DIGITAL ALLY INC
Form 10-Q
July 24, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013.

or

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

For the transition period from __________ to __________.

Commission File Number: 001-33899

Digital Ally, Inc.

(Exact name of registrant as specified in its charter)

Nevada	**20-0064269**

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

9705 Loiret Blvd, Lenexa, KS 66219

(Address of principal executive offices) (Zip Code)

(913) 814-7774

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer" "accelerated filer" and "smaller reporting company" in Rule 12b-2 of Exchange Act.

Large accelerated filer [ ] Accelerated filer [ ]
Non-accelerated filer [ ]
(Do not check if a smaller Smaller reporting company [X]
reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes [ ] No [X]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Class	**Outstanding at July 24, 2013**
Common Stock, $0.001 par value	2,135,564

FORM 10-Q

DIGITAL ALLY, INC.

JUNE 30, 2013

(Unaudited)

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION

Item 1 – Financial Statements.

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

JUNE 30, 2013 AND DECEMBER 31, 2012

(Unaudited)

	June 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$209,457	$703,172
Accounts receivable-trade, less allowance for doubtful accounts of $55,033 – 2013 and $70,193 – 2012	2,769,062	2,956,654
Accounts receivable-other	106,543	71,148
Inventories	8,238,792	7,294,721
Prepaid expenses	406,657	258,642
Total current assets	11,730,511	11,284,337
Furniture, fixtures and equipment	4,485,398	4,392,880
Less accumulated depreciation and amortization	3,468,571	3,454,087
	1,016,827	938,793
Restricted cash	662,500	662,500
Intangible assets, net	217,035	217,660
Other assets	268,415	241,446
Total assets	$13,895,288	$13,344,736
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$1,335,412	$1,520,207
Subordinated note payable-current, net of discount of $62,362 – 2013 and $0 – 2012	2,437,638	—
Accrued expenses	1,163,386	793,524
Capital lease obligation-current	77,344	66,087
Income taxes payable	5,667	6,717
Customer deposits	1,878	1,878
Total current liabilities	5,021,325	2,388,413
Long-term liabilities:		
Subordinated note payable-long-term, net of discount of $0 – 2013 and $96,378 – 2012	—	2,403,622

Litigation accrual-long term	530,000	530,000
Capital lease obligation-long term	100,693	120,988
Total long term liabilities	630,693	3,054,610
Commitments and contingencies		
Stockholder’s Equity:		
Common stock, $0.001 par value; 9,375,000 shares authorized; shares issued: 2,199,082 – 2013 and 2,099,082 – 2012	2,199	2,099
Additional paid in capital	23,599,314	23,304,401
Treasury stock, at cost (shares: 63,518 – 2013 and 63,518 - 2012)	(2,157,226)	(2,157,226)
Accumulated deficit	(13,201,017)	(13,247,561)
Total stockholders’ equity	8,243,270	7,901,713
Total liabilities and stockholders’ equity	$13,895,288	$13,344,736

See Notes to Consolidated Financial Statements.

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED

JUNE 30, 2013 AND 2012

(Unaudited)

	Three months ended June 30, 2013	Three months ended June 30, 2012	Six months ended June 30, 2013	Six months ended June 30, 2012
Product revenue	$4,801,499	$4,392,133	$9,393,622	$7,980,686
Other revenue	250,396	208,664	438,822	402,567
Total revenue	5,051,895	4,600,797	9,832,444	8,383,253
Cost of revenue	2,014,080	2,125,134	3,898,702	3,910,973
Gross profit	3,037,815	2,475,663	5,933,742	4,472,280
Selling, general and administrative expenses:				
Research and development expense	921,937	574,883	1,716,099	1,177,786
Selling, advertising and promotional expense	715,051	691,481	1,289,490	1,273,142
Stock-based compensation expense	191,521	120,796	295,013	241,437
Litigation charge and related expenses	—	654,082	—	654,082
General and administrative expense	1,230,545	1,309,951	2,472,962	2,733,543
Total selling, general and administrative expenses	3,059,054	3,351,193	5,773,564	6,079,990
Operating income (loss)	(21,239)	(875,530)	160,178	(1,607,710)
Interest income	3,637	2,143	6,820	4,779
Other income	21,219	—	21,219	—
Interest expense	(70,768)	(75,814)	(141,673)	(150,999)
Income (loss) before income tax (expense) benefit	(67,151)	(949,201)	46,544	(1,753,930)
Income tax (expense) benefit	—	—	—	—
Net income (loss)	$(67,151)	$(949,201)	$46,544	$(1,753,930)
Net income (loss) per share information:				
Basic	$(0.03)	$(0.47)	$0.02	$(0.87)
Diluted	$(0.03)	$(0.47)	$0.02	$(0.87)
Weighted average shares outstanding:				
Basic	2,096,231	2,025,759	2,080,342	2,022,491
Diluted	2,096,231	2,025,759	2,094,329	2,022,491

See Notes to Condensed Financial Statements.

F-2

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE SIX MONTHS ENDED JUNE 30, 2013

(Unaudited)

	Common Stock		Additional Paid In	Treasury	Accumulated	
	Shares	Amount	Capital	stock	deficit	Total
Balance, January 1, 2013	2,099,082	$ 2,099	$ 23,304,401	$ (2,157,226)	$ (13,247,561)	$ 7,901,713
Stock-based compensation	—	—	295,013	—	—	295,013
Restricted common stock grant	100,000	100	(100)	—	—	—
Net income	—	—	—	—	46,544	46,544
Balance, June 30, 2013	2,199,082	$ 2,199	$ 23,599,314	$ (2,157,226)	$ (13,201,017)	$ 8,243,270

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED JUNE 30, 2013 AND 2012

(Unaudited)

	2013	2012
Cash Flows From Operating Activities:		
Net income (loss)	$46,544	$(1,753,930)
Adjustments to reconcile net income (loss) to net cash flows used in operating activities:		
Depreciation and amortization	216,784	372,151
Stock based compensation	295,013	241,437
Provision for inventory obsolescence	(120,046)	3,306
Provision for doubtful accounts receivable	(15,160)	(13,392)
Change in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable - trade	202,752	(68,000)
Accounts receivable - other	(35,395)	44,721
Inventories	(824,025)	(270,859)
Prepaid expenses	(157,694)	21,357
Other assets	(26,969)	16,997
Increase (decrease) in:		
Accounts payable	(184,795)	53,106
Accrued expenses	369,862	(107,033)
Litigation accrual	—	530,000
Income taxes payable	(1,050)	(17,000)
Customer deposits	—	(30,021)
Net cash used in operating activities	(234,179)	(977,160)
Cash Flows from Investing Activities:		
Purchases of furniture, fixtures and equipment	(222,371)	(96,880)
Additions to intangible assets	(3,830)	(10,955)
Net cash used in investing activities	(226,201)	(107,835)
Cash Flows from Financing Activities:		
Payments on capital lease obligation	(33,335)	(2,338)
Net cash used in financing activities	(33,335)	(2,338)
Net decrease in cash and cash equivalents	(493,715)	(1,087,333)
Cash and cash equivalents, beginning of period	703,172	2,270,393
Cash and cash equivalents, end of period	$209,457	$1,183,060
Supplemental disclosures of cash flow information:		
Cash payments for interest	$107,722	$100,631
Cash payments for income taxes	$1,325	$17,000
Supplemental disclosures of non-cash investing and financing activities:		
Restricted common stock grant	$100	$130
Capital expenditures financed by capital lease obligations	$24,362	$94,760

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ALLY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business:

Digital Ally, Inc. (the "Digital Ally") and subsidiary (collectively, the "Company, "we, "us" and "our" ") produces digital video imaging and storage products for use in law enforcement, security and commercial applications. Our current products are a low cost, easy-to-install, in-car digital video rear view mirror designed for law enforcement vehicles and commercial fleets, such as ambulances and taxis; weather-resistant and rugged mobile digital video recording systems designed for use in motorcycles, ATV's and boats; a miniature digital video system designed to be worn on an individual's body (clipped to a pocket, belt, etc.); a hand-held speed detection device; and a digital video flashlight. These products make self-contained video and audio recordings onto flash memory cards that are incorporated into the body of the digital video rear view mirror, officer-worn video and audio system and a flashlight. We sell our products to law enforcement agencies and other security organizations, consumer and commercial fleet operators through direct sales domestically and third-party distributors internationally.

The Company was originally incorporated in Nevada on December 13, 2000 as Vegas Petra, Inc. and had no operations until 2004. On November 30, 2004, Vegas Petra, Inc. entered into a Plan of Merger with Digital Ally, Inc., at which time the merged entity was renamed Digital Ally, Inc.

The following is a summary of the Company's Significant Accounting Policies:

Basis of Consolidation:

The accompanying financial statements include the consolidated accounts of Digital Ally and its wholly-owned subsidiary, Digital Ally International, Inc. All intercompany balances and transactions have been eliminated during consolidation.

Digital Ally formed Digital Ally International, Inc. during August 2009 to facilitate the export sales of its products.

Fair Value of Financial Instruments:

The carrying amounts of financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and subordinated note payable, approximate fair value because of the short-term nature of these items.

Revenue Recognition:

Revenues from the sale of products are recorded when the product is shipped, title and risk of loss have transferred to the purchaser, payment terms are fixed or determinable and payment is reasonably assured.

We sell our products and services to law enforcement and commercial customers in the following manner:

Sales to domestic customers are made direct to the end customer (typically a law enforcement agency or a commercial customer) through our direct sales force, who are our employees. Revenue is recorded when the product is shipped to the end customer.

Sales to international customers are made through independent distributors who purchase products from the Company at a wholesale price and sell to the end user (typically law enforcement agencies or a commercial customer) at a retail price. The distributor retains the margin as its compensation for its role in the transaction. The distributor generally maintains product inventory, customer receivables and all related risks and rewards of ownership. Revenue is recorded when the product is shipped to the distributor consistent with the terms of the distribution agreement.

Repair parts and services for domestic and international customers are generally handled by our inside customer service employees. Revenue is recognized upon shipment of the repair parts and acceptance of the service or materials by the end customer.

Sales taxes collected on products sold are excluded from revenues and are reported as an accrued expense in the accompanying balance sheets until payments are remitted.

Other revenue is comprised of revenues from repair services and the sale of scrap and excess raw material and component parts. Revenue is recognized upon shipment of the product and acceptance of the service or materials by the end customer.

Obligations for sales returns and allowances are recognized at the time of sales on an accrual basis. The accrual is determined based upon historical return rates adjusted for known changes in key variables affecting these return rates. Sales returns and allowances aggregated $155,353 and $127,315 for the three months ended June 30, 2013 and 2012, respectively, and $343,779 and $178,616 for the six months ended June 30, 2013 and 2012, respectively.

Use of Estimates:

The preparation of the consolidated 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 amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents:

Cash and cash equivalents include funds on hand and in bank and short-term investments with original maturities of ninety (90) days or less.

Accounts Receivable:

Accounts receivable are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a weekly basis. The Company determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, and current economic conditions. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously written off are recorded when received.

A trade receivable is considered to be past due if any portion of the receivable balance is outstanding for more than thirty (30) days beyond terms. No interest is charged on overdue trade receivables.

Inventories:

Inventories consist of electronic parts, circuitry boards, camera parts and ancillary parts (collectively, “components”), work-in-process and finished goods, and are carried at the lower of cost (First-in, First-out Method) or market value. The Company determines the estimate for the reserve for slow moving or obsolete inventories by regularly evaluating individual inventory levels, projected sales and current economic conditions.

Furniture, fixtures and equipment:

Furniture, fixtures and equipment is stated at cost net of accumulated depreciation. Additions and improvements are capitalized while ordinary maintenance and repair expenditures are charged to expense as incurred. Depreciation is recorded by the straight-line method over the estimated useful life of the asset, which ranges from 3 to 10 years.

Intangible assets:

Intangible assets include deferred patent costs and license agreements. Legal expenses incurred in preparation of patent application have been deferred and will be amortized over the useful life of granted patents. Costs incurred in preparation of applications that are not granted will be charged to expense at that time. The Company has entered into several sublicense agreements whereby it has been assigned the exclusive rights to certain licensed materials used in its products. These sublicense agreements generally require upfront payments to obtain the exclusive rights to such material. The Company capitalizes the upfront payments as intangible assets and amortizes such costs over their estimated useful life.

Long-Lived Assets:

Long-lived assets such as property, plant and equipment and purchased intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or asset group be tested for possible impairment, the Company first compares undiscounted cash flows expected to be generated by that asset or asset group to its carrying value. If the carrying value of the long-lived asset or asset group is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying value exceeds its fair value. Fair value is determined through various valuation techniques including discounted cash flow models, quoted market values and third-party appraisals, as considered necessary. As of June 30, 2013 and December 31, 2012, there were no impairment indicators that required the Company to test for impairment in the carrying value of long-lived assets.

Warranties:

The Company's products carry explicit product warranties that extend up to two years from the date of shipment. The Company records a provision for estimated warranty costs based upon historical warranty loss experience and periodically adjusts these provisions to reflect actual experience. Accrued warranty costs are included in accrued expenses.

Customer Deposits:

The Company requires deposits in advance of shipment for certain customer sales orders, in particular when accepting orders from foreign customers for which the Company does not have a payment history. Customer deposits are reflected as a current liability in the accompanying consolidated balance sheets.

Shipping and Handling Costs:

Shipping and handling costs for outbound sales orders totaled $20,199 and $15,861 for the three months ended June 30, 2013 and 2012, respectively, and $42,670 and $29,961 for the six months ended June 30, 2013 and 2012, respectively. Such costs are included in selling, general and administrative expenses in the statements of operations.

Advertising Costs:

Advertising expense includes costs related to trade shows and conventions, promotional material and supplies, and media costs. Advertising costs are expensed in the period in which they are incurred. The Company incurred total advertising expense of approximately $129,917 and $127,055 for the three months ended June 30, 2013 and 2012, respectively, and $190,285 and $234,947 for the six months ended June 30, 2013 and 2012, respectively. Such costs are included in selling, general and administrative expenses in the consolidated statements of operations.

Income Taxes:

Deferred taxes are provided for by the liability method wherein deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The Company applies the provisions of the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") No. 740 - Income Taxes that provides a framework for accounting for uncertainty in income taxes and provided a comprehensive model to recognize, measure, present, and disclose in its financial statements uncertain tax positions taken or expected to be taken on a tax return. It initially recognizes tax positions in the financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are initially and subsequently measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the tax authority assuming full knowledge of the position and all relevant facts. Application requires numerous estimates based on available information. The Company considers many factors when evaluating and estimating its tax positions and tax benefits, and it recognized tax positions and tax benefits may not accurately anticipate actual outcomes. As it obtains additional information, the Company may need to periodically adjust its recognized tax positions and tax benefits. These periodic adjustments may have a material impact on its consolidated statements of operations.

The Company's policy is to record estimated interest and penalties related to the underpayment of income taxes as income tax expense in the consolidated statements of operations. There was no interest expense related to the underpayment of estimated taxes during the six months ended June 30, 2013 and 2012. There have been no penalties in 2013 and 2012.

Research and Development Expenses:

The Company expenses all research and development costs as incurred.

Stock-Based Compensation:

The Company grants stock-based compensation to its employees, board of directors and certain third party contractors. Share-based compensation arrangements may include the issuance of options to purchase common stock in the future or the issuance of restricted stock, which generally are subject to vesting requirements. The Company records stock-based compensation expense for all stock-based compensation granted after January 1, 2006 based on the grant-date fair value. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award.

The Company estimates the grant-date fair value of stock-based compensation using the Black-Scholes valuation model. Assumptions used to estimate compensation expense are determined as follows:

Expected term is determined using the contractual term and vesting period of the award;

Expected volatility of award grants made in the Company's plan is measured using the weighted average of historical daily changes in the market price of the Company's common stock over the period equal to the expected term of the award;

Expected dividend rate is determined based on expected dividends to be declared;

Risk-free interest rate is equivalent to the implied yield on zero-coupon U.S. Treasury bonds with a maturity equal to the expected term of the awards; and

Forfeitures are based on the history of cancellations of awards granted and management's analysis of potential forfeitures.

Segments of Business:

Management has determined that its operations are comprised of one reportable segment: the sale of digital audio and video recording and speed detection devices. For the three and six months ended June 30, 2013 and 2012, sales by geographic area were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	2013	2012
Sales by geographic area:				
United States of America	$4,960,111	$4,589,116	$9,659,846	$8,213,157
Foreign	91,784	11,681	172,598	170,096
	$5,051,895	$4,600,797	$9,832,444	$8,383,253

Sales to customers outside of the United States are denominated in U.S. dollars. All Company assets are physically located within the United States.

Accounting Developments:

New pronouncements issued but not effective until after June 30, 2013, are not expected to have a material impact on our financial position, results of operations or liquidity.

NOTE 2. BASIS OF PRESENTATION

The condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

The balance sheet at December 31, 2012 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements.

For further information, refer to the financial statements and footnotes included in the Company's annual report on Form 10-K for the year ended December 31, 2012.

NOTE 3. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

Financial instruments that potentially subject the Company to concentrations of credit risk consist of accounts receivable. Sales to domestic customers are typically made on credit and the Company generally does not require collateral. The Company performs ongoing credit evaluations of its customers' financial condition and maintains an allowance for estimated losses. Accounts are written off when deemed uncollectible and accounts receivable are presented net of an allowance for doubtful accounts. The allowance for doubtful accounts totaled $55,033 and $70,193 as of June 30, 2013, and December 31, 2012, respectively.

The Company sells through a network of unaffiliated distributors for international sales and both employee-based and independent sales agents for domestic sales. During 2012, the Company discontinued its use of independent sales agents for domestic sales and currently only utilizes employee-based domestic salesman. No distributor/agent individually exceeded 10% of total revenues, for the six months ended June 30, 2013. One customer receivable balance exceeded 10% of total accounts receivable as of June 30, 2013, which totaled $854,208, or 31% of total accounts receivable. One domestic distributor/agent individually exceeded 10% and represented $1,372,981, or 16% of total revenues, for the six months ended June 30, 2012. One customer receivable balance exceeded 10% of total accounts receivable as of June 30, 2012, which totaled $396,355, or 14% of total accounts receivable.

The Company purchases finished circuit boards and other proprietary component parts from suppliers located in the United States and on a limited basis from Asia. Although the Company obtains certain of these components from single source suppliers, management has located or is in process of locating alternative suppliers to reduce the risk in most cases to supplier problems that could result in significant production delays. The Company has not historically experienced any significant supply disruptions from any of its principal vendors, and does not anticipate future supply disruptions. The Company acquires most of its components on a purchase order basis and does not have long-term contracts with its suppliers.

The Company has entered into agreements with two unaffiliated companies ("Manufacturers") to develop, license and manufacture certain products that the Company offers for sale to its customers. Currently, these products represent less than 18% of the Company's total revenue; however, revenue generated by these products is expected to increase in the future to the extent that they may represent a significant portion of the Company's total revenue. These products can only be manufactured by the Manufacturers except in situations where the Manufacturers are unable for any reason to supply the products. Backup proprietary documentation for each product is required to be maintained offsite by each Manufacturer thereby allowing the Company to continue production in such cases where the Manufacturers are unable to supply the product. The Manufacturers are located in the United States and in Asia. Natural disasters, financial stress, bankruptcy and other factors may cause conditions that would disrupt either Manufacturer's ability to supply such products in quantities needed by the Company. It would take time for management to locate and activate alternative suppliers to replace the Manufacturers should it become necessary, which could result in significant production delays. The Company has not historically experienced any significant supply disruptions from either of these Manufacturers, and does not anticipate future supply disruptions.

NOTE 4. INVENTORIES

Inventories consisted of the following at June 30, 2013 and December 31, 2012:

	June 30, 2013	December 31, 2012
Raw material and component parts	$2,071,611	$2,475,857
Work-in-process	111,539	145,622
Finished goods	6,312,926	5,050,572
Subtotal	8,496,076	7,672,051
Reserve for excess and obsolete inventory	(257,284)	(377,330)
Total	$8,238,792	$7,294,721

Finished goods inventory includes units held by potential customers and sales agents for test and evaluation purposes. The cost of such units totaled $278,508 and $327,667 as of June 30, 2013 and December 31, 2012, respectively.

NOTE 5. SUBORDINATED NOTES PAYABLE AND CAPITAL LEASE OBLIGATIONS

	June 30, 2013	December 31, 2012
Subordinated notes payable, at par	$2,500,000	$2,500,000
Unamortized discount	(62,362)	(96,378)
Total notes payable	2,437,638	2,403,622
Less: Current maturities of long-term debt	2,437,638	—
Subordinated notes payable, long-term	$—	$2,403,622

During the year ended December 31, 2011, the Company, in two separate transactions, borrowed an aggregate of $2.5 million under two unsecured notes payable to a private, third-party lender. The loans were funded in May and November 2011 and both are represented by promissory notes (the "Notes") that bear interest at the rate of 8% per annum and are payable interest only on a monthly basis. The maturity date of the original Note in the principal amount of $1,500,000 was extended from May 30, 2012 to May 30, 2013 in conjunction with the issuance of the second Note during November 2011. Both Notes were due and payable in full on May 30, 2013 and could be prepaid without penalty at any time. The Notes are subordinated to all existing and future senior indebtedness, as such term is defined in the Notes.

The Company granted the lender warrants (the "Warrants") exercisable to purchase a total of 56,250 shares of its common stock at an exercise price of $8.00 per share (as modified) until November 30, 2013. The exercise price for the Warrants exercisable to purchase 37,500 shares issued with the first Note was reduced from $12.00 per share to $8.00 per share in consideration for the extension of the first Note's maturity date. The Company paid fees totaling $147,500 to an unaffiliated entity and issued warrants exercisable to purchase 13,750 shares of its Common Stock on the same terms and conditions as the Warrants for its services relating to the transactions, including the modification of the warrants issued pursuant to the first Note.

The Company allocated $236,726of the proceeds of the Notes to additional paid-in-capital, which represented the grant date fair value of the Warrant for 56,250 common shares issued to the lender and the warrant for 13,750 shares issued to the unaffiliated third party who arranged the transactions. In addition, the cash fees paid to the unaffiliated third party totaling $147,500 is included in the discount on the Notes. The modification of the original Note that occurred during November 2011 was treated as an early extinguishment of the debt.

On July 24, 2012, the Company entered into an agreement with the third party lender that extended the maturity date of the Notes from May 30, 2013 to May 30, 2014. In connection with the extension, the Company reduced the exercise price for the Warrants exercisable to purchase 56,250 shares previously granted to the lender from $8.00 to $4.00 and extended their expiration date from November 30, 2013 to November 30, 2015. The Company issued an unaffiliated third party a warrant exercisable to purchase 6,250 shares of Common Stock at a price of $4.00 per share through November 30, 2015 for its services in connection with the extension of the maturity dates of the Notes.

Additionally, the Company reduced the exercise price of warrants it had issued to such firm in May and November 2011 from $8.00 per share to $4.00 per share and extended their maturity dates to November 30, 2015. Such warrants are exercisable to purchase 13,750 shares of Common Stock. The Company allocated $38,052 to additional paid in capital, which represented the grant date fair value of the new warrants issued to the independent third party in July 2012 and the modification of the warrants for reducing the exercise price from $8.00 to $4.00 associated with extending the maturity date of the Note from May 30, 2013 to May 30, 2014. The restructuring of the Note that occurred in July 2012 was treated as a modification of the debt and the remaining unamortized discount of the note payable will be amortized to interest expense ratably over the modified terms of the Notes. The discount amortized to interest expense totaled $34,016 and $50,369 for the six months ended June 30, 2013, and 2012, respectively.

Capital Leases. Future minimum lease payments under non-cancelable capital leases having terms in excess of one year are as follows:

Year ending December 31:	
2013 (period from July 1, 2013 to December 31, 2013)	$44,976
2014	90,034
2015	58,025
2016	3,961
2017 and thereafter	—
Total future minimum lease payments	196,996
Less amount representing interest	18,959
Present value of minimum lease payments	178,037
Less current portion	77,344
Capital lease obligations, less current portion	$100,693

Assets under capital leases are included in furniture, fixtures and equipment as follows:

	June 30, 2013	December 31, 2012
Office furniture, fixtures and equipment	$259,295	$234,933
Less: accumulated amortization	(31,820)	(7,226)
Net furniture, fixtures and equipment	$227,475	$227,707

NOTE 6. ACCRUED EXPENSES

Accrued expenses consisted of the following at June 30, 2013 and December 31, 2012:

	June 30, 2013	December 31, 2012
Accrued warranty expense	$155,067	$173,385
Accrued sales commissions	88,420	39,639
Accrued payroll and related fringes	325,783	329,960
Accrued insurance	84,299	60,149
Accrued rent	231,373	66,287
Other	278,444	124,104
	$1,163,386	$793,524

Accrued warranty expense was comprised of the following for the six months ended June 30, 2013:

Beginning balance	$173,385
Provision for warranty expense	61,904
Charges applied to warranty reserve	(80,222)
Ending balance	$155,067

NOTE 7. INCOME TAXES

The effective tax rate for the six months ended June 30, 2013 and 2012 varied from the expected statutory rate as a result of the Company's decision to provide a 100% valuation allowance on net deferred tax assets. The Company has further determined that it would be appropriate to continue providing a full valuation allowance on net deferred tax assets as of June 30, 2013 because of our recent operating losses.

The valuation allowance on deferred tax assets totaled $6,400,000 and $6,395,000 as of June 30, 2013 and December 31, 2012, respectively. We record the benefit we will derive in future accounting periods from tax losses and credits and deductible temporary differences as "deferred tax assets," which are included in the caption "Deferred income taxes, net" on our consolidated balance sheets. In accordance with Accounting Standards Codification (ASC) 740, "Income Taxes," we record a valuation allowance to reduce the carrying value of our deferred tax assets if, based on all available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

The economic recession and its effect on state and local governmental budgets in particular remained weak in 2012 and 2011, and we incurred operating losses during this period. Law enforcement agencies are our primary customer and are typically funded through state and local tax roles. The economy showed improvement in the second half of 2012 but the impact on the state and local budgets is still uncertain at best. Despite the improvement in general economic conditions, our ongoing cost containment efforts, and our operating activity during the six months ended June 30, 2013, we remain in a three-year cumulative loss position at June 30, 2013. Accordingly, we determined there was not sufficient positive evidence regarding our potential for future profits to outweigh the negative evidence of our three-year cumulative loss position under the guidance provided in ASC 740. Therefore, we determined that our valuation allowance should be increased by $5,000 to continue to fully reserve our deferred tax assets at June 30, 2013. We expect to continue to maintain a full valuation allowance until we determine that we can sustain a level of profitability that demonstrates our ability to realize these assets. To the extent we determine that the realization of some or all of these benefits is more likely than not based upon expected future taxable income, a portion or all of the valuation allowance will be reversed. Such a reversal would be recorded as an income tax benefit and, for some portion related to deductions for stock option exercises, an increase in shareholders' equity.

At June 30, 2013, the Company had available approximately $7,750,000 of net operating loss carryforwards available to offset future taxable income generated. Such tax net operating loss carryforwards expire between 2026 and 2033. In addition, the Company had research and development tax credit carryforwards approximating $1,133,000 available as of June 30, 2013, which expire between 2023 and 2033.

The Internal Revenue Code contains provisions under Section 382 which limit a company's ability to utilize net operating loss carry-forwards in the event that it has experienced a more than 50% change in ownership over a three-year period. Current estimates prepared by the Company indicate that due to ownership changes which have occurred, approximately $765,000 of its net operating loss and $175,000 of its research and development tax credit carryforwards are currently subject to an annual limitation of approximately $1,151,000, but may be further limited by additional ownership changes which may occur in the future. As stated above, the net operating loss and research and development credit carryforwards expire between 2026 and 2033, allowing the Company to potentially utilize all of the limited net operating loss carry-forwards during the carryforward period.

As discussed in Note 1, "Summary of Significant Accounting Policies," tax positions are evaluated in a two-step process. We first determine whether it is more likely than not that a tax position will be sustained upon examination. If a tax position meets the more-likely-than-not recognition threshold, it is then measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. Management has identified no tax positions taken that would meet or exceed these thresholds and therefore there are no gross interest, penalties and unrecognized tax expense/benefits that are not expected to ultimately result in payment or receipt of cash in the consolidated financial statements.

The Company's federal and state income tax returns are closed for examination purposes by relevant statute and by examination for 2008 and all prior tax years. The Company recently under went an examination of its 2008 federal income tax return by the Internal Revenue Service. The examination process has been concluded with no proposed adjustments.

NOTE 8. COMMITMENTS AND CONTINGENCIES

Operating Leases. We have several non-cancelable operating lease agreements for office space and warehouse space that expire at various dates through April 2020. In September 2012, we entered into a non-cancelable long-term facility lease to combine all of our operations into one location effective November 2012. We have also entered into month-to-month leases for equipment and facilities. Rent expense for the six months ended June 30, 2013 and 2012 was $198,862 and $177,150, respectively, related to these leases. As reflected in the table below, we have a rent holiday and discounted rent for the first 12 months of the new facility lease which was effective November 1, 2012.

Year ending December 31:	
2013 (period from July 1, 2013 to December 31, 2013)	$138,819
2014	428,505
2015	433,965
2016	439,707
2017	445,449
2018 and thereafter	1,062,706
	$2,949,151

License agreements. The Company has several license agreements whereby it has been assigned the rights to certain licensed materials used in its products. Certain of these agreements require the Company to pay ongoing royalties based on the number of products shipped containing the licensed material on a quarterly basis. Royalty expense related to these agreements aggregated $21,401 and $19,264 for the six months ended June 30, 2013 and 2012, respectively.

Supply and distribution agreement. The Company entered into a supply and distribution agreement with Dragoneye Technology, LLC ("Dragoneye") on May 1, 2010 under which it was granted the exclusive world-wide right to sell and distribute a proprietary law enforcement speed measurement device and derivatives to its customers. The term of the agreement was 42 months after the date Dragoneye began full scale production of the product which commenced in August 2010 and final certification of the product was obtained. The agreement had minimum purchase requirements of 1,000 units per period over three commitment periods. On January 31, 2012, the supply and distribution agreement was amended to reduce the minimum purchase commitment over the second and third years by 52% of the original commitment. The Company agreed to release its world-wide right to exclusively market the product to the law enforcement community in exchange for the reduction in the purchase commitment.

The agreement requires minimum order quantities that represent a remaining commitment to acquire $634,680 of product through February 2014. Dragoneye is responsible for all warranty, damage or other claims, losses or liabilities related to the product and is obligated to defend and indemnify us against such risks. The Company held approximately $1,815,000 of such products in finished goods inventory as of June 30, 2013 and had sold approximately 615 units since the beginning of the agreement through June 30, 2013.

After the initial term has expired, the parties may continue the agreement on a month-to-month basis and is terminable by either party upon 30 days advance notice. The contract may be terminated earlier in case of material breach by either party that is not cured within thirty days of notice of the breach. The Company filed a lawsuit on June 15, 2013 against Dragoneye for breaching the contract and has ceased all purchases under the agreement. See "Legal Proceedings" for further details.

Litigation. The Company is subject to various legal proceedings arising from normal business operations. Although there can be no assurances, based on the information currently available, management believes that it is probable that the ultimate outcome of each of the actions will not have a material adverse effect on the consolidated financial statements of the Company. However, an adverse outcome in certain of the actions could have a material adverse effect on the financial results of the Company in the period in which it is recorded.

On June 8, 2009, we filed suit against Z3 Technologies, LLC ("Z3") in the U.S. District Court for the District of Kansas claiming breach of a production software license agreement entered into during October 2008 and the rescission of a second limited license agreement entered into during January 2009. Among other claims, we asserted that Z3 failed to deliver the material required under the contracts; that the product that was delivered by Z3 was defective and/or unusable; and that the January 2009 contract should be rescinded and declared void, unenforceable and of no force or effect. We paid license fees and made other payments to Z3 totaling $265,000 to date under these contracts. Z3 denied our claims and filed counterclaims that allege we did not have the right to terminate the contracts and therefore that it was damaged for loss of profits and related damages. In those counterclaims, Z3 sought to recover approximately $4.5 million from us exclusive of "prejudgment interest." Our insurance carrier settled a portion of the counterclaims under our director and officer liability insurance policy. The counterclaims that were not resolved by that settlement remained in controversy.

The trial of those claims began on June 25, 2012 and concluded with a jury verdict on July 3, 2012. The principal parts of the verdict were (i) an award of $30,000 to us on grounds that Z3 had breached its 2008 contract with us; (ii) an award of $15,000 in favor of Z3 by finding that we had breached the 2008 contract by failing to pay the balance of certain engineering fees; and (iii) an award of $100,000 in favor of Z3 based on the Court's finding that we breached the 2009 contract by failing to place an initial order for so-called "DM-365 modules" from Z3. As a result, the net judgment against us was $85,000. Further, despite our arguments at trial, the court also refused to reconsider the interlocutory summary judgment rulings rendered against us prior to trial in the amount of $445,000, which became final upon conclusion of the trial. Accordingly, the total judgment entered against us was $530,000 and no prejudgment interest on that sum was awarded.

We believe there are a number of errors in the court's rulings and the judgment entered on July 3, 2012 and are appealing them. We accrued the $530,000 judgment entered against us as a long-term liability as of June 30, 2013 due to the expected time required to conclude the appeal process. We have accrued the legal fees expected to be incurred during the appeal process. In order to stay the execution of judgment during the appeal process, we were required to post a bond in the amount of $662,500 in July 2012 and the respective funds will be reflected as restricted cash in future balance sheets until such time as the bond is no longer required.

On June 5, 2013, the Company filed a lawsuit as the plaintiff in the District Court of Johnson County, Kansas against Dragoneye, one of its domestic vendors. The Company entered into a supply and distribution agreement with Dragoneye on May 1, 2010 which was later amended on January 31, 2012 under which it was granted the right to sell and distribute a proprietary law enforcement speed measurement device and derivatives to its customers under the Company's trade name LaserAlly. The Company alleges in the complaint that Dragoneye has breached the contract whereby Dragoneye has failed to maintain as confidential information the Company's customer list; Dragoneye has infringed on the Company's trademarks, including LaserAlly and Digital Ally; Dragoneye has tortiously interfered with the Company's existing contracts and business relationships with its dealers, distributors, customers and trading partners; and Dragoneye has engaged in unfair competition and the Kansas Uniform Trade Secrets Statutes. The Company seeks the court to award damages related to the alleged actions of Dragoneye and to declare the Supply and Distribution agreement terminated and cancelled. Finally, the Company is seeking a temporary, preliminary and permanent injunction which prohibits Dragoneye from using or disclosing any of the Company's trade secrets and trademarks together with reasonable attorneys' fees, costs and expenses incurs as a result of this action.

Dragoneye was granted a request to remove the lawsuit from the District Court of Johnson County, Kansas State court and it is now in United States District Court for the District of Kansas. Dragoneye has filed its answer to the complaint which denies the allegations and has asserted counter claims against the Company for alleged breaching of the contract. The lawsuit is in the discovery phase.

On June 18, 2013, the Company filed a lawsuit as the plaintiff in the United States District Court for the District of Kansas against BCM Electronics Corp. SDN BHD ("BCM"), which is one of its foreign vendors. The Company seeks the court to award damages related to the alleged breach of contract regarding the failure of BCM to provide the component parts required under two purchase orders ("PO's"). The Company is also asking the court to declare the two PO's cancelled and terminated as a result of BCM's failure to perform. Finally, the Company is seeking a temporary, preliminary and permanent injunction which prohibits BCM from using or disclosing any of the Company's trade secrets together with reasonable attorneys' fees, costs and expenses incurs as a result of this action. BCM has not yet filed an answer to the complaint. The value of the two PO's are approximately $75,000.

We are also involved as a plaintiff and defendant in ordinary, routine litigation and administrative proceedings incidental to its business from time to time, including customer collections, vendor and employment-related matters. Management believes the likely outcome of any other pending cases and proceedings will not be material to its business or its financial condition.

401(k) Plan. In July 2008, the Company amended and restated its 401(k) retirement savings plan. The amended plan requires the Company to provide 100% matching contributions for employees who elect to contribute up to 3% of their compensation to the plan and 50% matching contributions for employee's elective deferrals on the next 2% of their contributions. The Company has made matching contributions totaling $52,717 and $54,700 for the six months ended June 30, 2013 and 2012, respectively. Each participant is 100% vested at all times in employee and employer matching contributions.

NOTE 9. STOCK-BASED COMPENSATION

The Company recorded pretax compensation expense related to the grant of stock options and restricted stock issued of $191,521 and $120,796 for the three months ended June 30, 2013 and 2012, respectively, and $295,013 and $241,437 for the six months ended June 30, 2013 and 2012, respectively.

As of June 30, 2013 the Company has adopted six separate stock option and restricted stock plans: (i) the 2005 Stock Option and Restricted Stock Plan (the "2005 Plan"), (ii) the 2006 Stock Option and Restricted Stock Plan (the "2006 Plan"), (iii) the 2007 Stock Option and Restricted Stock Plan (the "2007 Plan"), (iv) the 2008 Stock Option and Restricted Stock Plan (the "2008 Plan"), (v) the 2011 Stock Option and Restricted Stock Plan (the "2011 Plan") and (v) the 2013 Stock Option and Restricted Stock Plan (the "2013 Plan"). These Plans permit the grant of stock options or restricted stock to its employees, non-employee directors and others for up to a total of 975,000 shares of common stock. The Company believes that such awards better align the interests of its employees with those of its shareholders. Option awards have been granted with an exercise price equal to the market price of the Company's stock at the date of grant with such option awards generally vesting based on the completion of continuous service and having ten-year contractual terms. These option awards provide for accelerated vesting if there is a change in control (as defined in the Plans). The Company has registered all shares of common stock that are issuable under its Plans with the SEC with the exception of the 2013 Plan. A total of 51,106 options or restricted stock remain available for grant under the various Plans as of June 30, 2013.

In addition to the Stock Option and Restricted Stock Plans described above, the Company has issued other options outside of these Plans to non-employees for services rendered that are subject to the same general terms as the Plans, of which 1,250 options are fully vested and remain outstanding as of June 30, 2013.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model. The assumptions used for determining the grant-date fair value of options granted during the six months ended June 30, 2013 are reflected in the following table:

Expected term of the options in years	2-5 years
Expected volatility of Company stock	80%
Expected dividends	None
Forfeiture rate	10%

The following is a summary of stock options outstanding:

Options	Shares	Weighted Average Exercise Price
Outstanding at January 1, 2013	552,650	$ 17.87
Granted	40,000	4.16
Exercised	—	—