those items occurs.

On April 17, 2006, we engaged Hein & Associates LLP ("Hein") as our new certifying accountants. We have not consulted with Hein in the past regarding the application of accounting principles to a specified transaction or the type of audit opinion that might be rendered on our financial statements or as to any disagreement or reportable event as described in Item 304(a)(1)(iv) and Item 304(a)(1)(v).

On April 18, 2006, we provided GT with a copy of the disclosures we planned to make in response to Item 304(a) of the Securities Act. We requested that GT furnish us with a letter addressed to the Securities and Exchange Commission stating whether GT agrees with the statements we made in response to Item 304(a) and, if not, stating the respects in which it does not agree. A copy of GT's letter is attached as Exhibit 16.1 to our Form 8-K filed with the Commission on April 19, 2006.

ITEM 9A. CONTROLS AND PROCEDURES.

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

We conducted an evaluation, with the participation of our Chief Executive Officer and Acting Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined

in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, as of December 31, 2005, to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities Exchange Commission's rules and forms, including to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on that evaluation, our Chief Executive Officer and Acting Chief Financial Officer has concluded that as of December 31, 2005, our disclosure controls and procedures were not effective at the reasonable assurance level due to the material weaknesses described below.

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

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

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

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

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

REMEDIATION OF MATERIAL WEAKNESS

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

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

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

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

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

Controller, as planned, management may hire outside consultants to assist us in satisfying our financial reporting obligations.

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

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

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

The changes noted above, specifically, the changes relating to our (i) efforts to locate suitable candidates for the positions of Chief Financial Officer and Controller, (ii) engaging of financial consultants who are certified public accountants to assist us in identifying and evaluating complex accounting and reporting matters, (iii) new internal processes for identifying and disclosing both routine and non-routine transactions and for researching and determining proper accounting treatment for those transactions, and (iv) assignment of individuals to perform these processes and provision to those individuals of technical and other resources to help ensure the proper application of accounting principles and the timely and appropriate disclosure of routine and non-routine transactions, are the only changes during our most recently completed fiscal quarter that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act.

ITEM 9B. OTHER INFORMATION.

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

DIRECTORS AND EXECUTIVE OFFICERS

The names, ages and positions held by our directors and executive officers as of November 30, 2006 are as follows:

NAME	AGE	POSITIONS HELD
Carmine T. Oliva.......................	64	Chairman of the Board, President, Chief Execu Acting Chief Financial Officer, Secretary and
Graham Jefferies.......................	49	Executive Vice President, Chief Operating Off Director of various subsidiaries
Laurence P. Finnegan, Jr. (1)(2)(3)....	69	Director
Otis W. Baskin (1)(2)(3)...............	61	Director
Richard E. Mahmarian (2)(3)............	69	Director

----
(1) Member of the compensation committee.
(2) Member of the nominating committee.
(3) Member of the audit committee.

CARMINE T. OLIVA has been Chairman of the Board, President and Chief Executive Officer and a Class III director of EMRISE since March 26, 1997 and of our subsidiary, EMRISE Electronics, since he founded EMRISE Electronics in 1983. Mr. Oliva has been Acting Chief Financial Officer and Secretary of EMRISE since August 18, 2006 and served as Acting Chief Financial Officer from April to July 2005. Mr. Oliva has been Chairman of the Board of XCEL Corporation, Ltd. since 1985, and Chairman and Chief Executive Officer of CXR Larus since March 1997. In 2002, Mr. Oliva obtained a French government working permit and assumed responsibility as President of our CXR-AJ subsidiary. From January 1999 to January 2000, Mr. Oliva served as a director of Digital Transmission Systems Inc. (DTSX), a publicly held company based in Norcross, Georgia. From 1980 to 1983, Mr. Oliva was Senior Vice President and General Manager, ITT Asia Pacific Inc. Prior to holding that position, Mr. Oliva held a number of executive positions with ITT Corporation and its subsidiaries over an eleven-year period. Mr. Oliva attained the rank of Captain in the United States Army and is a veteran of the Vietnam War. Mr. Oliva earned a B.A. degree in Social Studies from Seton Hall University and an M.B.A. degree in Business from The Ohio State University.

GRAHAM JEFFERIES was appointed as Executive Vice President on October 21, 1999. Mr. Jefferies was also appointed as our Chief Operating Officer on January 3, 2005, after having served as Chief Operating Officer of our Telecommunications Group since October 21, 1999. Mr. Jefferies served as Executive Vice President of EMRISE from April 1999 through October 1999. Mr. Jefferies has served CXR-AJ as a director since March 1997 and as General Manager since July 2002, has served as Managing Director of Belix Power Conversions Ltd., Belix Wound Components Ltd. and Belix Company Ltd. since our acquisition of those companies in April 2000, as Managing Director of XCEL Power Systems, Ltd. since September 1996 and as Managing Director of XCEL Corporation, Ltd. since March 1992. Prior to joining us in 1992, he was Sales and Marketing Director of Jasmin Electronics PLC, a major United Kingdom software and systems provider, from 1987 to 1992. Mr. Jefferies held a variety of project management positions at GEC Marconi from 1978 to 1987. Mr. Jefferies earned a B.S. degree in Engineering from Leicester University, and has experience in mergers and acquisitions. Mr. Jefferies is a citizen and resident of the United Kingdom.

LAURENCE P. FINNEGAN, JR. has served as a Class II director since March 26, 1997. In addition to being a director of EMRISE Electronics from 1985 to March 1997, Mr. Finnegan was EMRISE Electronics' part-time Chief Financial Officer from 1994 to 1997. Mr. Finnegan has held positions with ITT (1970-1974) as controller of several divisions, Narco Scientific (1974-1983) as Vice President Finance, Chief Financial Officer, Executive Vice President and Chief Operating Officer, and Fischer & Porter (1986-1994) as Senior Vice President, Chief Financial Officer and Treasurer. Since August 1995, he has been a principal of GwynnAllen Partners, Bethlehem, Pennsylvania, an executive management consulting firm. Since December 1996, Mr. Finnegan has been a director and the President of GA Pipe, Inc., a manufacturing company based in Langhorne, Pennsylvania. From September 1997 to January 2001, Mr. Finnegan served as Vice President Finance and Chief Financial Officer of QuestOne Decision Sciences, an efficiency consulting firm based in Pennsylvania. Since August 2001, Mr. Finnegan has served as a director and the Vice President and Chief Financial Officer of VerdaSee Solutions, Inc., a consulting and software company based in Pennsylvania. Mr. Finnegan earned a B.S. degree in Accounting from St. Joseph's University.

OTIS W. BASKIN has served as a Class I director since February 6, 2004. He has been a Professor of Management at The George L. Graziadio School of Business and Management at Pepperdine University in Malibu, California since June 1995 and also served as dean from 1995 to 2001. He has been a member of the full-time faculty of the University of Houston - Clear Lake (1975-87) where he served as Coordinator of the Management Faculty and Director of the Center for Advanced Management Programs. He has also been Professor of Management at Arizona State University, West Campus (1987-91) and The University of Memphis (1991-95), in addition to serving as dean at both universities. Dr. Baskin worked with AACSB International (Association for the Advancement of Collegiate Schools of Business) as Special Advisor to the President and as Chief Executive Officer from July 2002 to June 2004. He is an Associate with the Family Business Consulting Group, where he advises family owned and closely held businesses. He has served as an advisor to Exxon/Mobile Research and Engineering Corporation, NASA and the United States Air Force. He earned a Ph.D. in Management, Public Relations and Communication Theory from The University of Texas at Austin, an M.A. degree in Speech Communication by the University of Houston, and a B.A. degree in Religion from Oklahoma Christian University.

RICHARD E. MAHMARIAN was appointed as a Class III director on March 1, 2006. He has served as a principal and Chairman, President and Chief Executive Officer of Control Solutions, Inc., a company that specializes in providing business systems including hardware, software, consumable products and services to major U.S. corporations, since December 2003. Mr. Mahmarian also has served as managing member and Chairman and Chief Executive Officer of REM Associates, LLC, a private investment and consulting company, since 1997. Mr. Mahmarian also owns R&R Palos Verdes Enterprises, Inc., a home construction company in the south bay area of Los Angeles, California, which was started in 1997. From 1998 until 2001, Mr. Mahmarian was the owner of Alpha Microsystems, LLC, a company that manufactured and sold mini-computer systems, personal computers and servers, provided network services and support, and information technology hardware and software services throughout North America through 50 field offices. He served in the U.S. Navy and was honorably discharged. While in the Navy, he received extensive training in advanced electronic technologies. Mr. Mahmarian earned a B.A. degree in Accounting from Upsala College and an M.B.A. in Marketing and Economics from Seton Hall University.

Our business, property and affairs are managed under the direction of our board. Directors are kept informed of our business through discussions with our executive officers, by reviewing materials provided to them and by participating in meetings of our board and its committees.

Our bylaws provide that our board of directors shall consist of at least four directors. Our board is divided into three classes of directors: Class I, Class II and Class III. The term of office of each class of directors is three years, with one class expiring each year at our annual meeting of stockholders. We currently have four directors on our board, with no vacancies. Our current board consists of one Class I director whose term expires at our 2006 annual meeting, one Class II director whose term expires at our 2007 annual meeting, and two Class III directors whose term expires at our 2008 annual meeting.

Our officers are appointed by and serve at the discretion of our board of directors. There are no family relationships among our executive officers and directors.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), requires our executive officers and directors, and persons who beneficially own more than 10% of a registered class of our common stock, to file initial reports of ownership and reports of changes in ownership with the Commission. These officers, directors and stockholders are required by the Commission regulations to furnish us with copies of all reports that they file.

Based solely upon a review of copies of the reports furnished to us during the year ended December 31, 2005 and thereafter, or any written representations received by us from directors, officers and beneficial owners of more than 10% of our common stock ("reporting persons") that no other reports were required, we believe that, during 2005, all Section 16(a) filing requirements applicable to our reporting persons were met.

CODE OF ETHICS

Our board of directors has adopted an Amended and Restated Code of Business Conduct and Ethics that applies to all of our directors, officers and employees and an additional Code of Business Ethics that applies to our Chief Executive Officer and senior financial officers. We filed copies of these codes as exhibits to our annual report on Form 10-K for the year ended December 31, 2005.

We intend to satisfy the disclosure requirement under Item 5.05 of Form 8-K relating to amendments to or waivers from provision of these codes that relate to one or more of the items set forth in Item 406(b) of Regulation S-K, by describing on our Internet website, located at http://www.emrise.com, within four business days following the date of a waiver or a substantive amendment, the date of the waiver or amendment, the nature of the amendment or waiver, and the name of the person to whom the waiver was granted.

Information on our Internet website is not, and shall not be deemed to be, a part of this report or incorporated into any other filings we make with the Commission.

ITEM 11. EXECUTIVE COMPENSATION.

COMPENSATION OF EXECUTIVE OFFICERS

The following table provides information concerning the annual and long-term compensation for the years ended December 31, 2005, 2004 and 2003 earned for services in all capacities as an employee by our Chief Executive Officer and each of our other executive officers who received an annual salary and bonus of more than $100,000 for services rendered to us during that period (collectively, the "named executive officers"). Mr. Foote resigned his position on August 18, 2006.

SUMMARY COMPENSATION TABLE

		ANNUAL COMPENSATION		LONG-TERM COMPENSATION AWARD
NAME AND PRINCIPAL POSITION	YEAR	SALARY	BONUS	SECURITIES UNDERLYING OPTIONS
Carmine T. Oliva .... President, Chief Executive Officer, Acting Chief Financial Officer and Secretary	2005	$350,000	$ --	50,000
	2004	$309,000	$ 94,000	26,000
	2003	$271,510	$ 70,000	53,000
Graham Jefferies .... Executive Vice President and Chief Operating Officer (2)	2005	$245,769	$ --	50,000
	2004	$237,017	$ 71,000	40,000
	2003	$210,295	$ 55,000	54,000
Randolph D. Foote...................... Former Senior Vice President, Chief Financial Officer and Secretary	2005	$170,920	$ --	50,000
	2004	$173,867	$ 40,000	25,000
	2003	$157,230	$ 30,000	35,000

----

(1) Represents the dollar value of insurance premiums we paid with respect to a $1,000,000 term life insurance policy for the benefit of Mr. Oliva's spouse.

(2) Mr. Jefferies is based in the United Kingdom and receives his remuneration in British pounds sterling. The compensation amounts listed for Mr. Jefferies are shown in United States dollars, converted from British pounds sterling using the average conversion rates in effect during the time periods of compensation. Mr. Jefferies served as Chief Operating Officer of our Telecommunications Group until he was appointed Chief Operating Officer of EMRISE in January 2005.

(3) Represents company contributions to Mr. Jefferies' retirement account.

(4) Represents company contributions to Mr. Foote's 401(k) retirement account.

RETIREMENT ACCOUNT MATCHING CONTRIBUTIONS

We matched up to the lesser of $2,000 and 20% of Mr. Foote's contributions to his 401(k) account. During 2005, 2004 and 2003, our matching contributions amounted to $2,117, $1,965 and $1,886, respectively. This matching arrangement was generally made available to all employees of EMRISE Corporation and provides for the same method of allocation of benefits between management and non-management participants.

Also, XPS makes matching contributions of up to 6% of Mr. Jefferies' salary to an executives' defined contribution plan. Other employees of XPS may receive matching contributions to a defined contribution plan of up to 4% of their salary. Amounts contributed to the defined contribution plans are intended to used to purchase annuities upon retirement. During 2005, 2004 and 2003, Mr. Jefferies received matching contributions of $14,037, $10,924 and $10,320, respectively.

OPTION GRANTS IN LAST FISCAL YEAR

The following table provides information regarding options granted in the year ended December 31, 2005 to the named executive officers. We did not grant any stock appreciation rights during 2005. This information includes hypothetical potential gains from stock options granted in 2005. These hypothetical gains are based entirely on assumed annual growth rates of 5% and 10% in the value of our common stock price over the ten-year life of the stock options granted in 2005. These assumed rates of growth were selected by the Commission for illustrative purposes only and are not intended to predict future stock prices, which will depend upon market conditions and our future performance and prospects.

NAMED OFFICER	GRANT DATE	NUMBER OF SECURITIES UNDERLYING OPTIONS GRANTED(1)	PERCENTAGE OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN FISCAL YEAR(2)	EXERCISE PRICE PER SHARE	EXPIRATION DATE	-
Carmine T. Oliva.......	12/30/05	50,000	0.7%	$2.00	12/29/15	$
Graham Jefferies.......	12/30/05	50,000	0.7%	$2.00	12/29/15	$
Randolph D. Foote......	12/30/05	50,000	0.7%	$2.00	12/29/15	$

----

(1) Options vested on the date of grant.
(2) Based on options to purchase 725,000 shares granted to our employees during 2005.
(3) Calculated using the potential realizable value of each grant.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES

The following table provides information regarding the value of unexercised options held by the named executive officers as of December 31, 2005. None of the named executives officers acquired shares through the exercise of options during 2005.

NAME	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS AT DECEMBER 31, 2005		VALUE ($) IN-THE-MON DECEMBER
	EXERCISABLE	UNEXERCISABLE	EXERCISABLE

Carmine T. Oliva..................	216,000	13,000	141,000
Graham Jefferies..................	214,000	20,000	135,000
Randolph D. Foote.................	147,500	12,500	96,000

----

(1) Based on the last reported sale price of our common stock of $1.34 on December 30, 2005 (the last trading day during 2005) as reported on ArcaEx(R), less the exercise price of the options.

61

EMPLOYMENT CONTRACTS AND TERMINATION OF EMPLOYMENT AND CHANGE-IN-CONTROL ARRANGEMENTS

CARMINE T. OLIVA

On February 24, 2006, we executed a five-year employment agreement with Carmine T. Oliva, our Chairman of the Board, President and Chief Executive Officer. The agreement is effective as of January 1, 2006, and replaces his previous employment agreement that was scheduled to automatically renew on that date. The agreement provides for an initial base salary of $350,000 during the first twelve months the agreement is in effect. Mr. Oliva is eligible to receive increases and bonuses at the discretion of our compensation committee and to participate in benefit and incentive programs we may offer.

If we terminate Mr. Oliva's employment for due cause or due to Mr. Oliva's breach of the agreement by refusing to continue his employment, our obligation to pay any further compensation, severance allowance, or other amounts payable under the agreement terminates on the date of termination, other than benefits under retirement and benefit plans and programs that are earned and vested by the date of termination, pro rata annual salary through the date of termination, any stock options that have vested as of the date of termination, and accrued vacation as required by California law. "Due cause" includes any intentional misapplication of our funds or other material assets, or any other act of dishonesty injurious to us, or conviction of a felony or a crime involving moral turpitude. "Due cause" also includes abuse of controlled substances or alcohol and breach, nonperformance or nonobservance of any of the terms of the agreement, provided that Mr. Oliva fails to satisfactorily remedy the performance problem following 90 days' written notice.

We may terminate Mr. Oliva's employment immediately upon written notice to him. Mr. Oliva may terminate the agreement at any time for good reason within 30 days after he learns of the event or condition constituting good reason. "Good reason" includes: changes in Mr. Oliva's position, duties, responsibilities, titles or status; a reduction in his base salary to an amount less than the greater of $350,000 or 10% below the base salary in effect at the time of the reduction; our failure to continue in effect benefits required under the agreement, to obtain the assumption of the agreement by any successor or assign, or to timely cure any material breach after Mr. Oliva gives us written notice; a material reduction in support services, staff, office space and accouterments which reduction is not generally effective for all officers; or if we avail ourselves of or are subjected by any third party to any other proceeding involving insolvency or the protection of or from creditors and the proceeding is not discharged or terminated within 90 days.

If Mr. Oliva's service terminates without due cause or for good reason prior to the expiration of the agreement on January 1, 2011, Mr. Oliva will be

entitled to his salary through the end of the month in which termination occurs plus credit for accrued vacation, a severance payment equal to three times his then current annual salary, net of taxes, a prorated incentive bonus, if any, for the fiscal year during which termination occurs, and all medical and life insurance benefits to which he was entitled immediately prior to the date of termination (or at the election of Mr. Oliva in the event of a change in control, immediately prior to the date of the change in control) for a period of three years or the date or dates that Mr. Oliva's continued participation in our medical and/or life insurance plans is not possible under the plans, whichever is earlier. If our medical and/or life insurance plans do not allow Mr. Oliva's continued participation, then we are required to pay to Mr. Oliva, in monthly installments, the monthly premium or premiums that had been payable by us covering the three-year period.

A "change in control" includes: a consolidation or merger in which we are not the surviving corporation or pursuant to which all or substantially all of our common stock would be converted into cash, securities or other property, other than a merger in which the holders of our common stock immediately prior to the merger have the same proportionate ownership of common stock of the surviving corporation immediately after the merger; a sale, lease, exchange or other transfer (in one transaction or a series of related transactions) of all,

or substantially all, of our assets; stockholder approval of any plan or proposal for liquidation or dissolution; any person other than persons who were stockholders on January 1, 2006, becomes the beneficial owner of 50% or more of our outstanding common stock; during any period of two consecutive years, individuals who at the beginning of such period constitute the entire board cease to constitute a majority of the board unless the election, or the nomination for election by our stockholders, of each new director was approved by a vote of at least two-thirds of the directors then still in office who were directors at the beginning of the period; or there is any change of control of a nature required to be reported in response to Item 6 (e) of Schedule 14A under the Exchange Act.

If Mr. Oliva becomes mentally or physically incapable of performing the services required under the agreement for a period of 240 consecutive days, and the incapacity is confirmed by the written opinion of two practicing medical doctors, we may terminate Mr. Oliva's employment under the agreement upon 30 days' prior written notice. Upon Mr. Oliva's death, the agreement will terminate immediately. If Mr. Oliva's employment is terminated due to his incapacity or death, Mr. Oliva or his estate or legal representative will be entitled to receive benefits under our retirement and benefits plans and programs that are earned and vested at the date of termination, a prorated incentive bonus for the fiscal year in which incapacity or death occurs, and Mr. Oliva's annual salary then in effect for one year following the date of termination, offset, however, by any payments received by Mr. Oliva as a result of any disability insurance maintained by us for Mr. Oliva's benefit.

The agreement contains non-competition provisions that prohibit Mr. Oliva from engaging or participating in a competitive business or soliciting our customer or employees during his employment with us and for two years afterward. The agreement also contains provisions that restrict disclosure by Mr. Oliva of our confidential information and assign ownership to us of inventions created by him in connection with his employment.

RANDOLPH D. FOOTE

On February 24, 2006, we entered into a two-year employment agreement with Randolph D. Foote, our Senior Vice President, Chief Financial Officer and Secretary. The agreement was effective as of January 1, 2006 and replaced his existing employment agreement that was scheduled to expire in July 2006. The agreement provided for an initial base salary of $175,000 during the first twelve months the agreement is in effect. Mr. Foote was eligible to receive increases and bonuses at the discretion of our compensation committee and to participate in other benefit and incentive programs we may offer.

On August 18, 2006, Mr. Foote, our then Senior Vice President, Chief Financial Officer and Secretary, resigned from those positions, and all positions with EMRISE's subsidiaries. In connection with his resignation, we and Mr. Foote entered into a Resignation and Separation Agreement, which became effective on August 25, 2006. Under the agreement, Mr. Foote resigned all of his positions and, we and Mr. Foote jointly terminated his employment agreement dated effective as of January 1, 2006. The agreement provides that effective as of August 21, 2006, Mr. Foote will be assigned to temporary employment with us, which the parties anticipate will terminate by approximately December 31, 2006 (the "Employment Separation Date"). During the time of his temporary employment, Mr. Foote will assist us in, among other things, the preparation of our restated financial statements and our filings with the Securities and Exchange Commission and will continue to receive his base salary and employment benefits (other than paid vacation benefits, bonus or incentive compensation).

After the Employment Separation Date, Mr. Foote will continue to provide reasonable cooperation and assistance to us on an as-needed basis during the 12-month period following the Employment Separation Date in consideration of the following payments: (i) a total gross amount of $182,200 during such period, payable in equal periodic amounts on our regular pay dates, and (ii) reimbursement of Mr. Foote's health plan benefit provisions during the 12-month period.

GRAHAM JEFFERIES

On February 24, 2006, we entered into a three-year employment agreement with Graham Jefferies, our Executive Vice President and Chief Operating Officer. The agreement is effective as of January 1, 2006, and replaces his previous employment agreement that was scheduled to expire in July 2006. The agreement provides for an initial base salary of 152,800 British pounds sterling per year (approximately U.S. $263,350 as of January 1, 2006) during the first twelve months that the agreement is in effect, which amount is to be paid by our subsidiary, EEL. Mr. Jefferies is eligible to receive increases and bonuses at the discretion of our compensation committee and to participate in other benefit and incentive programs we may offer.

If Mr. Jefferies' employment terminates for due cause or due to Mr. Jefferies' breach of the agreement by refusing to continue his employment, our obligation to pay any further compensation, severance allowance, or other amounts payable under the agreement terminates on the date of termination, other than benefits under retirement and benefit plans and programs that are earned and vested by the date of termination, Mr. Jefferies' pro rata annual salary through the date of termination, any stock options that have vested as of the date of termination, and accrued vacation as required by applicable law.

We may terminate Mr. Jefferies' employment immediately upon written

notice. Mr. Jefferies may terminate the agreement at any time for good reason within 30 days after Mr. Jefferies learns of the event or condition constituting good reason. If termination without due cause by us or for good reason by Mr. Jefferies occurs prior to the expiration of the agreement on January 1, 2009, Mr. Jefferies will be entitled to his salary through the end of the month during which the termination occurs plus credit for accrued vacation, a severance payment in an amount equal to two times his then current annual salary, net of applicable taxes, a prorated incentive bonus, if any, for the fiscal year during which termination occurs, and all medical and life insurance benefits to which Mr. Jefferies was entitled immediately prior to the date of termination (or at the election of Mr. Jefferies in the event of a change in control, immediately prior to the date of the change in control) for a period of two years or the date or dates that Mr. Jefferies' continued participation in our medical and/or life insurance plans is not possible under the plans, whichever is earlier. If our medical and/or life insurance plans do not allow Mr. Jefferies' continued participation, then we will be obligated to pay to Mr. Jefferies, in monthly installments, the monthly premium or premiums that had been payable by us covering the two-year period.

If Mr. Jefferies becomes mentally or physically incapable of performing the services required under the agreement for a period of 180 consecutive days, the agreement will terminate; provided, however, that Mr. Jefferies will remain an employee of EEL. and will be entitled to remuneration in an amount equal to the amount paid under EEL's permanent health scheme, subject to the paragraph immediately below. Upon Mr. Jefferies' death, the agreement will terminate immediately.

If Mr. Jefferies' employment is terminated due to his incapacity or death, Mr. Jefferies or his estate or legal representative will be entitled to receive benefits under retirement and benefits plans and programs that are earned and vested at the date of termination, a prorated incentive bonus for the fiscal year in which incapacity or death occurs, and Mr. Jefferies' annual salary then in effect for one year following the date of termination, offset by any payments received by Mr. Jefferies as a result of any permanent insurance scheme maintained by us for Mr. Jefferies' benefit.

The agreement contains non-competition provisions that prohibit Mr. Jefferies from engaging or participating in a competitive business or soliciting our customer or employees during his employment with us and for two years afterward. The agreement also contains provisions that restrict disclosure by Mr. Jefferies of our confidential information and assign ownership to us of inventions created by Mr. Jefferies in connection with his employment.

The terms "due cause," "good reason" and "change in control" have the same meanings as in Mr. Oliva's employment agreement described above.

BOARD COMMITTEES

Our board of directors currently has an audit committee, a compensation committee and a nominating committee.

The audit committee selects our independent auditors, reviews the results and scope of the audit and other services provided by our independent auditors, reviews our financial statements for each interim period and for our year end and our internal financial and accounting controls, and recommends, establishes and monitors our disclosure controls and procedures. From March 22,

2004 to May 24, 2005, the audit committee consisted of Messrs. Finnegan and Baskin. From May 25, 2005 until December 21, 2005, the audit committee consisted of Messrs. Finnegan, Baskin and Runyon. Following Mr. Runyon's departure from our board of directors on December 21, 2005, the audit committee consisted of Messrs. Finnegan and Baskin, with Mr. Finnegan continuing as chairman. Mr. Mahmarian was appointed as the third member of the audit committee when he joined our board on March 1, 2006. The audit committee held four meetings during 2005. Our board of directors has determined that Messrs. Finnegan and Mahmarian are audit committee financial experts. The audit committee operates pursuant to a charter approved by our board of directors and audit committee, according to the rules and regulations of the Commission. A copy of the charter was attached as Appendix A to our definitive proxy statement for our 2005 annual meeting of stockholders.

The compensation committee is responsible for establishing and administering our policies involving the compensation of all of our executive officers and establishing and recommending to our board of directors the terms and conditions of all employee and consultant compensation and benefit plans. Our entire board of directors also may perform these functions with respect to our employee stock option plans. From January 1, 2005 until December 21, 2005, this committee consisted of Messrs. Runyon and Finnegan. Since December 21, 2005, the committee has consisted of Messrs. Finnegan and Mr. Baskin, with Mr. Baskin serving as chairman. The compensation committee held two meetings and took action by written consent on one occasion during 2005. The compensation committee operates pursuant to a charter approved by our board of directors and compensation committee. A copy of the charter was attached as Appendix B to the proxy statement for our 2005 annual meeting of stockholders.

The nominating committee recommends nominees to the board of directors and committees of the board of directors, develops and recommends to the board of directors corporate governance principles, and oversees the evaluation of the board of directors and management. From January 1, 2005 until December 21, 2005, the nominating committee consisted of Mr. Runyon. Since December 21, 2005, the nominating committee has consisted of Mr. Finnegan and Mr. Baskin, with Mr. Finnegan serving as chairman. The nominating committee held two meetings and took action by written consent on one occasion during 2005. The nominating committee utilizes a variety of methods for identifying and evaluating nominees for director, including candidates that may be referred by stockholders.

The nominating committee will consider candidates for director recommended by any stockholder that is the beneficial owner of shares representing more than 1.0% of the then-outstanding shares of our common stock and that has beneficially owned those shares for at least one year. The nominating committee will evaluate those recommendations by applying its regular nominee criteria and considering the additional information described in the

nominating committee's below-referenced charter. Stockholders that desire to recommend candidates for the board for evaluation may do so by contacting EMRISE Corporation in writing, identifying the potential candidate and providing background and other information in the manner described in the nominating committee's charter. Candidates may also come to the attention of the nominating committee through current board members, professional search firms and other persons. In evaluating potential candidates, the nominating committee will take into account a number of factors, including, among others, the following:

- independence from management;

- depth of understanding of technology, manufacturing, sales and marketing, finance and/or other elements directly relevant to the technology and business of our company;
- education and professional background;
- judgment, skill, integrity and reputation;
- existing commitments to other businesses as a director, executive or owner;
- personal conflicts of interest, if any; and
- the size and composition of the board of directors.

In addition, prior to nominating a sitting director for re-election at an annual meeting of stockholders, the nominating committee considers the director's past attendance at, and participation in, meetings of the board of directors and its committees and the director's formal and informal contributions to their respective activities.

The nominating committee operates pursuant to a charter approved by our board of directors and nominating committee. A copy of the charter was attached as Appendix C to the definitive proxy statement for our 2005 annual meeting of stockholders.

Our board of directors has determined that each of Messrs. Baskin, Finnegan and Mahmarian is independent under Rule 5.3(k) of the NYSE Arca Equities Rules because none of those directors has, or during the past three years has had, a material relationship with us, either directly or as a partner, stockholder or officer of an organization that has a relationship with us, and none of those directors is disqualified from being deemed independent under any of subparagraphs (A)-(F) of Rule 5.3(k)(1) of the NYSE Arca Equities Rules. Our board of directors has also determined that each of member of the audit committee is independent under Rule 10A-3(b)(1) of the Securities and Exchange Commission.

Under the NYSE Arca Equities Rules, the non-management members of our board of directors must meet at regularly scheduled executive sessions without management, with a non-management director presiding over each executive session. A presiding director for each session is selected by the board members in attendance at the session based upon the topics to be discussed at the session. The non-management directors can be contacted by calling the Chairman of the Audit Committee. Further, if the non-management directors include directors who are not independent, then we should at least once a year schedule an executive session including only independent directors.

Our corporate governance guidelines, charters of the audit, compensation and nominating committees, and our code of business conduct and ethics is included on our website. The foregoing information is also available in print to any stockholder who requests it.

Under the NYSE Arca Equities Rules we must disclose if any member of our nominating committee or compensation committee is not independent.

COMPENSATION OF DIRECTORS

Each non-employee director is entitled to receive $1,000 per month as compensation for his services. In addition, each board member chairing a standing committee is entitled to receive $500 per month as compensation for his services. We reimburse all directors for out-of-pocket expenses incurred in connection with attendance at board and committee meetings. We may periodically award options or warrants to our directors under our existing option and incentive plans. On December 30, 2005, we granted to each of Messrs. Baskin and Finnegan a fully-vested ten-year option to purchase up to 35,000 shares of our common stock at an exercise price of $2.00 per share. On April 16, 2006, we granted to Mr. Mahmarian an option to purchase 50,000 shares of our common stock at an exercise price of $1.00 per share. The option vests in two equal installments of 25,000 shares on October 17, 2006 and April 17, 2007.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

From January 1, 2005 until December 21, 2005, the compensation committee consisted of Messrs. Runyon and Finnegan. Since December 21, 2005, the committee has consisted of Messrs. Finnegan and Mr. Baskin. No member of the board of directors has a relationship that would constitute an interlocking relationship with executive officers and directors of another entity.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

BENEFICIAL OWNERSHIP TABLE

Except as otherwise indicated in the related footnotes, the following table sets forth information with respect to the beneficial ownership of our common stock as of November 30, 2006, by:

- each person known by us to beneficially own more than 5% of the outstanding shares of our common stock;

- each of our directors;

- each of the current executive officers named in the summary compensation table contained in the "Management" section of this report; and

- all of our directors and executive officers as a group.

Beneficial ownership is determined in accordance with the rules of the Commission, and includes voting or investment power with respect to the securities. To our knowledge, except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table below have sole voting and investment power with respect to all shares of common stock shown as beneficially owned by them. Except as indicated in the discussion of contractual beneficial ownership limitations below and except as indicated in the footnotes to the principal stockholders table below, shares of common stock underlying derivative securities, if any, that currently are exercisable or convertible or are scheduled to become exercisable or convertible for or into shares of common stock within 60 days after the date of the table are deemed to be outstanding in calculating the percentage ownership of each listed person or group but are not deemed to be outstanding as to any other person or group. Percentage of beneficial ownership is based on 38,081,750 shares of common stock outstanding as of the date of the table.

The warrants described in the footnotes to the table contain provisions limiting the exercise of the warrants to the extent necessary to insure that following the exercise, the total number of shares of common stock then beneficially owned by the warrant holder and its affiliates and others whose beneficial ownership would be aggregated with the holder's for purposes of Section 13(d) of the Exchange Act does not exceed 9.999% of the total number of then issued and outstanding shares of our common stock (including for such purpose the shares of common stock issuable upon such exercise or call). The 9.999% beneficial ownership limitation may not be waived. However, the beneficial ownership limitation does not preclude a holder from exercising a warrant and selling the shares underlying the warrant in stages over time where each stage does not cause the holder and its affiliates to beneficially own shares in excess of the limitation amount.

The address of each of the following stockholders, unless otherwise indicated in the footnotes to the table, is c/o EMRISE Corporation, 9485 Haven Avenue, Suite 100, Rancho Cucamonga, California 91730. Messrs. Oliva, Finnegan, Baskin, and Mahmarian are directors of EMRISE Corporation. Messrs. Oliva and Jefferies are executive officers of EMRISE Corporation.

NAME OF BENEFICIAL OWNER	AMOUNT AND NATURE OF BENEFICIAL OWNERSHIP
Carmine T. Oliva	1,398,305(1)
Laurence P. Finnegan, Jr.	260,171(2)
Otis W. Baskin	90,000(3)
Richard E. Mahmarian	35,000(4)
Graham Jefferies	237,276(5)
Austin W. Marxe and David M. Greenhouse	4,153,288(6)
Jon D. Gruber	2,387,650(7)
All executive officers and directors as a group (5 persons)	2,020,752(8)

---

* Less than 1.00%

(1) Includes 81,889 shares held individually by Mr. Oliva's spouse, and 229,000 shares underlying options.

(2) Includes 216,000 shares underlying options.

(3) Includes 85,000 shares underlying options.

(4) Includes 25,000 shares underlying options.

(5) Includes 234,000 shares underlying options.

(6) Based on share beneficial ownership information contained in a Form 4 filed September 29, 2006, in which Austin W. Marxe and David M. Greenhouse, the controlling principals of AWM Investment Company, Inc. ("AWM"). AWM serves as the general partner of MGP Advisers Limited Partnership, the general partner of and investment advisor to Special Situations Fund III QP, L.P. Messrs. Marxe and Greenhouse share sole voting and investment power over 4,153,288 shares of common stock owned by Special Situation Fund III QP, L.P. The address for Messrs. Marxe and Greenhouse is 527 Madison Avenue, Suite 2600, New York, New York 10022.

(7) Based on share beneficial ownership information contained in a Schedule 13G filed February 3, 2006, in which Mr. Gruber reported that he is a member of a group that includes Gruber and McBaine Capital Management, LLC, Jon D. Gruber, J. Patterson McBaine and Eric B. Swergold, each of whom shares voting and dispositive power over 1,764,900 outstanding shares and 337,500 shares underlying warrants. Also includes an additional 285,250 shares over which Mr. Gruber reports sole voting and dispositive

power. The address for Mr. Gruber is 50 Osgood Place, Penthouse, San Francisco, California 94133.

(8) Includes 789,000 shares underlying options and 81,889 outstanding shares held individually by Mr. Oliva's wife.

EQUITY COMPENSATION PLAN INFORMATION

The following table gives information about our common stock that may be issued upon the exercise of options, warrants and rights under all of our existing equity compensation plans as of December 31, 2005.

Plan category	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS	WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS	NU REMA FUT EQ SECU
	(a)	(b)	
Equity compensation plans approved by security holders............	2,107,748(1)	$1.05	
Equity compensation plans not approved by security holders....	4,486,685(3)	$1.63	
Total........................	6,594,433		

----

(1) Represents shares of common stock underlying options that are outstanding under our 1993 Stock Option Plan, our Employee Stock and Stock Option Plan, our 1997 Stock Incentive Plan and our Amended and Restated 2000 Stock Option Plan. The material features of these plans are described in note 9 to our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003.

(2) Represents shares of common stock available for issuance under options that may be issued under our Amended and Restated 2000 Stock Option Plan.

(3) Represents shares of common stock underlying warrants that are described in note 9 to our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

We are or have been a party to employment and compensation arrangements with related parties, as more particularly described above under the headings "Compensation of Executive Officers," "Employment Contracts and Termination of Employment and Change-in-Control Arrangements" and "Compensation of Directors."

We have entered into an indemnification agreement with each of our directors and executive officers. The indemnification agreements and our certificate of incorporation and bylaws require us to indemnify our directors and officers to the fullest extent permitted by Delaware law.

On January 5, 2005, we issued to 17 accredited record holders in a

private offering an aggregate of 12,503,500 shares of our 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. Each of The Pinnacle Fund, L.P., JLF Offshore Fund, Ltd., JLF Asset Management, LLC (which entity is investment manager of four of the investors, including JLF Offshore Fund, Ltd.) and Jeffrey L. Feinberg (the managing member of JLF Asset Management, LLC), became a beneficial owner of more than 5% of our outstanding common stock at the closing of the offering.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

We dismissed Grant Thornton LLP as our principal accountant on April 13, 2006 and retained Hein & Associates LLP as our principal accountant on April 17, 2006. We had no relationship with Hein & Associates LLP prior to their retention as our principal accountant. On June 28, 2006, we engaged Hein & Associates LLP to reaudit our consolidated financial statements for the years ending December 31, 2003, 2004 and 2005. Fees related to the reaudit are estimated to be $900,000.

The following table sets forth the aggregate fees billed to us by Grant Thornton LLP, our former independent registered public accounting firm, for professional services rendered for the years ended December 31, 2005 and 2004:

FEE CATEGORY	2005	2004
Audit Fees	$ 642,000	$ 449,000
Audit-Related Fees	26,000	4,000
Tax Fees	114,000	106,000
All Other Fees	--	--
Total	$ 782,000	$ 559,000

AUDIT FEES. Consists of fees billed for professional services rendered for the audit of our consolidated financial statements and review of the interim consolidated financial statements included in quarterly reports and services that are normally provided by an independent registered public accounting firm in connection with statutory and regulatory filings or engagements. Audit fees increased due to the audit work required to provide assurance on the Pascall and RO financial statements, to expand audit work required on internal controls, and the higher value of the British pounds sterling and the euro when those expenses are converted to United States dollars for this report in 2005 as compared to 2004.

AUDIT-RELATED FEES. Audit-related fees during 2005 relate to due diligence procedures in connection with the Pascall acquisition. Audit-related fees during 2004 relate to due diligence procedures in connection with the Larus Corporation acquisition.

TAX FEES. Consists of fees billed for professional services for tax compliance, tax advice and tax planning. These services include assistance regarding federal, state and international tax compliance, tax audit defense, customs and duties, mergers and acquisitions, and international tax planning.

ALL OTHER FEES. Consists of fees for products and services other than the services reported above. In 2005 and 2004, no such other fees were incurred.

Our audit committee pre-approved all services provided by our former independent registered public accounting firm, Grant Thornton LLP, and pre-approves all services provided by our current registered public accounting firm, Hein & Associates LLP.

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a)(1), (a)(2) and (c) Financial Statements and Financial Statement Schedules

Reference is made to the financial statements and financial statement schedule listed on and attached following the Index to Financial Statements and Financial Statement Schedule contained at page F-1 of this report.

(a)(3) and (b) Exhibits

Reference is made to the exhibits listed on the Index to Exhibits that follows the financial statements and financial statement schedule.

EMRISE CORPORATION AND SUBSIDIARIES

INDEX TO FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULE

Financial Statements

Report of Independent Registered Public Accounting Firm..

Consolidated Balance Sheets as of December 31, 2005 and 2004....................................

Consolidated Statements of Operations for the Years Ended December 31, 2005, 2004 and 2003.......

Consolidated Statements of Comprehensive Income (Loss) for the Years Ended December 31, 2005, 2004 and 2003..

Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2005, 2004 and 2003..

Consolidated Statements of Cash Flows for the Years Ended December 31, 2005, 2004 and 2003..

Notes to Consolidated Financial Statements for the Years Ended December 31, 2005, 2004 and 2003..

Financial Statement Schedule

Consolidated Schedule II Valuation and Qualifying Accounts for the Years Ended December 31, 2005, 2004 and 2003..

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
and Stockholders of EMRISE Corporation

We have audited the accompanying consolidated balance sheets of EMRISE Corporation and subsidiaries, a Delaware corporation, as of December 31, 2005 and 2004, and the related consolidated statements of operations, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of EMRISE Corporation and subsidiaries as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The consolidated Schedule II for the years ended December 31, 2005, 2004 and 2003 is presented for purposes of complying with the Securities and Exchange Commission's rules and is not a required part of the basic consolidated financial statements. This schedule has been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

/S/ HEIN & ASSOCIATES LLP

Irvine, California
December 13, 2006

EMRISE CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2005 AND 2004
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

ASSETS	2005 (restated)(1)
Current assets:	
Cash and cash equivalents	$ 4,371
Accounts receivable, net of allowance for doubtful accounts of $379 and $153, respectively	9,413
Inventories, net of allowances for inventory obsolescence of $4,053 and $2,251, respectively	10,277
Deferred income taxes	1,386
Prepaid and other current assets	536
Total current assets	25,983
Property, plant and equipment, net	2,073
Goodwill	12,066
Intangible assets other than goodwill, net of accumulated amortization of $350 in 2005 and $40 in 2004	3,709
Other assets	630
	$ 44,461
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Borrowings under lines of credit	$ 3,283
Current portion of long-term debt	504
Notes payable to stockholders, current portion	500
Accounts payable	4,949
Income taxes payable	218
Accrued expenses	3,571
Total current liabilities	13,025
Long-term debt, less current portion	742
Notes payable to stockholders, less current portion	1,750
Deferred income taxes	1,108
Other liabilities	823
Total liabilities	17,448
Commitments and contingencies (Notes 13 and 18)	
Stockholders' equity:	
Preferred stock, $0.01 par value. Authorized 10,000,000 shares; zero issued and outstanding	--
Common stock, $0.0033 par value. Authorized 150,000,000 shares; issued and	

outstanding 37,550,000 shares and 24,777,000 shares in 2005 and 2004, respectively	124
Additional paid-in capital	42,877
Accumulated deficit	(15,118)
Accumulated other comprehensive (loss) income	(870)
Total stockholders' equity	27,013
	$ 44,461

(1) See Notes to Consolidated Financial Statements--"Note 2--Restatement of 2004 and 2005 Fi Statements."

See accompanying notes to consolidated financial statements.

EMRISE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	2005 (restated)(1)	2004 (restated)(1)	2003
Net sales	$ 41,270	$ 29,637	$ 25,519
Cost of sales	23,714	16,089	14,835
Gross profit	17,556	13,548	10,684
Operating expenses:			
Selling, general and administrative	13,707	10,212	7,812
Engineering and product development	2,621	1,521	951
Income from operations	1,228	1,815	1,921
Other income (expense):			
Interest expense	(455)	(433)	(416)
Interest income	153	--	--
Other income (expense), net	248	(6)	(58)
Income before income taxes	1,174	1,376	1,447
Income tax (benefit) expense	(267)	49	286
Net income	$ 1,441	$ 1,327	$ 1,161
Basic earnings per share	$ 0.04	$ 0.06	$ 0.05
Diluted earnings per share	$ 0.04	$ 0.05	$ 0.05

(1) See Notes to Consolidated Financial Statements--"Note 2--Restatement of 2004 and 2005 Financial Statements."

See accompanying notes to consolidated financial statements.

EMRISE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003
(IN THOUSANDS)

	2005 (restated)(1)	2004 (restated)(1)	2003
Net income	$ 1,441	$ 1,327	$
Other comprehensive income (loss):			
Foreign currency translation adjustment	(1,357)	379	
Comprehensive income	$ 84	$ 1,706	$

(1) See Notes to Consolidated Financial Statements--"Note 2--Restatement of 2004 and 2005 Financial Statements."

See accompanying notes to consolidated financial statements.

EMRISE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003
(IN THOUSANDS)

	Series B Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Ac
	Shares	Amount	Shares	Amount		
Balance at January 1, 2003	64	$ 400	21,535	$ 71	$ 24,900	
Preferred Series A conversions	--	--	1,263	4	283	
Preferred Series B conversions	(63)	(396)	635	2	395	
Foreign currency translation adjustment	--	--	--	--	--	
Accretion of redeemable preferred stock	--	--	--	--	--	
Warrants issued for services	--	--	--	--	19	
Exercise of warrants and options	--	--	43	--	16	
Net income	--	--	--	--	--	
Balance at December 31, 2003	1	4	23,476	77	25,613	
Preferred Series B conversions	(1)	(3)	3	--	3	
Preferred Series B redemption	--	(1)	--	--	1	
Stock options exercised	--	--	19	--	5	

Foreign currency translation adjustment	--	--	--	--	--
Stock issued for Larus acquisition	--	--	1,214	4	996
Warrants exercised	--	--	65	1	19
Warrants issued for services	--	--	--	--	38
Value of warrants issued to acquire Larus	--	--	--	--	72
Net income (restated)(1)	--	--	--	--	--
Balance at December 31, 2004 (restated)(1)	--	--	24,777	82	26,747
Stock options exercised	--	--	106	--	39
Warrants exercised	--	--	163	--	50
Issuance of common stock and warrants, net of issuance costs	--	--	12,504	42	16,018
Foreign currently translation adjustment	--	--	--	--	--
Warrants issued for services	--	--	--	--	23
Net income (restated)(1)	--	--	--	--	--
Balance at December 31, 2005 (restated)(1)	--	$ --	37,550	$ 124	$ 42,877

----

(1) See Notes to Consolidated Financial Statements--"Note 2--Restatement of 2004 and 2005 Financi

See accompanying notes to consolidated financial statements.

F-6

EMRISE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003
(IN THOUSANDS)

	2005 (restated)(1)	2004 (restated)(1)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,441	$ 1,327
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	964	287
Deferred income taxes	(873)	(206)
Provision for doubtful accounts	151	--
Provision for inventory obsolescence	1,403	1,116
Stock and warrants issued for services	23	38
Changes in operating assets and liabilities net of businesses acquired:		
Accounts receivable	374	289
Inventories	(469)	(452)
Prepaid and other assets	(23)	23
Accounts payable	(1,064)	1,637
Accrued expenses and other liabilities	(787)	(175)

Cash provided by operating activities	1,140	3,884
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net purchases of property, plant and equipment	(287)	(724)
Cash received from sale of property, plant and equipment	20	8
Cash collected on notes receivable	--	--
Net cash paid for the acquisition of Pascall	(10,154)	--
Net cash paid for the acquisition of RO Associates	(4,623)	--
Net cash paid for acquisition of Larus, net of cash acquired	--	(1,492)
Cash used in investing activities	(15,044)	(2,208)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds (repayments) of current notes payable	2,405	(2,004)
Repayments of long-term debt	(1,602)	(250)
Proceeds from long-term debt	1,097	65
Cash from warrant/option exercise	90	25
Net proceeds from issuance of common stock	16,060	--
Cash provided by (used in) financing activities	18,050	(2,164)
Effect of exchange rate changes on cash	(832)	371
Net increase (decrease) in cash and cash equivalents	3,314	(117)
Cash and cash equivalents at beginning of year	1,057	1,174
Cash and cash equivalents at end of year	$ 4,371	$ 1,057

----

(1) See Notes to Consolidated Financial Statements--"Note 2--Restatement of 2004 and 2005 Fi Statements."

See accompanying notes to consolidated financial statements.

EMRISE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003
(IN THOUSANDS)

	2005 (restated)(1)	2004 (restated)(1)
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	$ 439	$ 367
Income taxes	$ 341	$ 428
SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Issuance of subordinated notes for Larus acquisition	$ --	$ 3,000

Common stock issued upon conversion of redeemable preferred stock	$ --	$ 3
Accretion of redeemable preferred stock	$ --	$ --
Common stock issued to acquire Larus	$ --	$ 1,000

----

(1) See Notes to Consolidated Financial Statements--"Note 2--Restatement of 2004 and 2005 Fi Statements."

See accompanying notes to consolidated financial statements.

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION AND BUSINESS

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

BASIS OF PRESENTATION

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and each of its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

REVENUE RECOGNITION

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

The Company recognizes revenue from domestic sales of its electronic components and communications equipment at the point of shipment of those products. Product returns are infrequent and require prior authorization because the Company's sales are final and the Company quality tests its products prior to shipment to ensure they meet the specifications of the binding purchase orders under which they are shipped. When a distributor requests and receives authorization to return a product, the request must be accompanied by a purchase order for a replacement product. When an end-user requests to return a product, the Company either repairs or replaces the product.

Revenue recognition for products and services provided by the Company's United Kingdom subsidiaries, which include EMRISE Electronics Ltd. ("EEL"), XCEL Power Systems, Ltd. ("XPS") and Pascall Electronics Ltd. ("Pascall"), 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. Engineering/design services were not significant in 2005, 2004 and 2003. 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, the Company recognizes 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. The Company's U.K. subsidiaries do not offer customer discounts, rebates or price protection on these products.

The Company recognizes revenue for products sold by its 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, the Company's electronic components, network access and transmission products and communication timing and synchronization products carry a one-year limited parts and labor warranty. The Company's 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 the Company's option. Historically, warranty repairs have not been material. The Company does 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, the Company recognizes repair revenues when the product is shipped back to the customer. Service revenues represented 2.6%, 5.7%

and 3.1% of net sales in 2005, 2004 and 2003, respectively.

RO Associates Incorporated ("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, the Company recognizes initial license fee revenue upon delivery of the product technology. The Company recognizes guaranteed minimum license royalties as revenue as they become due. Per unit royalties that exceed the guaranteed minimum are recognized as earned when reported.

Shipping and handling fees billed to customers totaled $261,000 for the year ended December 31, 2005 and were charged to cost of sales. Such amounts were not significant for the year ended December 31, 2004 and 2003. Shipping and handling fees billed to international customers are included in net sales and totaled less than 1.0% of net sales for the years ended December 31, 2005, 2004 and 2003. Depending on the operating division, shipping and handling costs are included in cost of sales or selling, general and administrative expenses. Freight is charged to cost of sales and the charge is reversed when the customer is invoiced for the freight.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of all highly liquid investments with an original maturity of three months or less when purchased. As of December 31, 2005, 2004 and 2003, cash in foreign accounts was $2,447,000, $1,035,000 and $535,000, respectively.

INVENTORIES

The Company's finished goods electronic components inventories generally are built to order. The Company's communications equipment inventories generally are built to forecast, which requires the Company to produce a larger amount of finished goods in its communications equipment business so that the Company's customers can promptly be served. The Company's products consist of numerous electronic and other parts, which necessitates that it exercise detailed inventory management. The Company values its 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). The Company performs physical inventories at least once a year. The Company regularly reviews inventory quantities on hand and records a provision for excess and obsolete inventory based primarily on its estimated forecast of product demand and production requirements for the next twelve months. Additionally, to determine inventory write-down provisions, the Company reviews product line inventory levels and individual items as necessary and periodically reviews assumptions about forecasted demand and market conditions. Any parts or finished goods that are determined to be obsolete, either in connection with the physical count or at other times of observation, are reserved for and subsequently discarded and written-off.

In addition, the communications equipment industry is characterized by rapid technological change, frequent new product development, and rapid product obsolescence that could result in an increase in the amount of obsolete inventory quantities on hand. Also, the Company's estimates of future product demand may prove to be inaccurate, in which case the Company may have understated or overstated the provision required for excess and obsolete inventory. In the future, if the Company's inventory is determined to be overvalued, the Company would be required to recognize such costs in its cost of goods sold at the time of such determination. Likewise, if the Company's inventory is determined to be undervalued, the Company may have over-reported its costs of goods sold in previous periods and would be required to recognize additional operating income at the time of sale. Therefore, although the Company makes every effort to ensure the accuracy of its forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of the Company's inventory and its reported operating results.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed principally using the straight-line method over the useful lives of the assets (or lease term, if shorter) as follows:

Buildings..	50 years
Machinery, equipment and fixtures...................	3-7 years
Leasehold improvements.............................	5 years

Maintenance and repairs are expensed as incurred, while renewals and betterments are capitalized. Research and development costs are expensed as incurred.

LONG-LIVED ASSETS

The Company reviews the carrying amount of its long-lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

PRODUCT WARRANTY LIABILITIES

Generally, the Company's electronic components, network access and transmission products and communication timing and synchronization products carry a one-year limited parts and labor warranty and the Company's communications test instruments and European network access and transmission

products carry a two-year limited parts and labor warranty. Products returned under warranty typically are tested and repaired or replaced at the Company's option. Historically, the Company has not experienced significant warranty costs or returns.

The Company records in accrued expenses a liability for estimated costs that it expects to incur under its basic limited warranties when product revenue is recognized. Factors affecting the Company's warranty liability include the number of units sold, historical and anticipated rates of claim, and costs per claim. The Company periodically assesses the adequacy of its warranty liability accrual based on changes in these factors.

The changes in the Company's product warranty liability during 2005 and 2004 were as follows:

	Year Ended December 31,	
	2005	2004
Liability, beginning of year	$ 64,000	$ 79,000
Expense for new warranties issued	86,000	64,000
Warranty claims	--	(79,000)
Liability, end of year	$ 150,000	$ 64,000

INCOME TAXES

The Company uses the liability method of accounting for income taxes in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109, ACCOUNTING FOR INCOME TAXES. Deferred income taxes are recognized based on the differences between financial statement and income tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. The provision for income taxes represents the tax payable for the year and the change during the year in deferred tax assets and liabilities.

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 SFAS No. 123, ACCOUNTING FOR STOCK-BASED COMPENSATION, as amended by SFAS No. 148 ACCOUNTING FOR STOCK-BASED COMPENSATION - PRESENTATION AND DISCLOSURE.

The following table sets forth the net income and basic and diluted earnings per share for the periods presented as if the Company had elected the fair value method of accounting for stock options:

	2005 (restated)	2004 (restate
Net income:		
As reported	$ 1,441,000	$ 1,327,
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, net of related tax effect	(819,000)	(127,
Pro forma	$ 622,000	$ 1,200,
Basic earnings per share:		
As reported	$ 0.04	$ 0
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, net of related tax effect	(0.02)	
Pro forma	$ 0.02	$ 0
Diluted earnings per share:		
As reported	$ 0.04	$ 0
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, net of related tax effect	(0.02)	
Pro forma	$ 0.02	$ 0

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 88% to 107%; risk-free interest rate of 3% to 4.25%;

expected lives of 7 years.

EARNINGS PER SHARE

Earnings per share is calculated according to SFAS No. 128, EARNINGS PER SHARE. Basic earnings per share includes no dilution and is computed by dividing net income available to common stockholders by the weighted average number of shares outstanding during the year. Diluted earnings per share reflects the potential dilution of securities that could share in the earnings of the Company.

FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, requires all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized on the balance sheet, for which it is practicable to estimate fair value. This statement defines fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties. As of December 31, 2005 and 2004, the fair value of all financial instruments approximated carrying value.

The carrying amount of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses are reasonable estimates of their fair value because of the short maturity of these items. The Company believes the carrying amounts of its notes payable and long-term debt approximate fair value because the interest rates on these instruments are subject to change with, or approximate, market interest rates.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions 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 amounts of revenues and expenses during the reporting period. Actual results could materially differ from those estimates.

CONCENTRATION OF CREDIT RISK

Financial instruments, which potentially expose the Company to concentration of credit risk, consist primarily of cash and accounts receivable. The Company places its cash with high quality financial institutions. At times, cash balances may be in excess of the amounts insured by the Federal Deposit Insurance Corporation.

The Company's accounts receivable result from sales to a broad customer base. The Company extends credit to its customers based upon an evaluation of the customer's financial condition and credit history and generally does not require collateral. Accounts receivable are generally due within 30 days in the

Company's U.S., France and U.K. operations and are stated net of an allowance for doubtful accounts. Accounts outstanding for longer than the contractual payment terms are considered past due. Provisions for uncollectible accounts are made based on the Company's specific assessment of the collectibility of all past due accounts. Credit losses are provided for in the financial statements and consistently have been within management's expectations. Sales to Rockwell Collins, Inc. represented approximately 10% of our total net sales during 2005. No other customer represented 10% or more of our total net sales for that period. Sales to BAE Systems companies represented 15% and 13% of total net sales in 2004 and 2003, respectively.

FOREIGN CURRENCY TRANSLATION

The accounts of foreign subsidiaries have been translated using the local currency as the functional currency. Accordingly, foreign currency denominated assets and liabilities have been translated to U.S. dollars at the current rate of exchange on the balance sheet date and at the average for the period reported for the statement of operations. The effects of translation are recorded as a separate component of stockholders' equity in accumulated other comprehensive income (loss). Exchange gains and losses arising from transactions denominated in foreign currencies are translated at the exchange rates applicable on the dates of the transactions and are included in operations.

(2) RESTATEMENT OF 2004 AND 2005 FINANCIAL STATEMENTS

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

The effects of the restatement on net sales, cost of sales, gross profit, operating expenses, income from operations, net income, and basic and diluted earnings per share as of and for the year ended December 31, 2004 are as follows:

	AS ORIGINALLY REPORTED	RESTATEMENT ADJUSTMENTS	AS RESTATE

	(IN THOUSANDS, EXCEPT PER SHARE DATA)		
Net sales	$ 29,861	$ (224)	$ 29,63
Cost of sales	$ 16,146	$ (57)*	$ 16,08
Gross profit	$ 13,715	$ (167)*	$ 13,54
Operating expenses	$ 11,747	$ (14)*	$ 11,73
Income from operations	$ 1,968	$ (153)	$ 1,81
Net income	$ 1,480	$ (153)	$ 1,32
Basic earnings per share	$ 0.06	$ --	$ 0.0
Diluted earnings per share	$ 0.06	$ (0.01)	$ 0.0

The effects of the restatement on net sales, cost of sales, gross profit, operating expenses, income from operations, net income, and basic and diluted earnings per share as of and for the year ended December 31, 2005 are as follows:

	AS ORIGINALLY REPORTED	RESTATEMENT ADJUSTMENTS	AS RESTATED
Net sales	$ 41,046	$ 224	$ 41,270
Cost of sales	$ 23,656	$ 58*	$ 23,714
Gross profit	$ 17,390	$ 166*	$ 17,556
Operating expenses	$ 16,315	$ 13*	$ 16,328
Income from operations	$ 1,075	$ 153	$ 1,228
Net income	$ 1,288	$ 153	$ 1,441
Basic earnings per share	$ 0.03	$ 0.01	$ 0.04
Diluted earnings per share	$ 0.03	$ 0.01	$ 0.04

----

* Differences attributable to rounding.

(3) INVENTORIES, NET

Inventories are summarized as follows as of December 31:

	2005 (restated)	2004 (restated)
Raw materials	$ 4,668,000	$ 3,222,000
Work-in-process	2,716,000	1,280,000
Finished goods	2,893,000	2,047,000
	$10,277,000	$ 6,549,000

Included in the amounts above are allowances for inventory obsolescence of $4,053,000 and $2,251,000 at December 31, 2005 and 2004, respectively.

Allowances for inventory obsolescence are recorded as necessary to reduce obsolete inventory to estimated net realizable value or to specifically reserve for obsolete inventory that the Company intends to dispose of. The inventory items identified for disposal at each year end are generally discarded during the following year.

(4) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following as of December 31:

	2005	2004
Land and buildings..................................	$ 343,000	$ 390,0
Machinery, equipment and fixtures...................	4,002,000	3,999,0
Leasehold improvements..............................	663,000	482,0
	5,008,000	4,871,0
Accumulated depreciation and amortization...........	(2,935,000)	(3,962,0
	$ 2,073,000	$ 909,0

(5) GOODWILL AMORTIZATION AND IMPAIRMENT TESTING

SFAS No. 142, GOODWILL AND OTHER INTANGIBLE ASSETS, disallows the amortization of goodwill and provides for impairment testing of goodwill carrying values on an annual basis 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. In applying SFAS No. 142, the Company performed the transitional reassessment and impairment tests required as of January 1, 2002. At the time of adoption, the Company had $1,084,000 of accumulated amortization of goodwill. The Company performed its annual required tests of impairment as of December 31, 2005, 2004 and 2003 for goodwill in the electronic components segment and the communications equipment segment reporting units. No events or changes in circumstances occurred between annual tests that would have required an interim goodwill impairment test.

(6) LINES OF CREDIT

Outstanding borrowings under the Company's revolving lines of credit were as follows as of December 31:

	2005	2004
Line of credit with a U.S. commercial lender.....	$ --	$ 118,000
Lines of credit with foreign banks..............	3,283,000	760,000

	$ 3,283,000	$ 878,000

(7) CREDIT FACILITIES

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

The credit facility provides for a $9,000,000 revolving line of credit secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment. Borrowings do not need to be supported by specific receivables or inventory balances unless aggregate borrowings under the line of credit exceed $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 the outstanding borrowings under the line of credit can not exceed an aggregate of 80% of eligible accounts receivable plus 30% of the value of eligible finished goods inventory. Interest is payable monthly. The interest rate is variable and is adjusted monthly based on the prime rate. The prime rate at December 31, 2005 was 7.25%.

The credit facility is subject to various financial covenants on a consolidated basis, which were updated on November 17, 2005.

As of December 31, 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 December 31, 2005, the Company was in compliance with each of the covenants of the credit facility.

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 $75,000 at December 31, 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 $123,000 was outstanding at December 31, 2005. The interest rate is equal to the 90-day London InterBank Offered Rate ("LIBOR") (4.54% at December 31, 2005) plus 3.75% per annum. Amounts borrowed under this arrangements are amortized over 60 months from the respective dates of borrowing and are secured by the purchased equipment.

As of December 31, 2005, the Company's foreign subsidiaries had credit facilities, including lines of credit and term loans, with Lloyds TSB Bank PLC ("Lloyds TSB") and Lloyds TSB Commercial Finance Limited ("Lloyds") in England, IFN Finance, a subsidiary of ABN AMRO Holdings, N.V., Banc National de Paris, Societe Generale in France, and Sogelease and Johnan Shinkin Bank in Japan. At December 31, 2005, the balances outstanding under the Company's United Kingdom, France and Japan credit facilities were $3,006,000, $1,090,000 and $32,000, 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, a subsidiary of ABN AMRO Holdings, N.V., was terminated, and all debt to Venture Finance PLC was paid off. The Lloyds facility provides a revolving loan secured by receivables, with a maximum availability of 2,100,000 British pounds sterling (approximately U.S. $3,613,000 based on the exchange rate in effect on December 31, 2005). The annual interest rate on the revolving loan is 1.5% above the Lloyds TSB base rate. The Lloyds TSB base rate was 4.5% at December 31, 2005. This credit facility covers a period of 24 months, expiring on July 31, 2007. The financial covenants include a 50% cap on combined export gross sales of XPS and Pascall and days sales outstanding of less than 65 days, and the funding balance is capped at 125% of XPS and Pascall combined gross sales.

On August 26, 2005, XPS entered into an agreement with Lloyds for an unsecured cashflow loan of 300,000 British pounds sterling (approximately U.S. $516,000 based on the exchange rate in effect on December 31, 2005), payable over 12 months. The loan is structured as an overadvance on the previously negotiated 2,100,000 British pounds sterling revolving loan with Lloyds, bringing the maximum aggregate commitment on the revolving loan to 2,400,000 British pounds sterling (approximately U.S. $4,129,000 based on the exchange rate in effect on December 31, 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 TSB plus 1.9%. The Lloyds TSB base rate at December 31, 2005 was 4.5%. Lloyds TSB has sole discretion to switch the details on this overadvance account if Lloyds determines that we will have difficulty in meeting the specific reductions in the overadvance account.

On August 26, 2005, EEL, a United Kingdom-based subsidiary of the Company, entered into an agreement with Lloyds TSB for an unsecured term loan for 500,000 British pounds sterling (approximately U.S. $860,000 based on the exchange rate in effect on December 31, 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 TSB base rate plus 2.5%. The Lloyds TSB base rate at December 31, 2005 was 4.5%. The loan

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

also includes financial covenants. EEL must maintain consolidated profit before taxation and interest paid and payable of no less than 500% of the consolidated interest paid and payable. The Company failed to comply with this covenant and received a waiver. The Company and the bank are reviewing the covenants for possible amendment. Additionally, EEL must maintain consolidated profit before taxation, depreciation, amortization of goodwill and other intangibles and interest paid and payable of no less than 300% of the consolidated principal repayments and the consolidated interest paid and payable.

In the event of a default, Lloyds 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 must pay an increased interest rate per annum equal to 3% above the rate of interest in effect from time to time under the note.

In April 2003, CXR-AJ obtained a credit facility from IFN Finance, a subsidiary of ABN AMRO N.V. This credit facility is for a maximum of $1,421,000 based on the exchange rate in effect at December 31, 2005 for the conversion of euros into United States dollars. CXR-AJ also had $34,000 of term loans with two 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 December 31, 2005, the French T4M rate was 2.26%, and this facility had a balance of $1,056,000. This facility has no financial performance covenants.

XCEL Japan Ltd., or XJL, obtained a term loan on November 29, 2002 from Johnan Shinkin Bank. The loan is amortized over five years, carries an annual fixed interest rate of 3.25% and is secured by the assets of XJL. The balances of the loan as of December 31, 2005 and 2004 were $32,000 and $73,000, respectively, using the exchange rates in effect at those dates for conversion of Japanese yen into United States dollars. There are no financial performance covenants applicable to this loan.

(8) LONG-TERM DEBT

A summary of long-term debt follows as of December 31:

	2005
Term notes payable to U.S. commercial lender (a)....................	$ 75,000
Term notes payable to foreign banks (b).............................	844,000
Capitalized lease and equipment loan obligations (c)................	327,000
	1,246,000
Current portion...	(504,000)
	$ 742,000

(a) The Company's domestic credit facility with Wells Fargo Bank, N.A. 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 balances of $75,000 and $126,000 at December 31, 2005 and 2004, respectively.

(b) The Company has agreements with several foreign banks that include term borrowings that mature at various dates through 2008. Interest rates on the borrowings bear interest at rates ranging from 3.25% to 7% and are payable in monthly installments. The balances by country of origination at December 31, 2005 were: United Kingdom - $778,000; France - $34,000; and Japan - $32,000. At December 31, 2004, the balances by country of origination were: United Kingdom - $715,000; France - $62,000; and Japan - $56,000.

The unsecured United Kingdom term loan in the original principal amount of $860,000 is payable over 36 months commencing in September 2005 at $24,000 per month and interest is the base rate plus 2.5%.

The term loans in France had aggregate balances of $34,000 and $62,000 at December 31, 2005 and 2004, respectively, and is payable over 60 months and secured by the assets of the local subsidiary, bears an annual interest rate of 4% and is not subject to financial performance covenants.

The term loan in Japan is a five-year amortizable loan that commenced in November 2002 and had balances of $32,000 and $56,000 as of December 31, 2005 and 2004, respectively, carries an annual fixed interest rate of 3.25%, is secured by the Japanese subsidiary's assets and is not subject to financial performance covenants.

(c) Capitalized lease obligations are calculated using interest rates appropriate at the inception of the lease and range from 6% to 18%. Leases are amortized over the lease term using the effective interest method. The leases all contain bargain purchase options and expire at various dates through December 31, 2017. Wells Fargo Bank, N.A. has provided capital equipment loans with balances at December 31, 2005 of $123,000. The capital equipment loans are amortized over five years and bear interest at the bank's 30-day LIBOR plus 4%.

Principal maturities related to long-term debt, including loans from stockholders (Note 18), as of December 31, 2005 were as follows:

Year Ending December 31,	Amount
2006	$ 1,004,000
2007	923,000
2008	756,000
2009	538,000
2010	275,000

Total	$ 3,496,000

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

(9) ACCRUED EXPENSES

Accrued expenses as of December 31 consisted of the following:

	2005 (restated)	2004 (restated)
Accrued salaries	$ 675,000	$ 805,000
Accrued payroll taxes and benefits	735,000	491,000
Advance payments from customers	219,000	77,000
Other accrued expenses	1,942,000	1,628,000
Total accrued expenses	$3,571,000	$3,001,000

No other individual item represented more than 5% of total current liabilities.

(10) STOCKHOLDERS' EQUITY

STOCK OPTIONS AND WARRANTS

The Company has four stock option plans:

- Employee Stock and Stock Option Plan, effective July 1, 1994, providing for non-qualified stock options as well as restricted and non-restricted stock awards to both employees and outside consultants. Up to 520,000 shares were authorized for issuance under this plan. Terms of related grants under the plan are at the discretion of the board of directors. The board of directors does not intend to issue any additional options or make any additional stock grants under this plan.

- 1993 Stock Option Plan, providing for the grant of up to 300,000 incentive and non-qualified stock options to purchase stock at not less than the current market value on the date of grant. Options granted under this plan vest ratably over three years and expire 10 years after date of grant. The board of directors does not intend to issue any additional options under this plan.

- The 1997 Stock Incentive Plan (the "1997 Plan") provides that options granted may be either qualified or nonqualified stock options and are required to be granted at fair market value on the date of grant. Subject to termination of employment, options may expire up to ten years from the date of grant and

are nontransferable other than in the event of death, disability or certain other transfers that the committee of the board of directors administering the 1997 Plan may permit. Up to 1,600,000 stock options were authorized to be granted under the 1997 Plan. All outstanding options of former optionholders under the XET 1987 Employee Stock Option Plan were converted to options under the 1997 Plan as of the date of the merger between the Company and EMRISE Electronics at the exchange rate of 1.451478. The board of directors does not intend to issue any additional options under this plan.

F-22

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

o The 2000 Stock Option Plan was adopted by the board of directors in November 2000 and approved by the stockholders on January 16, 2001. The board of directors adopted the Amended and Restated 2000 Stock Option Plan (the "2000 Plan") effective as of August 3, 2001. Under the 2000 Plan, options granted may be either incentive or nonqualified options. Incentive options must have an exercise price of not less than the fair market value of a share of common stock on the date of grant. Nonqualified options must have an exercise price of not less than 85% of the fair market value of a share of common stock on the date of grant. Up to 2,000,000 options may be granted under the 2000 Plan. No option may be exercised more than ten years after the date of grant.

The Company accounts for stock-based compensation under the "intrinsic value" method. Under this method, no compensation expense is recorded for these plans and arrangements for current employees whose grants provide for exercise prices at or above the market price on the date of grant. Compensation or other expense is recorded based on intrinsic value (excess of market price over exercise price on date of grant) for employees, and fair value of the option awards for others.

The following table shows activity in the outstanding options for the years ended December 31, 2005, 2004 and 2003:

	2005		2004		2
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares
Outstanding at beginning of year	2,133,000	$ 0.97	1,729,000	$ 0.96	1,432,00
Granted	725,000	$ 1.92	424,000	$ 0.96	344,00
Exercised	(106,000)	$ 0.38	(19,000)	$ 0.33	(28,00
Forfeited	(644,000)	$ 1.88	(1,000)	$ 3.44	(19,00

Outstanding at end of year	2,108,000	$ 1.05	2,133,000	$ 0.97	1,729,00

The following table summarizes information with respect to stock options at December 31, 2005:

	Options			Options Exercis	
Range of Exercise Price	Number Outstanding December 31, 2005	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable December 31, 2005	W E
$0.20 to $1.00	1,317,000	6.08	$ 0.54	1,217,000	
$1.01 to $2.00	780,000	9.38	1.87	680,000	
$3.01 to $4.00	11,000	0.62	3.13	11,000	
	2,108,000	7.27	$ 1.05	1,908,000	

The fair value of options granted during 2005 was $738,000 at a weighted average value of $1.02. The fair value of options granted during 2004 was $337,000, at a weighted average value of $0.79 per share. The fair value of options granted during 2003 was $42,000, at a weighted average value of $0.12 per share.

If the Company had instead elected the fair value method of accounting for stock-based compensation, compensation cost would be accrued at the estimated fair value of all stock option grants over the service period, regardless of later changes in stock prices and price volatility. The fair value at date of grant for options granted in 2005, 2004 and 2003 has been estimated based on a Black-Scholes pricing model with the following assumptions: no dividend yield; expected volatility of 88% to 92% in 2005, 92% to 107% in 2004 and 92% in 2003; risk-free interest rate of 3.0% to 4.25%; and average expected lives of seven years.

The board of directors has also authorized the issuance of common stock purchase warrants to certain officers, directors, stockholders, key employees and other parties as follows:

	Number of Shares	Exerc Per Share
Balance outstanding at January 1, 2003	404,000	$0.25 to $2.50
Warrants issued	401,000	0.75 to 1.00
Warrants expired/forfeited	(138,000)	0.66

Warrants exercised	(14,000)	0.66
Balance outstanding at December 31, 2003	653,000	$0.25 to $2.50
Warrants issued	250,000	0.85 to 1.30
Warrants expired/forfeited	(32,000)	2.50
Warrants exercised	(65,000)	0.25 to 0.31
Balance outstanding at December 31, 2004	806,000	$0.31 to $1.30
Warrants issued	3,886,000	1.73 to 2.00
Warrants exercised	(205,000)	0.39 to 0.75
Balance outstanding at December 31, 2005	4,487,000	$0.75 to $2.00

During 2005, the Company issued warrants to purchase up to 3,886,000 shares of common stock at exercise prices ranging from of $1.73 to $2.00 (3,776,000 in conjunction with the Company's January 2005 stock offering and 110,000 as compensation for services rendered). The estimated value of the warrants issued during 2005 for services rendered was $23,000 and was calculated using the Black-Scholes pricing model with the following assumptions: risk-free interest rate of 3%, expected life of 3 years, no dividend yield, and an expected volatility of 107.19%.

During 2004, the Company issued warrants to purchase up to 250,000 shares of common stock at exercise prices ranging from of $0.85 to $1.30 per share in consideration for services rendered or to be rendered and in connection with the acquisition of Larus Corporation. The estimated value of the warrants issued during 2004 for services rendered was $38,000 and was calculated using the Black-Scholes pricing model with the following assumptions: risk-free interest rate of 2.5% to 3.25%, expected life of 3 years, no dividend yield, and an expected volatility of 107%. The estimated value of the warrants issued in connection with the acquisition of Larus Corporation was $72,526 and was calculated using the Black-Scholes pricing model with the following assumptions: risk-free interest rate of 3.25%, expected life of three years, no dividend yield, and an expected volatility of 107.19%.

During 2003, the Company issued warrants to purchase up to 300,000 shares of common stock at the exercise price of $0.75 and 101,000 shares at the exercise price of $1.00. The Company issued the warrants for services rendered or to be rendered. The estimated value of the warrants was $19,000 and was calculated using the Black-Scholes pricing model with the following assumptions: risk-free interest rate of 1.6%, expected lives of 3 years, no dividend yield and an expected volatility of 84.8%.

As of December 31, 2005, the Company was authorized to issue 150,000,000 shares of common stock. As of that date, the Company had 37,550,250 shares of common stock outstanding and 6,594,443 shares of common stock that

could become issuable pursuant to the exercise of outstanding stock options and warrants.

As described in Note 19, the Company issued shares of common stock and warrants to purchase shares of common stock in a private offering on January 5, 2005.

DIVIDENDS

No dividends on the Company's common stock have been paid to date. The Company currently intends to retain future earnings to fund the development and growth of its business and, therefore, does not anticipate paying cash dividends on its common stock within the foreseeable future. Any future payment of dividends on the Company's common stock will be determined by the Company's board of directors and will depend on the Company's financial condition, results of operations, contractual obligations and other factors deemed relevant by the Company's board of directors.

(11) INCOME TAXES

The Company files a consolidated U.S. federal income tax return. This return includes all domestic companies 80% or more owned by the Company. State tax returns are filed on a consolidated, combined or separate basis depending on the applicable laws relating to the Company and its domestic subsidiaries.

Income before income taxes was taxed under the following jurisdictions for the years ended December 31:

	2005 (restated)	2004 (restated)	
Domestic	$ 25,000	$ 762,000	$
Foreign	1,149,000	614,000	
Total	$ 1,174,000	$ 1,376,000	$

Income tax expense (benefit) consisted of the following for the years ended December 31:

	2005 (restated)	2004 (restated)	
Current			
Federal	$ --	$ 34,000	$
State	--	52,000	
Foreign	535,000	242,000	
Total current	$ 535,000	$ 328,000	$

Deferred			
Federal	$ (705,000)	$ (204,000)	$

State	30,000	(11,000)	
Foreign	(127,000)	(64,000)	
Total deferred	$ (802,000)	$ (279,000)	$
Total			
Federal	$ (705,000)	$ (170,000)	$
State	30,000	41,000	
Foreign	408,000	178,000	
Total	$ (267,000)	$ 49,000	$

Income tax expense (benefit) differed from the amount obtained by applying the statutory federal income tax rate of 34% to income before income taxes as follows for the years ended December 31:

	2005 (restated)	2004 (restated)	
Tax at U.S. federal statutory rate	$ 399,000	$ 468,000	$
State taxes, net of federal income tax benefit	30,000	41,000	
Foreign income taxes	(42,000)	248,000	
Change in valuation allowances	(607,000)	(179,000)	
Permanent differences	(47,000)	(6,000)	
Utilization of net operating losses	--	(523,000)	
Other	--	--	
	$ (267,000)	$ 49,000	$

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities were as follows as of December 31:

	2005 (restated)	(
Deferred tax assets:		
Fixed assets depreciation	$ --	$
Allowance for doubtful accounts	44,000	
Inventory reserves and uniform capitalization	770,000	
Other accrued liabilities	361,000	
Deferred compensation	118,000	
Alternative minimum tax credit carryforwards	142,000	

Capital loss carryforwards	136,000	
Net operating loss carryforwards	4,661,000	
Total deferred tax assets	6,232,000	
Valuation allowance for deferred tax assets	(4,846,000)	
Deferred tax assets (current)	1,386,000	
Deferred tax liabilities:		
Depreciation	(51,000)	
Intangible assets other than goodwill	(1,057,000)	
Deferred tax liabilities (long-term)	(1,108,000)	
Net deferred tax assets (liabilities)	$ 278,000	$

As of December 31, 2005, the Company had recorded $1,386,000 of net deferred tax assets and $1,108,000 of deferred tax liabilities. The Company had federal and state net operating loss carryforwards of approximately $14,187,000 and $14,121,000 as of December 31, 2005 and 2004, respectively, that expire at various dates through 2023. As of December 31, 2005 and 2004, the Company recorded a valuation allowance on the deferred tax asset. Management believes sufficient uncertainty exists regarding the realizability of the deferred tax asset items and that a valuation allowance is required. Management considers projected future taxable income and tax planning strategies in making this assessment. For the years ended December 31, 2005 and 2004, management recorded reduction in its valuation allowances of $607,000 and $179,000, respectively, based on the domestic book income in 2005 and 2004 and projections for future taxable income over periods that the deferred assets are deductible. Management believes that it is more likely than not that the Company will realize the benefits of its net deferred tax asset. The amount of the deferred tax assets considered realizable, however, could materially change in the near future if estimates of future taxable income during the carryforward period are changed.

As a result of the merger in 1997 of the privately held EMRISE Electronics with a wholly-owned, newly formed subsidiary of the Company, with EMRISE Electronics as the surviving subsidiary, the Company experienced a more than 50% ownership change for federal income tax purposes. As a result, an annual limitation will be placed upon the Company's ability to realize the benefit of a significant portion of its federal net operating loss and credit carryforwards. The Company currently has $9,606,000 of net operating losses not subject to annual limitation, as these losses were generated subsequent to the 50% change in ownership. The remaining net operating loss of $4,581,000 generated before the change in ownership is subject to the annual limitation. Of the $4,581,000 net operating loss carryforward subject to limitation, approximately $276,000 per year is available to offset future federal taxable income.

(12) EARNINGS PER SHARE

The following table illustrates the computation of basic and diluted earnings per share:

	2005 (restated)	2004 (restate
NUMERATOR:		
Net income	$ 1,441,000	$ 1,327,
Less: accretion of the excess of the redemption value over the carrying value of redeemable preferred stock	--	
Income attributable to common stockholders	$ 1,441,000	$ 1,327,
DENOMINATOR:		
Weighted average number of common shares outstanding during the period - basic	37,253,000	24,063,
Incremental shares from assumed conversions of warrants, options and preferred stock	1,195,000	776,
Adjusted weighted average shares - diluted	38,448,000	24,839,
Basic earnings per share	$ 0.04	$ 0
Diluted earnings per share	$ 0.04	$ 0

The following table shows the common stock equivalents that were outstanding as of December 31, 2005 and 2004 but were not included in the computation of diluted earnings per share because the options' or warrants' exercise price was greater than the average market price of the common shares and, therefore, the effect would be anti-dilutive:

	Number of Shares	Exercise Price Per Share
Anti-dilutive common stock options:		
As of December 31, 2005	686,000	$2.00
As of December 31, 2004	1,027,000	$1.00 to $3.44
Anti-dilutive common stock warrants:		
As of December 31, 2005	3,886,000	$1.73 to $2.00
As of December 31, 2004	326,000	$1.00 to $1.30

(13) COMMITMENTS AND CONTINGENCIES

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

LEASES

The Company conducts most of its operations from leased facilities under operating leases that expire at various dates through 2013. The leases generally require the Company to pay all maintenance, insurance and property tax costs and contain provisions for rent increases. Total rent expense, net of sublease income, for 2005, 2004 and 2003 was approximately $885,000, $1,070,000 and $909,000, respectively.

The future minimum rental payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year (including the related party lease discussed in Note 16) are as follows:

Year Ending December 31,	Amount
2006	$ 1,202,000
2007	1,140,000
2008	745,000
2009	551,000
2010	430,000
2011 and thereafter	162,000
Total	$ 4,230,000

LITIGATION

The Company is not currently a party to any material legal proceedings. However, the Company and its subsidiaries are, from time to time, involved in legal proceedings, claims and litigation arising in the ordinary course of business. While the amounts claimed may be substantial, the ultimate liability cannot presently be determined because of considerable uncertainties that exist. Therefore, it is possible the outcome of such legal proceedings, claims and litigation could have a material effect on quarterly or annual operating results or cash flows when resolved in a future period. However, based on facts currently available, management believes such matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

EMPLOYEE BENEFIT PLANS

Effective October 1, 1998, the Company instituted a defined contribution plan ("401(k) Plan") covering the majority of its U.S. domestic employees. Participants may make voluntary pretax contributions to such plans up to the limit as permitted by law. Company contributions to the 401(k) plan are discretionary. The Company made contributions of $36,000, $25,000 and $20,000 to the 401(k) Plan for the years ended December 31, 2005, 2004 and 2003, respectively.

The Company's subsidiary in France has a defined benefit pension plan. The plan is an unfunded plan. As of the December 31, 2005 and 2004 measurement dates, the status of the defined benefit pension plan was as follows:

	2005	2004
Projected benefit obligation.................	$ 163,000	$ 178,000
Fair value of plan assets...................	$ --	$ 12,000
Unfunded accumulated benefit................	$ 155,000	$ 166,000
Accumulated benefit obligation..............	$ 163,000	$ 122,000
Employer contributions......................	$ --	$ 19,000
Participant contributions...................	$ --	$ --
Benefits paid...............................	$ 18,000	$ 19,000

Contributions to be paid to the plan during the year ended December 31, 2006 are estimated to be none.

Weighted average assumptions used to determine pension benefit obligations at December 31, 2005 and 2004 were as follows:

	2005	2004
Discount rate................................	4.5%	4.5%
Expected return on plan assets...............	4.0%	--
Rate of compensation increase................	--	4.5%

The components of the net periodic pension costs for the years ended December 31, 2005 and 2004 were as follows:

	2005	2004
Service cost..................................	$ 11,000	$ 11,000
Interest cost.................................	7,000	7,000
Expected return on plan assets................	--	--
Amortization of transition asset, prior service cost and actuarial loss...............	--	--
Net periodic benefit cost.....................	$ 18,000	$ 18,000

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

The following table sets forth the changes in benefit obligation for the years ended December 31, 2005 and 2004:

	2005	2004
Change in benefit obligations:		
Benefit obligation at beginning of year......	$ 122,000	$ 96,000
Service cost.................................	11,000	11,000
Interest cost................................	7,000	7,000
Benefits paid................................	18,000	(19,000)

Contributions..............................	--	19,000
Effect of foreign currency translation.......	5,000	8,000
Benefit obligation at end of year...........	$ 163,000	$ 122,000

EXECUTIVE MANAGEMENT

Effective January 1, 2001, the Company and Carmine T. Oliva, its Chief Executive Officer, entered into an employment agreement that provided for an annual base salary of $250,000, with annual merit increases, an initial term of five years, two renewal periods of two years each, and severance pay of at least three years' salary during the initial period or at least two years' salary during a renewal period. On February 24, 2006, the Company and Mr. Oliva entered into a new five-year employment agreement effective as of January 1, 2006. The new employment agreement provides for an annual base salary of $350,000 and severance of three times his annual base salary, net of taxes, under certain circumstances.

Effective July 2, 2001, the Company and Randolph D. Foote, its Senior Vice President, Chief Financial Officer and Secretary, entered into an employment agreement that provides for an initial annual salary of $130,000, an initial term of three years, two renewal periods of one year each, and severance pay of at least one years' salary. On February 24, 2006, the Company and Mr. Foote entered into a new two-year employment agreement effective as of January 1, 2006. The new employment agreement provided for an annual base salary of $175,000 and severance of one and one-half times his annual base salary, net of taxes, under certain circumstances.

Effective July 2, 2001, the Company and Graham Jefferies, Managing Director of EEL and Executive Vice President and Chief Operating Officer of the Company, entered into an employment agreement that provides for an initial annual salary of 100,000 British pounds sterling (approximately $141,000 at the then current exchange rates), an initial term of three years, two renewal periods of one year each, and severance pay of at least one years' salary. On February 24, 2006, the Company and Mr. Jefferies entered into a new three-year employment agreement effective as of January 1, 2006. The new employment agreement provides for an annual base salary of 152,800 British pounds sterling per year (approximately U.S. $263,350 as of January 1, 2006) and severance of twice his annual base salary, net of taxes, under certain circumstances.

(14) SEGMENT AND MAJOR CUSTOMER INFORMATION

The Company has two reportable segments: electronic components and communications equipment. The electronic components segment operates in the U.S., European and Asian markets and designs, manufactures and markets digital switches and power supplies. The communications equipment segment operates principally in the U.S. and European markets and designs, manufactures and distributes voice and data transmission and networking equipment and communications test instruments.

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.

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

Each segment has business units or components as described in paragraph 30 of SFAS No. 142. Each component has discrete financial information and a management structure. Following is a description of the Company's segment and component structure as of December 31, 2005:

Reporting Units Within Electronic Components Segment:

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

- EMRISE Electronics - Monrovia, California: XCEL Circuits Division - printed circuit boards mostly for intercompany sales

- RO - Sunnyvale, California manufacturer of standard power supplies using proprietary technology.

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

- EEL - Ashford, Kent, England: Power supplies and conversion for defense and aerospace applications; this reporting unit also includes XPS and Pascall.

Reporting Units Within Communications Equipment Segment:

- CXR Telcom division of CXR Larus Corporation - San Jose, California: Telecommunications test equipment for the field and central office applications

- Larus division of CXR Larus Corporation - San Jose, California: Telecommunications synchronous timing devices and network access equipment

- CXR-Anderson Jacobson - Abondant, France: network access and modem equipment

As described in Note 17, the Company acquired PEHL and Pascall in March 2005. These two entities are being included in EEL reporting unit of the electronic components segment.

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

Selected financial data for each of the Company's operating segments is shown below.

	2005 (restated)	2004 (restated)	2003
Sales to external customers			
Electronic components	$25,687,000	$15,262,000	$16,168,000
Communications equipment	15,583,000	14,375,000	9,351,000
Total	$41,270,000	$29,637,000	$25,519,000
Interest expense			
Electronic components	$ 181,000	$ 180,000	$ 247,000
Communications equipment	274,000	250,000	162,000
Total	$ 455,000	$ 430,000	$ 409,000
Depreciation and amortization			
Electronic components	$ 674,000	$ 91,000	$ 72,000
Communications equipment	241,000	126,000	65,000
Total	$ 915,000	$ 217,000	$ 137,000
Segment profits			
Electronic components	$ 3,191,000	$ 2,612,000	$ 3,590,000
Communications equipment	697,000	1,580,000	74,000
Total	$ 3,888,000	$ 4,192,000	$ 3,664,000
Segment assets			
Electronic components	$25,144,000	$ 8,435,000	$ 9,466,000
Communications equipment.....	16,358,000	16,371,000	6,969,000
Total	$41,502,000	$24,806,000	$16,435,000

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 20

GOODWILL AND OTHER INTANGIBLE ASSETS BY SEGMENT AS OF DECEMBER 31, 2005

	Goodwill -- Not Amortizable	Trademarks and Trade Names -- Not Amortizable	Technology Acquired -- 10-Year Life Amortizable	Customer Relationships -- 10-Year Life Amortizable	Covena to Co -- 3 Li Amort
Gross cost					
Electronic components	$ 6,702,000	$ 813,000	$ 484,000	$ 200,000	$ 20
Communications equipment ...	6,428,000	750,000	1,150,000	200,000	
Total	$13,130,000	$ 1,563,000	$ 1,634,000	$ 400,000	$ 20
Accumulated amortization					
Electronic components	$ 192,000	$ --	$ 16,000	$ 7,000	$ 5
Communications equipment ...	872,000	--	172,000	30,000	
Total	$ 1,064,000	$ --	$ 188,000	$ 37,000	$ 5
Carrying value					
Electronic components	$ 6,510,000	$ 813,000	$ 468,000	$ 193,000	$ 15
Communications equipment ...	5,556,000	750,000	978,000	170,000	
Total	$12,066,000	$ 1,563,000	$ 1,446,000	$ 363,000	$ 15

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

GOODWILL AND OTHER INTANGIBLE ASSETS BY SEGMENT AS OF DECEMBER 31, 2004

Gross cost	Goodwill -- Not Amortizable	Trademarks and Trade Names -- Not Amortizable	Technology Acquired -- 10-Year Life Amortizable	Cu Relat 10-Y Amo
Electronic components	$ 1,297,000	$ --	$ --	$
Communications equipment ...	5,668,000	2,800,000	500,000	
Total	$ 6,965,000	$ 2,800,000	$ 500,000	$

Accumulated amortization				
Electronic components	$ 212,000	$ --	$ --	$
Communications equipment ...	872,000	--	25,000	
Total	$ 1,084,000	$ --	$ 25,000	$
Carrying value				
Electronic components	$ 1,085,000	$ --	$ --	$
Communications equipment ...	4,796,000	2,800,000	475,000	
Total	$ 5,881,000	$ 2,800,000	$ 475,000	$

CHANGES IN GOODWILL BY SEGMENT

	Electronic Components	Communications Equipment	
Balance at January 1, 2003	$ 914,000	$ 1,432,000	$
Goodwill acquired	--	--	
Impairment	--	--	
Foreign currency translation	101,000	--	
Balance December 31, 2003	$ 1,015,000	$ 1,432,000	$
Balance at January 1, 2004	$ 1,015,000	$ 1,432,000	$
Goodwill acquired	--	3,363,000	
Impairment	--	--	
Foreign currency translation	70,000	1,000	
Balance December 31, 2004 (restated)	$ 1,085,000	$ 4,796,000	$
Balance at January 1, 2005	$ 1,085,000	$ 4,796,000	$
Goodwill acquired or reclassed from other intangibles......	5,930,000	760,000	
Impairment	--	--	
Foreign currency translation	(505,000)	--	
Balance December 31, 2005 (restated)	$ 6,510,000	$ 5,556,000	$

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

The following is a reconciliation of the reportable segment revenues, profit or loss and assets to the Company's consolidated totals.

	2005 (restated)	2004 (restated)	
Net sales			
Total sales for reportable segments	$ 41,270,000	$ 29,637,000	$
Elimination of intersegment sales	--	--	
Total consolidated net sales	$ 41,270,000	$ 29,637,000	$
Income before income taxes			
Total income for reportable segments	$ 3,888,000	$ 4,192,000	$
Unallocated amounts:			
General corporate expenses	(2,714,000)	(2,816,000)	
Consolidated income before income taxes	$ 1,174,000	$ 1,376,000	$
Assets			
Total assets for reportable segments	$ 41,502,000	$ 24,806,000	$
Other assets	2,959,000	338,000	
Total consolidated assets	$ 44,461,000	$ 25,144,000	$
Interest expense			
Interest expense for reportable segments	$ 455,000	$ 430,000	$
Other interest expense	--	3,000	
Total interest expense	$ 455,000	$ 433,000	$
Depreciation and amortization			
Depreciation and amortization expense for reportable segments	$ 915,000	$ 217,000	$
Other depreciation and amortization expense.........	49,000	70,000	
Total depreciation and amortization	$ 964,000	$ 287,000	$

A summary of the Company's net sales and identifiable assets by geographical area follows:

	2005 (restated)	2004 (restated)	2003
Net sales:			
United States	$15,957,000	$12,521,000	$ 7,971,000
Japan	1,271,000	935,000	838,000
France	6,657,000	7,016,000	6,627,000
United Kingdom	17,385,000	9,165,000	10,083,000
	$41,270,000	$29,637,000	$25,519,000
Long-lived assets:			
United States	$ 734,000	$ 440,000	$ 117,000
Japan	7,000	11,000	16,000
France	101,000	142,000	107,000
United Kingdom	1,231,000	316,000	82,000
	$ 2,073,000	$ 909,000	$ 322,000

Sales and purchases between geographic areas have been accounted for on the basis of prices set between the geographic areas, generally at cost plus 40%. Identifiable assets by geographic area are those assets that are used in the Company's operations in each location. Net sales by geographic area have been determined based upon the country from which the product was shipped.

One customer in the electronic components segment accounted for 10% or more of net sales during 2005, 2004 and 2003.

(15) 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. The Company is currently evaluating the provisions of SFAS No. 151 and does not expect that adoption will have a material effect on its 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:

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003 (CONTINUED)

- 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.

- 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. The Company is required to adopt this new standard on January 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. The Company expects its expense for options outstanding as of December 31, 2005 will be approximately $103,000 in 2006 and $29,000 in 2007 with the application of SFAS 123(R).

As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using APB Opinion No. 25's intrinsic value method. Consequently, the Company generally recognizes no compensation cost for employee stock options under its employee stock option plans. Although the adoption of SFAS No. 123(R)'s fair value method will have no adverse effect on the Company's balance sheet or total cash flows, the adoption will affect the Company's 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 the Company uses to value future share-based payments to employees and estimated forfeiture rates. See Note 1 for the effect on reported net income and earnings per share that would have occurred if the Company had accounted for its 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. The Company does not believe its adoption of SPAS No. 153 will have a material effect on its 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. The Company does not believe our adoption of SFAS No. 154 will have a material effect on its consolidated financial position, results of operations or cash flows.

On June 29, 2005, the FASB ratified Emerging Issues Task Force 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 the Company's second quarter of fiscal 2005. The Company does not believe the adoption of Issue No. 05-06 will have a material effect on its consolidated financial position, results of operations or cash flows.

(16) QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following is a summary of the quarterly operations for the years ended December 31, 2005 and 2004 (in thousands, except for per share data).

	2005		
	Mar. 31 (restated)	June 30	Sept. 30
Net sales	$ 7,523	$ 9,962	$ 11,177
Gross profit	$ 3,278	$ 3,963	$ 4,866
Net income (loss)	$ (197)	$ 21	$ 816
Income available to common stockholders	$ (197)	$ 21	$ 816
Earnings (loss) per share:			
Basic	$ (0.01)	$ 0.02	$ 0.02
Diluted	$ (0.01)	$ 0.00	$ 0.02

	2004

	Mar. 31	June 30	Sept. 30
Net sales	$ 6,192	$ 6,432	$ 7,469
Gross profit	$ 2,747	$ 2,899	$ 3,230
Net income	$ 70	$ 369	$ 158
Income available to common stockholders	$ 70	$ 369	$ 158
Earnings per share:			
Basic	$ 0.00	$ 0.02	$ 0.01
Diluted	$ 0.00	$ 0.02	$ 0.01

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003 (CONTINUED)

QUARTERLY RESULTS OF OPERATIONS--RESTATEMENT ADJUSTMENTS

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

FIRST QUARTER ENDED MARCH 31, 2005	AS ORIGINALLY REPORTED	RESTATEMENT ADJUSTMENTS	AS RESTATED
	(IN THOUSANDS, EXCEPT PER SHARE DATA)		
Net sales	$ 7,299	$ 224	$ 7,523
Cost of sales	4,187	58	4,245
Gross profit	3,112	166	3,278
Operating expenses	3,363	13	3,376
Loss from operations	(251)	(153)	(98)
Net loss	$ (350)	$ 153	$ (197)
Basic and diluted loss per share	$ (0.01)	$ --	$ (0.01)

FOURTH QUARTER ENDED DECEMBER 31, 2004	AS ORIGINALLY REPORTED	RESTATEMENT ADJUSTMENTS	AS RESTATED

(IN THOUSANDS, EXCEPT PER SHARE DATA)

Net sales	$ 9,768	$ (224)	$ 9,544
Cost of sales	4,929	(57)	4,872
Gross profit	4,839	(167)	4,672
Operating expenses	3,965	(14)	3,951
Income from operations	874	(153)	721
Net income	$ 883	$ (153)	$ 730
Basic and diluted earnings per share	$ 0.03	$ --	$ 0.03

EMRISE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003 (CONTINUED)

(17) ACQUISITIONS

LARUS CORPORATION ACQUISITION

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

The purchase price for the acquisition totaled $6,539,500 and consisted of $1,000,000 in cash, the issuance of 1,213,592 shares of the Company's common stock with a fair value of $1,000,000, $887,500 in the form of two short-term, zero interest promissory notes that were repaid in 2004, $3,000,000 in the form of two subordinated secured promissory notes, warrants to purchase up to an aggregate of 150,000 shares of the Company's common stock at $1.30 per share, and approximately $580,000 of acquisition costs. The number of shares of the Company's common stock issued as part of the purchase price was calculated based on the $0.824 per share average closing price of the Company's common stock for the five trading days preceding the transaction. The warrants to purchase 150,000 shares of common stock were valued at $72,000 using a Black-Scholes formula that included a volatility of 107.19%, an interest rate of 3.25%, a life of three years and no assumed dividend.

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

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

	Amount in Thousands
Current assets	$ 2,460
Property, plant and equipment	90
Intangible assets other than goodwill	2,100
Goodwill	4,043
Total assets acquired	8,693
Current liabilities	(450)
Deferred income taxes	(815)
Unfavorable lease obligation and other liabilities	(888)
Total liabilities assumed	(2,153)
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 December 31, 2005 is anticipated to be approximately $135,000 per year for each of the next five years.

The following table summarizes, on an unaudited pro forma basis, the combined results of operations of the Company and Larus Corporation, as though the acquisition occurred as of January 1, 2003. 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):

	Year Ended December 31,	
	2004 (restated)	2003
Revenues	$ 32,262	$ 31,376
Net income	$ 1,611	$ 1,264
Earnings per share of common stock:		
Basic	$ 0.07	$ 0.06
Diluted	$ 0.06	$ 0.05

PASCALL ACQUISITION

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

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 underwrite 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, noninterference 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.

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	5,534
Total assets acquired	13,097
Current liabilities	(2,863)
Other liabilities	(80)
Total liabilities assumed	(2,943)
Net assets acquired	$ 10,154

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

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

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

RO ACQUISITION

On September 2, 2005, the Company's wholly-owned subsidiary, EMRISE Electronics, entered into a stock purchase agreement dated effective as of August 31, 2005 to acquire RO, a California corporation. 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.

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 stockholders' equity, accounts receivable, accounts payable, cash on hand and net inventory of RO, as determined by the consolidated, unaudited balance sheet as of August 31, 2005, prepared in accordance with accounting principles generally accepted in the United States of America. In addition, concurrently with the closing of the acquisition of RO, EMRISE Electronics paid in full all then existing credit facilities of RO in the aggregate amount of $1,602,000.

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

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 tern 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 $65,000 in acquisition costs:

	Dollars in Thousands
Current assets	$ 3,213
Property, plant and equipment	329
Intangibles, including goodwill	2,360
Other assets	66
Total assets acquired	5,968
Current liabilities	(943)
Other liabilities	(393)
Total liabilities assumed	(1,336)
Net assets acquired	$ 4,632

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003 (CONTINUED)

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).

	Year Ended December 31,	
	2005 (restated)	2004 (restated)
Revenues	$ 47,933	$ 52,767
Net income	$ 1,324	$ 2,072
Earnings per share of common stock:		
Basic	$ 0.04	$ 0.06
Diluted	$ 0.03	$ 0.06

(18) RELATED PARTY TRANSACTIONS

On July 13, 2004, the Company issued two promissory notes to the former stockholders of Larus Corporation totaling $3,000,000 in addition to paying cash and issuing shares of common stock and two zero interest short-term notes totaling $887,500 that were repaid in 2004, in exchange for 100% of the common stock of Larus Corporation (see Note 17). These notes are subordinated to the Company's bank debt and are payable in 72 equal monthly payments of principal totaling $41,667 per month plus interest at the 30-day LIBOR plus 5% with a maximum interest rate of 7% during the first two years of the term of the notes, 8% during the third and fourth years, and 9% thereafter. At December 31, 2005, the 30-day LIBOR was 4.54%.

Future maturities of notes payable to stockholders are as follows:

Year Ending December 31,	
2006	$ 500,000
2007	500,000
2008	500,000
2009	500,000
2010	250,000
	$ 2,250,000

Interest paid on these notes in 2005 and 2004 was $179,000 and $75,000, respectively.

The Company 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. 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 $.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 2005 and 2004 totaled $378,000 and $171,000, respectively. Future minimum lease payments under the operating lease payable to the stockholders are included in Note 12.

The Company entered into a lease for the RO building commencing September 1, 2005 through August 31, 2007 with Caspian Associates ("Caspian"), a California general partnership. Richard Okada, who was President of RO prior to the Company's acquisition and is currently the President of RO, is a general partner of Caspian. The acquisition agreement provides for an increase from the current favorable terms of the lease agreement based on certain financial performance of RO over the period of the lease. If the financial performance is met, the lease automatically extends to August 31, 2010 and is adjusted to the market value at that time, otherwise it will terminate on August 31, 2007 and convert to a month-to-month lease. The Company paid $37,000 on this lease in 2005. Future commitments on this lease are $147,360 in 2006 and $98,240 in 2007.

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

(19) STOCK ISSUANCE

On January 5, 2005, the Company issued to 17 accredited record holders in a private offering an aggregate of 12,503,500 shares of common stock at a purchase price of $1.44 per share and five-year investor warrants to purchase up to an additional 3,125,875 shares of our common stock at an exercise price of $1.73 per share, for total proceeds of approximately $18,005,000. The Company paid cash placement agent fees and expenses of approximately $961,000, and issued five-year placement warrants to purchase up to an aggregate of 650,310 shares of common stock at an exercise price of $1.73 per share in connection with the offering. The total warrants issued, representing 3,776,185 shares of the Company's common stock, have an estimated value of $4,400,000. Additional costs related to the financing include legal, accounting and consulting fees that totaled approximately $984,000 through December 31, 2005 including liquidated damages of $480,000 charged directly to equity as a return of capital against the gross proceeds of the financing. The Company used a portion of the proceeds from this financing to fund the acquisition of Pascall described in Note 16. The Company used 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. 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. The 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, prorated 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.

(20) SUBSEQUENT EVENTS

STOCK ISSUANCE

In May 2006, the Company determined that its recent periodic filings could not be relied upon and underwent an audit for the years 2003, 2004 and 2005 that had been audited previously. This matter caused the Company's S-3 filing to become no longer effective and caused the obligation of the Company under the Registration Rights Agreement to pay 1% liquidated damages to the remaining shareholders from their remaining shares still owned of the private offering. Such payments were made in the amounts of $44,064 for the months of June through November 2006, for a total of $220,320. These payments were charged to administrative expenses.

EXECUTIVE MANAGEMENT

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

CREDIT FACILITIES

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

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

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

The WFBC credit facility provides a $5,000,000 revolving line of credit secured by accounts receivable, other rights to payment and general intangibles, inventories and equipment. The line of credit is formula-based which generally provides that the outstanding borrowings under the line of credit may not exceed

an aggregate of 80% of eligible accounts receivable plus 10% of the value of eligible finished goods inventory. Interest is payable monthly. The interest rate is variable and is adjusted monthly based on the prime rate plus 1%. The prime rate at December 1, 2006 was 8.25%.

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

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

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

EMRISE CORPORATION AND SUBSIDIARIES
CONSOLIDATED SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS
YEARS ENDED DECEMBER 31, 2005 (RESTATED), 2004 (RESTATED) AND 2003

Description	Balance at Beginning of Year	Additions Charged to Costs and Expenses	Deductions Write-offs of Accounts	Reserve Acquired with Acquisition
Allowance for doubtful accounts:				
Year ended December 31, 2005	$ 153,000	$ 151,000	$ (33,000)	$ 108,000
Year ended December 31, 2004	$ 161,000	$ --	$ (32,000)	$ 24,000
Year ended December 31, 2003	$ 130,000	$ 61,000	$ (30,000)	$ --
Allowance for inventory obsolescence:				
Year ended December 31, 2005	$ 2,251,000	$ 1,403,000	$(1,150,000)	$ 1,549,000
Year ended December 31, 2004	$ 1,692,000	$ 1,116,000	$ (557,000)	$ --
Year ended December 31, 2003	$ 1,497,000	$ 924,000	$ (729,000)	$ --

INDEX TO EXHIBITS

EXHIBIT NUMBER	DESCRIPTION
2.1	Stock Purchase Agreement dated July 13, 2004 between MicroTel International Inc.; Noel C. McDermott; Warren P. Yost; Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995; and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (1)
2.2	Agreement dated March 1, 2005 among Intelek Properties Limited, XCEL Corporation Limited, Intelek PLC and EMRISE Corporation relating to the sale and purchase of the outstanding capital shares of Pascall Electronic (Holdings) Limited (13)
2.3	Supplemental Agreement dated March 18, 2005 among Intelek Properties Limited, XCEL Corporation Limited, Intelek PLC and EMRISE Corporation (13)
2.4	Loan Agreement dated March 18, 2005 among XCEL Corporation Limited, Pascall Electronics Limited and Pascall Electronic (Holdings) Limited (13)
2.5	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 (16)
2.6	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 (17)
3.1	Amended and Restated Certificate of Incorporation of EMRISE Corporation filed with the Secretary of State of Delaware on May 9,

	2005 (14)
3.2	Amended and Restated Bylaws adopted by the Board of Directors of the Corporation on September 1, 2004 (3)
10.1	1993 Stock Option Plan (#) (5)
10.2	Employee Stock and Stock Option Plan (#) (6)
10.3	1997 Stock Incentive Plan (#) (7)
10.4	Amended and Restated 2000 Stock Option Plan (#) (9)
10.5	Form of Executive Officer and Director Indemnification Agreement entered into between the Registrant and each of Carmine T. Oliva, Robert B. Runyon, Laurence P. Finnegan, Jr., Otis W. Baskin, Richard E. Mahmarian, Randolph D. Foote and Graham Jefferies (2)
10.6	Description of Retirement Account Matching Contributions (#) (20)
10.7	Credit Facility Letter Agreement dated June 1, 2004 between Wells Fargo Bank, N.A., XET Corporation and CXR Telcom Corporation (10)
10.8	Revolving Line of Credit Note dated June 1, 2004 in the principal amount of up to $3,000,000 made by XET Corporation and CXR Telcom Corporation in favor of Wells Fargo Bank, N.A. (10)
10.9	Term Note dated June 1, 2004 in the principal amount of $150,000 made by XET Corporation and CXR Telcom Corporation in favor of Wells Fargo Bank, N.A. (10)
10.10	Continuing Guaranty made by XET Corporation and CXR Telcom Corporation in favor of Wells Fargo Bank, N.A. (10)

EXHIBIT NUMBER	DESCRIPTION
10.11	Security Agreement Equipment made by XET Corporation in favor of Wells Fargo Bank, N.A. (10)
10.12	Security Agreement Equipment made by CXR Telcom Corporation in favor of Wells Fargo Bank, N.A. (10)
10.13	Continuing Security Agreement Rights to Payment and Inventory made by XET Corporation in favor of Wells Fargo Bank, N.A. (10)
10.14	Continuing Security Agreement Rights to Payment and Inventory made by CXR Telcom Corporation in favor of Wells Fargo Bank, N.A. (10)
10.15	Deed of Guarantee and Indemnity dated November 12, 2002 made by MicroTel International Inc., XCEL Corporation Limited, Belix Power Conversion Limited and Belix Wound Components Limited in favor of Venture Finance PLC (11)
10.16	Advantage Facility dated November 12, 2002 between XCEL Power

Systems, Ltd. and Venture Finance PLC (11)

10.17	Cashflow Loan Agreement dated November 12, 2002 between XCEL Power Systems, Ltd. and Venture Finance PLC (11)
10.18	Term Loan Agreement dated November 12, 2002 between XCEL Power Systems, Ltd. and Venture Finance PLC (11)
10.19	Deed of Subordination dated November 12, 2002 between Venture Finance PLC, MicroTel International Inc. and XCEL Corporation Limited (11)
10.20	Agreement for the Purchase of Debts dated November 12, 2002 between XCEL Power Systems, Ltd. and Venture Finance PLC (11)
10.21	Letter Agreement dated October 23, 2002 between XCEL Power Systems, Ltd. and Venture Finance PLC regarding Amendments to Agreement for the Purchase of Debts (11)
10.22	Credit Facility Agreement dated April 8, 2003, between IFN Finance and CXR, S.A.S. (11)
10.23	English Summary of Credit Facility Agreement dated April 8, 2003 between IFN Finance and CXR, S.A.S. (12)
10.24	Subordinated Secured Promissory Note dated July 13, 2004 in the principal amount of $1,681,318.68 made by MicroTel International Inc. in favor of Noel C. McDermott Revocable Living Trust dated December 19, 1995 (10)
10.25	Subordinated Secured Promissory Note dated July 13, 2004 in the principal amount of $1,318,681.32 made by MicroTel International Inc. in favor of Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)
10.26	Pledge and Security Agreement dated July 13, 2004 between MicroTel International Inc.; Noel C. McDermott, as Collateral Agent; Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995; and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)
10.27	Intercreditor Agreement dated July 13, 2004 between MicroTel International Inc.; Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995; and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)

EXHIBIT NUMBER	DESCRIPTION
10.28	Continuing Guarantee dated July 13, 2004 made by Larus Corporation in favor of Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995, and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)

10.29	Continuing Guarantee dated July 13, 2004 made by Vista Labs Incorporated in favor of Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995, and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)
10.30	Continuing Guarantee dated July 13, 2004 made by CXR Telcom in favor of Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995, and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)
10.31	Security Agreement dated July 13, 2004 made by Larus Corporation in favor of Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995, and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)
10.32	Security Agreement dated July 13, 2004 made by Vista Labs Incorporated in favor of Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995, and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)
10.33	Security Agreement dated July 13, 2004 made by CXR Telcom in favor of Noel C. McDermott, as Trustee of the Noel C. McDermott Revocable Living Trust dated December 19, 1995, and Warren P. Yost and Gail A. Yost, as Co-Trustees Under Declaration of Trust dated March 9, 1988 (10)
10.34	Lease agreement between the Registrant and Property Reserve Inc. dated September 16, 1999 (8)
10.35	Lease agreement between XET, Inc. and Rancho Cucamonga Development dated August 30, 1999 (8)
10.36	Commercial Lease dated July 13, 2004 between the Registrant, as Tenant, and Noel C. McDermott and Warren P. Yost, as Landlord, for the premises located at 894 Faulstich Court, San Jose, California (10)
10.37	Executive Employment Agreement dated February 24, 2006 by and between the Registrant and Carmine T. Oliva (#) (19)
10.38	Executive Employment Agreement dated February 24, 2006 by and between the Registrant and Randolph D. Foote (#) (19)
10.39	Executive Employment Agreement dated February 24, 2006 by and between the Company and Graham Jefferies (#) (19)
10.40	Securities Purchase Agreement dated December 29, 2004 among EMRISE Corporation and the investors listed on an attachment thereto (4)
10.41	Registration Rights Agreement dated December 29, 2004 among EMRISE Corporation and the investors who are parties to the Securities Purchase Agreement dated December 29, 2004 (4)

EXHIBIT NUMBER	DESCRIPTION
10.42	Form of Investor Warrant issued by EMRISE Corporation to the investors who are parties to the Securities Purchase Agreement dated December 29, 2004 (4)
10.43	Loan Agreement dated March 18, 2005 among XCEL Corporation Limited, Pascall Electronics Limited and Pascall Electronic (Holdings) Limited (13)
10.44	Form of Incentive Stock Option Agreement Under Amended and Restated 2000 Stock Option Plan (#) (15)
10.45	Form of Non-Qualified Stock Option Agreement Under Amended and Restated 2000 Stock Option Plan (#) (15)
10.46	Credit Agreement between EMRISE Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (18)
10.47	Revolving Line of Credit Note between EMRISE Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (18)
10.48	Security Agreement between EMRISE Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (18)
10.49	Continuing Security Agreement between EMRISE Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (18)
10.50	Continuing Guaranty between CXR Telcom Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (18)
10.51	Continuing Guaranty between EMRISE Electronics Corporation and Wells Fargo Bank, National Association dated as of August 25, 2005 (18)
10.52	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 (18)
10.53	Debt Purchase Agreement between Lloyds TSB Commercial Finance Limited and Pascall Electronics Limited dated June 28, 2005 (18)
10.54	Debt Purchase Agreement between Lloyds TSB Commercial Finance Limited and XCEL Power Systems Limited dated June 28, 2005 (18)
10.55	Loan Agreement between Lloyds TSB Commercial Finance Limited and XCEL Power Systems Limited dated June 28, 2005 (18)
10.56	Business Loan Agreement between Lloyds TSB Bank PLC and XCEL Corporation Limited dated June 30, 2005 (18)
10.57	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 (18)

EXHIBIT NUMBER	DESCRIPTION
10.58	Deed of Guaranty and Indemnity between XCEL Corporation Limited and Lloyds TSB Commercial Finance Limited dated June 21, 2005 (18)
10.59	Deed of Guarantee and Indemnity between Pascall Electronics Limited and Lloyds TSB Commercial Finance Limited dated June 21, 2005 (18)
10.60	Deed of Guarantee and Indemnity between XCEL Corporation Limited and Lloyds TSB Commercial Finance Limited dated June 21, 2005 (18)
10.61	Deed of Priorities between Lloyds TSB Commercial Finance Limited and Lloyds TSB Bank PLC and Pascall Electronics Limited dated June 28, 2005 (18)
10.62	Deed of Priorities between Lloyds TSB Commercial Finance Limited and Lloyds TSB Bank PLC and XCEL Power Systems Limited dated June 28, 2005 (18)
10.63	All Assets Debenture given by XCEL Power Systems Limited in favor of Lloyds TSB Commercial Finance Limited dated June 28, 2005 (18)
10.64	First Amendment to Credit Agreement dated as of November 17, 2005 by and between Emrise Corporation and Wells Fargo Bank, N.A. (20)
10.65	Description of Compensation of Directors (#) (20)
14.1	Amended and Restated Code of Business Conduct and Ethics (20)
14.2	Code of Business Ethics for CEO and Senior Financial Officers (20)
21	Subsidiaries of the Registrant (20)
23	Consent of Hein & Associates LLP, Independent Registered Public Accounting Firm *
31.1	Certification of Principal Executive Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 *
31.2	Certification of Principal Financial Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 *
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 *

---

* Filed herewith.

(#) Management contract or compensatory plan, contract or arrangement required to be filed as an exhibit.

(1) Filed as an exhibit to the Registrant's current report on Form 8-K for July 13, 2004 and incorporated herein by reference.

(2) Filed as an exhibit to the Registrant's current report on Form 8-K for December 8, 2004 and incorporated herein by reference.

(3) Filed as Appendix G to the Registrant's definitive proxy statement for the Registrant's 2004 annual meeting of stockholders and incorporated herein by reference.

(4) Filed as an exhibit to the Registrant's current report on Form 8-K for December 29, 2004 and incorporated herein by reference.

(5) Filed as an exhibit to the Registrant's annual report on Form 10-K for the year ended December 31, 2000 and incorporated herein by reference.

(6) Filed as an exhibit to the Registrant's definitive proxy statement for the Registrant's annual meeting of stockholders held June 11, 1998 and incorporated herein by reference.

(7) Filed as an exhibit to the Registrant's definitive proxy statement for the special meeting of stockholders held January 16, 2001 and incorporated herein by reference.

(8) Filed as an exhibit to the Registrant's interim report on Form 10-Q for September 30, 1999 and incorporated herein by reference.

(9) Filed as an exhibit to the Registrant's quarterly report on Form 10-Q for September 30, 2001 and incorporated herein by reference.

(10) Filed as an exhibit to the Registrant's quarterly report on Form 10-Q for June 30, 2004 and incorporated herein by reference.

(11) Filed as an exhibit to the Registrant's quarterly report on Form 10-Q for June 30, 2003 and incorporated herein by reference.

(12) Filed as an exhibit to amendment no. 1 to the Registrant's quarterly report on Form 10-Q for June 30, 2003 and incorporated herein by reference.

(13) Filed as an exhibit to the Registrant's current report on Form 8-K for March 18, 2005 and incorporated herein by reference.

(14) Filed on May 19, 2005 as an exhibit to the Registrant's current report on Form 8-K for May 6, 2005 and incorporated herein by reference.

(15) Filed as an exhibit to the Registrant's annual report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference.

(16) Filed as an exhibit to the Registrant's current report on Form 8-K for September 2, 2005 and incorporated herein by reference.

(17) Filed as an exhibit to amendment no. 1 to the Registrant's current report on Form 8-K for September 2, 2005 and incorporated herein by reference.

(18) Filed as an exhibit to the Registrant's quarterly report on Form 10-Q for September 30, 2005 and incorporated herein by reference.

(19) Filed as an exhibit to the Registrant's Form 8-K for February 24, 2006

and incorporated herein by reference.

(20) Filed as an exhibit to the Registrant's annual report on Form 10-K for the year ended December 31, 2005.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 on this 14th day of December, 2006.

EMRISE CORPORATION

By: /s/ Carmine T. Oliva

Carmine T. Oliva
Chairman of the Board, President,
Chief Executive Officer, Acting Chief
Financial Officer and Secretary

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURE	CAPACITY	
/s/ Carmine T. Oliva Carmine T. Oliva	Chairman of the Board, President, Chief Executive Officer (principal executive officer), Acting Chief Financial Officer (principal accounting and financial officer), Secretary and Director	De
/s/ Laurence P. Finnegan, Jr. Laurence P. Finnegan, Jr.	Director	De
/s/ Otis W. Baskin Otis W. Baskin	Director	De
/s/ Richard E. Mahmarian Richard E. Mahmarian	Director	De

EXHIBITS ATTACHED TO THIS REPORT

EXHIBIT NUMBER	DESCRIPTION
23	Consent of Hein & Associates LLP, Independent Registered Public Accounting Firm
31.1	Certification of Principal Executive Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002