DIGITAL ALLY INC
Form 10-Q
August 14, 2014

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, 2014.

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 reporting company)	Smaller reporting company [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]

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 August 14, 2014**
Common Stock, $0.001 par value	2,706,791

FORM 10-Q

DIGITAL ALLY, INC.

JUNE 30, 2014

(Unaudited)

TABLE OF CONTENTS **Page(s)**

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.	F-1
Condensed Consolidated Balance Sheets – June 30, 2014 and December 31, 2013 (Unaudited)	F-1
Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2014 and 2013 (Unaudited)	F-2
Condensed Consolidated Statements of Stockholders' Equity for the Six Months Ended June 30, 2014 (Unaudited)	F-3
Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2014 and 2013 (Unaudited)	F-4
Notes to the Condensed Consolidated Financial Statements (Unaudited)	F-5
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.	3
Item 3. Quantitative and Qualitative Disclosures About Market Risk.	24
Item 4. Controls and Procedures.	24

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.	25
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.	27
Item 3. Defaults Upon Senior Securities.	27
Item 4. Mine Safety Disclosures.	27
Item 5. Other Information.	28
Item 6. Exhibits.	28

SIGNATURES 29

EXHIBITS 30

CERTIFICATIONS

PART I – FINANCIAL INFORMATION

Item 1 – Financial Statements.

DIGITAL ALLY, INC.

CONSOLIDATED BALANCE SHEETS

JUNE 30, 2014 AND DECEMBER 31, 2013

	June 30, 2014 (Unaudited)	**December 31, 2013**
Assets		
Current assets:		
Cash and cash equivalents	$676,634	$454,978
Accounts receivable-trade, less allowance for doubtful accounts of $65,977 – 2014 and $55,033 – 2013	1,919,785	1,835,780
Accounts receivable-other	120,030	153,563
Inventories, net	8,527,668	8,046,471
Prepaid expenses	368,123	402,823
Restricted cash	662,500	—
Total current assets	12,274,740	10,893,615
Furniture, fixtures and equipment	4,212,543	4,559,504
Less accumulated depreciation and amortization	3,314,123	3,621,432
	898,420	938,072
Restricted cash	—	662,500
Intangible assets, net	314,049	267,281
Other assets	249,671	245,045
Total assets	$13,736,880	$13,006,513
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$1,530,070	$1,441,151
Accrued expenses	1,392,574	1,471,458
Senior secured convertible note payable-current	1,000,000	—
Subordinated note payable-short-term, net of discount of $121,411 – 2014 and $0 – 2013	2,378,589	—

Derivative liabilities	258,731	—
Capital lease obligation-current	92,317	91,279
Deferred revenue-current	40,778	6,000
Income taxes payable	8,585	8,615
Litigation accrual	530,000	—
Customer deposits	1,878	1,878
Total current liabilities	7,233,522	3,020,381
Long-term liabilities:		
Subordinated note payable-long-term, net of discount of $0 – 2014 and $187,634 – 2013	—	2,312,366
Senior secured convertible note payable-long-term, at fair value	649,170	—
Litigation accrual-long term	—	530,000
Deferred revenue-long term	323,600	24,000
Capital lease obligation-long term	19,294	64,989
Total long term liabilities	992,064	2,931,355
Commitments and contingencies		
Stockholder's equity:		
Common stock, $0.001 par value; 9,375,000 shares authorized; shares issued: 2,470,381 – 2014 and 2,284,048 – 2013	2,470	2,284
Additional paid in capital	25,271,139	24,955,220
Treasury stock, at cost (shares: 63,518 – 2014 and 63,518 - 2013)	(2,157,226)	(2,157,226)
Accumulated deficit	(17,605,089)	(15,745,501)
Total stockholders' equity	5,511,294	7,054,777
Total liabilities and stockholders' equity	$13,736,880	$13,006,513

See Notes to Consolidated Financial Statements.

F-1

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED

JUNE 30, 2014 AND 2013

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2014	**2013**	**2014**	**2013**
Product revenue	$3,329,876	$4,801,499	$7,104,572	$9,393,622
Other revenue	119,878	250,396	253,523	438,822
Total revenue	3,449,754	5,051,895	7,358,095	9,832,444
Cost of revenue	1,521,365	2,014,080	3,108,767	3,898,702
Gross profit	1,928,389	3,037,815	4,249,328	5,933,742
Selling, general and administrative expenses:				
Research and development expense	695,101	921,937	1,550,350	1,716,099
Selling, advertising and promotional expense	664,077	715,051	1,271,221	1,289,490
Stock-based compensation expense	183,419	191,521	314,266	295,013
General and administrative expense	1,351,442	1,230,545	2,625,293	2,472,962
Total selling, general and administrative expenses	2,894,039	3,059,054	5,761,130	5,773,564
Operating income (loss)	(965,650)	(21,239)	(1,511,802)	160,178
Interest income	7,510	3,637	10,024	6,820
Interest expense	(127,249)	(70,768)	(227,061)	(141,673)
Income (loss) from derivative valuation	97,142	—	97,142	—
Secured Convertible note payable issuance expenses	—	—	(224,438)	—
Other income (expense)	158	21,219	(3,453)	21,219
Income (loss) before income tax (expense) benefit	(988,089)	(67,151)	(1,859,588)	46,544
Income tax (expense) benefit	—	—	—	—
Net income (loss)	$(988,089)	$(67,151)	$(1,859,588)	$46,544
Net income (loss) per share information:				
Basic	$(0.43)	$(0.03)	$(0.82)	$0.02
Diluted	$(0.43)	$(0.03)	$(0.82)	$0.02
Weighted average shares outstanding:				
Basic	2,317,309	2,096,231	2,263,230	2,080,342
Diluted	2,317,309	2,096,231	2,263,230	2,094,329

See Notes to Condensed Financial Statements.

F-2

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE SIX MONTHS ENDED JUNE 30, 2014

(Unaudited)

	Common Stock		Additional Paid In	Treasury	Accumulated	
	Shares	Amount	Capital	stock	deficit	Total
Balance, January 1, 2014	2,284,048	$ 2,284	$ 24,955,220	$ (2,157,226)	$ (15,745,501)	$ 7,054,777
Stock-based compensation	—	—	314,266	—	—	314,266
Restricted common stock grant	192,500	192	(192)	—	—	—
Restricted common stock forfeitures	(6,190)	(6)	6	—	—	—
Issuance of common stock upon exercise of stock options	94	1	2,500	—	—	2,501
Common shares surrendered in connection with cashless exercise of stock options	(71)	(1)	(661)	—	—	(662)
Net loss	—	—	—	—	(1,859,588)	(1,859,588)
Balance, June 30, 2014	2,470,381	$ 2,470	$ 25,271,139	$ (2,157,226)	$ (17,605,089)	$ 5,511,294

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED JUNE 30, 2014 AND 2013

(Unaudited)

	2014	**2013**
Cash Flows From Operating Activities:		
Net income (loss)	$(1,859,588)	$46,544
Adjustments to reconcile net income (loss) to net cash flows used in operating activities:		
Depreciation and amortization	244,319	216,784
Secured convertible note payable issuance expenses	224,438	—
Stock based compensation	314,266	295,013
Income from derivative valuation	(97,142)	—
Change in fair value of secured convertible note payable	2,808	—
Provision for inventory obsolescence	182,660	(120,046)
Provision for doubtful accounts receivable	10,944	(15,160)
Change in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable - trade	(94,949)	202,752
Accounts receivable - other	33,533	(35,395)
Inventories	(663,857)	(824,025)
Prepaid expenses	9,473	(157,694)
Other assets	(4,626)	(26,969)
Increase (decrease) in:		
Accounts payable	88,919	(184,795)
Accrued expenses	(78,884)	369,862
Income taxes payable	(30)	(1,050)
Deferred revenue	334,378	—
Net cash used in operating activities	(1,353,338)	(234,179)
Cash Flows from Investing Activities:		
Purchases of furniture, fixtures and equipment	(103,310)	(222,371)
Additions to intangible assets	(54,440)	(3,830)
Net cash used in investing activities	(157,750)	(226,201)
Cash Flows from Financing Activities:		
Proceeds from senior secured convertible note payable	2,000,000	—
Debt issuance expenses for secured convertible note payable	(224,438)	—
Payments on capital lease obligation	(44,658)	(33.335)
Proceeds from exercise of stock options	1,840	—
Net cash provided by (used) in financing activities	1,732,744	(33,335)
Net increase (decrease) in cash and cash equivalents	221,656	(493,715)
Cash and cash equivalents, beginning of period	454,978	703,172

Cash and cash equivalents, end of period	$676,634	$209,457
Supplemental disclosures of cash flow information:		
Cash payments for interest	$138,729	$107,722
Cash payments for income taxes	$10,030	$1,325
Supplemental disclosures of non-cash investing and financing activities:		
Restricted common stock grant	$192	$100
Restricted common stock forfeitures	$(6)	$—
Capital expenditures financed by capital lease obligations	$—	$24,362
Issuance of common stock purchase warrants for senior secured note payable	$355,873	$—

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") produces digital video imaging, audio recording and related storage products for use in law enforcement and security applications. Its current products are an in-car digital video/audio recorder contained in a rear-view mirror for use in law enforcement and commercial fleets, a weather-resistant mobile digital video recording system for use on motorcycles, ATV's and boats, a miniature digital video system designed to be worn on an individual's body; a digital video/audio recorder contained in a flashlight sold to law enforcement agencies and other security organizations; and a hand-held laser speed detection device that it is offering primarily to law enforcement agencies. The Company has active research and development programs to adapt its technologies to other applications. The Company has the ability to integrate electronic, radio, computer, mechanical, and multi-media technologies to create unique solutions to address needs in a variety of other industries and markets, including mass transit, school bus, taxi cab and the military.

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, restricted cash, accounts receivable, accounts payable and subordinated note payable, approximate fair value because of the short-term nature of these items. The Company has elected to account for its senior secured convertible notes payable and derivative liabilities on its fair value basis.

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. Customers do not have a right to return the product other than for warranty reasons for which they would only receive repair services or replacement product.

The Company sells its 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 its direct sales force, which is composed of its 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.

Extended warranties are offered on selected products and when a customer purchases an extended warranty the associated proceeds are treated as deferred revenue and recognized over the term of the extended warranty.

Sales returns and allowances aggregated $88,435 and $155,353 for the three months ended June 30, 2014 and 2013, respectively, and $315,311 and $343,779 for the six months ended June 30, 2014 and 2013, respectively. 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

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, 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 three to ten 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 under which 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.

Debt:

The Company's debt securities are accounted for at amortized cost, except where the Company has elected to account for its senior convertible note payable on its fair value basis.

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, 2014 and December 31, 2013, 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. Extended warranties are offered on selected products and when a customer purchases an extended warranty the associated proceeds are treated as deferred revenue and recognized over the term of the extended warranty.

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 $14,643 and $20,199 for the three months ended June 30, 2014 and 2013, respectively, and $29,402 and $$42,670 for the six months ended June 30, 2014 and 2013, 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 $128,888 and $129,917 for the three months ended June 30, 2014 and 2013, respectively, and $231,994 and $190,285 for the six months ended June 30, 2014 and 2013, 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, 2014 and 2013. There have been no penalties in 2014 and 2013.

Research and Development Expenses:

The Company expenses all research and development costs as incurred. Development costs of computer software to be sold, leased, or otherwise marketed are subject to capitalization beginning when a product’s technological feasibility has been established and ending when a product is available for general release to customers. In most instances, the Company’s products are released soon after technological feasibility has been established. Costs incurred subsequent to achievement of technological feasibility were not significant, and software development costs were expensed as incurred during 2014 and 2013.

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, 2014 and 2013, sales by geographic area were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	**2013**	**2014**	**2013**
Sales by geographic area:				
United States of America	$3,324,131	$4,960,111	$7,183,363	$9,659,846
Foreign	125,623	91,784	174,732	172,598
	$3,449,754	$5,051,895	$7,358,095	$9,832,444

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:

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") No. 2014-09, *"Revenue from Contracts with Customers"* ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The standard is effective for interim and annual periods beginning after December 15, 2016 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is not permitted. The Company has not yet selected a transition method and is currently evaluating the standard and the impact on its consolidated financial statements and footnote disclosures.

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, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

The balance sheet at December 31, 2013 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, 2013.

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 $65,977 and $55,033 as of June 30, 2014, and December 31, 2013, respectively.

The Company uses primarily a network of unaffiliated distributors for international sales and employee-based direct sales force for domestic sales. No distributor/agent individually exceeded 10% of total revenues, for the six months ended June 30, 2014 or June 30, 2013. No customer receivable balance exceeded 10% of total accounts receivable as of June 30, 2014. 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.

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 (the “Manufacturers”) to develop, license and manufacture certain products that the Company offers for sale to its customers. Currently, these products represent approximately 50% of the Company’s total revenue; and are expected to increase in the future to the extent that they may represent an even more 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 discontinued purchases from one of the manufacturers of the LaserAlly product and is re-evaluating such product line.

NOTE 4. INVENTORIES

Inventories consisted of the following at June 30, 2014 and December 31, 2013:

	June 30, 2014	**December 31, 2013**
Raw material and component parts	$2,268,673	$ 2,204,216
Work-in-process	323,562	5,714
Finished goods	6,378,805	6,097,254
Subtotal	8,971,040	8,307,184
Reserve for excess and obsolete inventory	(443,372)	(260,713)
Total	$8,527,668	$ 8,046,471

Finished goods inventory includes units held by potential customers and sales agents for test and evaluation purposes. The cost of such units totaled $425,410 and $340,093 as of June 30, 2014 and December 31, 2013, respectively.

NOTE 5. SUBORDINATED NOTES PAYABLE, SENIOR SECURED CONVERTIBLE NOTE PAYABLE, AND CAPITAL LEASE OBLIGATIONS

	June 30, 2014	December 31, 2013
Subordinated notes payable, at par	$2,500,000	$ 2,500,000
Unamortized discount	(121,411)	(187,634)
Total notes payable	2,378,589	2,312,366
Less: Current maturities of long-term debt	2,378,589	—
Subordinated notes payable, long-term	$—	$ 2,312,366

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 $236,726 of 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 Notes that occurred in July 2012 was treated as a modification of the debt and the remaining unamortized discount of the Notes will be amortized to interest expense ratably over the modified terms of the Notes.

On December 4, 2013, the Company entered into an agreement with the same third party lender to extend the maturity date of the Notes from May 30, 2014 to May 30, 2015. In connection with the extension, the Company granted the lender warrants exercisable to purchase 40,000 shares of its common stock at $8.50 per share through December 3, 2018. The Company also paid fees totaling $10,000 to an unaffiliated third party and issued a warrant exercisable to purchase 10,000 shares of Common Stock at a price of $8.50 per share through December 3, 2018 for its services in connection with the extension of the maturity dates of the Notes. The Company allocated $205,820 to additional paid in capital, which represented the grant date fair value of the new warrants issued to the lender and the unaffiliated third party who arranged the transaction. In addition, the cash fees paid to the unaffiliated third party totaling $10,000 were included in the discount on the Notes. The restructuring of the Notes that occurred in December 2013 was treated as a modification of the debt and the remaining unamortized discount of the Notes will be amortized to interest expense ratably over the modified terms of the Notes. The discount amortized to interest expense totaled $68,459 and $34,016 for the six months ended June 30, 2014, and 2013, respectively.

Senior Secured Convertible Note Payable

	June 30, 2014	December 31, 2013
Secured convertible note payable at fair value	1,649,170	—
Less: Current maturities	(1,000,000)	—
Secured convertible note payable, long-term	$649,170	—

On March 24, 2014, the Company completed a private placement of $2.0 million aggregate principal amount of a Senior Secured Convertible Note (the “Secured Convertible Note”). The Secured Convertible Note bears interest at 6% per annum payable quarterly and is secured by all assets of the Company. Principal payments are not required until the sixth month after issuance and continue ratably for the remaining 18-month term of the Secured Convertible Note. The principal and interest payments can be made through the payment of cash or in-kind by transferring unrestricted and fully registered shares in an amount equivalent to 80% of the volume weighted average trading price for the 20 consecutive trading days preceding the payment date. The Secured Convertible Note is convertible to common shares at the holder’s option at a conversion price of $8.55 per share at any time the Secured Convertible Note is outstanding. In addition, the Company may force conversion if the market price exceeds $17.10 per share for 20 consecutive trading days. See Note 13 Subsequent Events for details regarding the holder of the Secured Convertible Note converting $1,777,777.76 of principal into common stock of the Company between July 11 and July 14, 2014.

In connection with the private placement the Company issued a warrant to purchase 100,000 shares of common stock (the “Warrant”) at $10.00 per share. The Warrant is exercisable immediately and expires March 24, 2019. The Secured Convertible Note and Warrant contain anti-dilution provisions and restrict the incurrence of additional secured indebtedness. The Company paid a placement agent fee of $120,000 and approximately $104,500 of third party costs for the transaction, which included legal fees. The Company elected to account for the Secured Convertible Note on its fair value basis, therefore, all related debt issuance expenses which totaled $224,438 was charged to other expenses in March 2014.

The Company issued the lender a Warrant for 100,000 common shares and the associated fair value of the derivative liability was calculated to be $355,873 at March 31, 2014. At June 30, 2014, the fair value of the derivative liability was $258,731 and $97,142 was reported as income from derivative valuation.

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:	
2014 (period from July 1, 2014 to December 31, 2014)	$50,720
2015	63,728
2016	3,961
2017	—
2018 and thereafter	—
Total future minimum lease payments	118,409
Less amount representing interest	6,798
Present value of minimum lease payments	111,611
Less current portion	92,317
Capital lease obligations, less current portion	$19,294

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

	June 30, 2014	December 31, 2013
Office furniture, fixtures and equipment	$280,304	$ 280,304
Less: accumulated amortization	(99,844)	(64,572)
Net furniture, fixtures and equipment	$180,460	$ 215,732

NOTE 6. Fair Value Measurement

In accordance with ASC Topic 820 — *Fair Value Measurements and Disclosures* (“ASC 820”), the Company utilizes the market approach to measure fair value for its financial assets and liabilities. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets or liabilities, such as a business.

ASC 820 utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

Level 1 — Quoted prices in active markets for identical assets and liabilities

Level 2 — Other significant observable inputs (including quoted prices in active markets for similar assets or liabilities)

Level 3 — Significant unobservable inputs (including the Company's own assumptions in determining the fair value)

The following table represents the Company's hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2014.

	Level 1	**Level 2**	**Level 3**	**Total**
Liabilities				
Senior Secured Convertible Note	$ -	$ -	$1,649,170	$1,649,170
Derivative liabilities	$ -	$ -	$258,731	$258,731
	$ -	$ -	$1,907,901	$1,907,901

NOTE 7. ACCRUED EXPENSES

Accrued expenses consisted of the following at June 30, 2014 and December 31, 2013:

	June 30, 2014	**December 31, 2013**
Accrued warranty expense	$167,900	$ 167,970
Accrued sales commissions	27,352	53,172
Accrued payroll and related fringes	327,326	389,807
Accrued insurance	74,095	67,387
Accrued rent	276,475	291,416
Accrued litigation charges	188,316	208,316
Accrued research and development expenses	165,533	—
Other	165,577	293,390
	$1,392,574	$ 1,471,458

Accrued warranty expense was comprised of the following for the six months ended June 30, 2014:

	2014
Beginning balance	$167,970
Provision for warranty expense	43,737
Charges applied to warranty reserve	(43,807)
Ending balance	$167,900

F-13

NOTE 8. INCOME TAXES

The effective tax rate for the six months ended June 30, 2014 and 2013 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, 2014 because of the overall net operating loss carryforwards available.

The valuation allowance on deferred tax assets totaled $8,720,000 and $7,970,000 as of June 30, 2014 and December 31, 2013, 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 recovery from the economic recession, which adversely impacted state and local governmental budgets in particular, remained weak in 2013 and 2012, and we incurred operating losses during this period. Law enforcement agencies are our primary customer and are typically funded through state and local tax rolls. The economy showed improvement in 2013 and 2012, but the establishment of a long-term positive impact on the state and local budgets is still uncertain at best. Despite the improvement in general economic conditions, our ongoing cost containment efforts, we incurred additional losses in 2013 and the six months ended June 30, 2014 that placed us in a three-year cumulative loss position at June 30, 2014. 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 to increase our valuation allowance by $750,000 to continue to fully reserve our deferred tax assets at June 30, 2014. 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, 2014, the Company had available approximately $11,420,000 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 $1,381,000 available as of June 30, 2014, which expire between 2023 and 2034.

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 2010 and all prior tax years.

NOTE 9. 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. We have also entered into month-to-month leases for equipment and facilities. Rent expense for the six months ended June 30, 2014 and 2013 was $198,862 and $198,862, respectively, related to these leases. Following are our minimum lease payments for each year and in total.

Year ending December 31:	
2014 (period from July 1, 2014 to December 31, 2014)	$214,703
2015	433,965
2016	439,707
2017	445,449
2018	451,248
Thereafter	611,458
	$2,596,530

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 $13,996 and $21,401 for the six months ended June 30, 2014 and 2013, 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 originally required minimum order quantities that represent a remaining unfulfilled commitment to acquire $634,680 of product as of June 30 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 $1,358,000 of such products in finished goods inventory as of June 30, 2014 and had sold approximately 889 units since the beginning of the agreement through June 30, 2014.

The Company filed a lawsuit on June 15, 2013 against Dragoneye for breaching the contract. See “Litigation” below. The Company discontinued purchases of additional units as of that date.

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 Z3Technologies, 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.

Both parties appealed to the United States Court of Appeals for the 10th Circuit, and on May 16 2014, the Court of Appeals affirmed that judgment in part and reversed it in part. As a result of the Court's decision, our obligation to Z3 is approximately $600,697, including pre-judgment and post-judgment interest. In July 2012 at the inception of the appeal, we deposited $662,500 for a bond as security for the obligation represented by the judgment. We will use such sum to satisfy the judgment and the expenses of the appeal and no additional funds will be required. We recently determined not to ask for a rehearing by the Court.

We accrued the $530,000 judgment entered against it as a long-term liability as of June 30, 2013 due to the expected time required to conclude the appeal process. We also accrued the legal fees and pre-judgment and post-judgment interest expected to be incurred during the appeal process. We reflected the bond of $662,500 as restricted cash in our subsequent balance sheets.

On June 5, 2013, we filed a lawsuit in the District Court of Johnson County, Kansas against Dragoneye. We had entered into a supply and distribution agreement with Dragoneye on May 1, 2010 under which we were granted the right to sell and distribute a proprietary law enforcement speed measurement device and derivatives to our customers under the trade name LaserAlly. The parties amended the agreement on January 31, 2012. In our complaint we allege that Dragoneye breached the contract because it failed to maintain as confidential information our customer list; it infringed on our trademarks, including LaserAlly and Digital Ally; it tortiously interfered with our existing contracts and business relationships with our dealers, distributors, customers and trading partners; and it engaged in unfair competition and the Kansas Uniform Trade Secrets Statutes. We amended the complaint to include claims regarding alleged material defects in the products supplied under the agreement. The parties have agreed in principle to resolve their claims and are negotiating a settlement agreement which will require us to pay all outstanding and unpaid invoices including interest at 10% through the date the settlement agreement is executed. Such amount was approximately $ 210,000 and was recorded in accounts payable and accrued liabilities at June 30, 2014. Dragoneye has agreed to cancel the remaining obligation to purchase LaserAlly's and to accept responsibility for and to correct the defect in the products delivered at its cost.

On June 18, 2013, we 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 our foreign vendors. We requested 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"). We also asked the court to declare the two PO's cancelled and terminated as a result of BCM's failure to perform. Finally, we requested a temporary, preliminary and permanent injunction to prohibit BCM from using or disclosing any of our trade secrets together with reasonable attorneys' fees, costs and expenses incurred as a result of this action. The court issued a default judgment against BCM on August 23, 2013 totaling $255,000 and as a result, we cancelled the open payables we had with BCM (approximately $59,000) in the third quarter 2013. We have not accrued any other amounts related to the default judgment due to the uncertainty of collection. Any recovery will be recorded as income if and when it occurs.

On October 25, 2013, we filed a complaint in the United States District Court for the District of Kansas to eliminate threats by a competitor, Utility Associates, Inc. ("Utility"), of alleged patent infringement regarding U.S. Patent No. 6,831,556 (the "556 patent"). Specifically, the lawsuit seeks a declaration that our mobile video surveillance systems do not infringe any claim of the 556 patent. In addition, we have begun proceedings to invalidate the '556 patent through a request for *inter partes review* of the '556 patent at the United States Patent and Trademark Office. We became aware that Utility had recently mailed letters to current and prospective purchasers of our mobile video surveillance systems threatening that the use of such systems purchased from third parties not licensed to the '556 patent would create liability for them for patent infringement. We reject Utility's assertion and will vigorously defend the right of end-users to purchase such systems from providers other than Utility. The United States District Court for the District of Kansas dismissed the lawsuit because it decided that Kansas was not the proper jurisdictional forum for the dispute. The court's decision was not a ruling on the merits of the case. We have appealed the decision.

On June 4, 2014 we filed an Unfair Competition lawsuit against Utility Associates, Inc. (“Utility”) in the United States District Court for the District of Kansas. In the lawsuit we contend that Utility has defamed us and illegally interfered with our contracts, customer relationships and business expectancies by falsely asserting to our customers and others that our products violate the ’556 Patent, of which Utility claims to be the holder.

Our suit also includes claims against Utility for tortious interference with contract and violation of the Kansas Uniform Trade Secrets Act (KUSTA), arising out of Utility’s employment of one of our employees, in violation of that employee’s Non-Competition and Confidentiality agreements with us. In addition to damages, we seek temporary, preliminary, and permanent injunctive relief, prohibiting Utility from, among other things, continuing to threaten or otherwise interfere with our customers. We have requested a hearing upon the Motion for Temporary Restraining Order and Preliminary Injunction, which we filed contemporaneously with our complaint against Utility.

On October 25, 2013, we filed a complaint in the United States District Court for the District of Kansas to eliminate threats by a competitor, Utility Associates, Inc. (“Utility”), of alleged patent infringement regarding U.S. Patent No. 6,831,556 (the “556 patent”). Specifically, the lawsuit seeks a declaration that our mobile video surveillance systems do not infringe any claim of the 556 patent. In addition, we will be take steps to invalidate the 556 patent through appropriate procedures at the United States Patent and Trademark Office. We became aware that Utility had repeatedly mailed letters to current and prospective purchasers of our mobile video surveillance systems threatening that the use of such systems purchased from third parties not licensed to the 556 patent would create liability for them for patent infringement. We reject Utility’s assertion and will vigorously defend the right of end-users to purchase such systems from providers other than Utility. The United States District Court for the District of Kansas dismissed the lawsuit because it decided that Kansas was not the proper jurisdictional forum for the dispute. The court’s decision was not a ruling on the merits of the case. We have appealed the decision.

On June 13, 2014, Utility filed suit in the United States District Court for the Northern District of Georgia against us alleging infringement of the ’556 patent.” The suit was served on us on June 20, 2014. In light of the lawsuit we filed against Utility noted above, we believe this suit should be dismissed and transferred to Kansas. As alleged in our first filed lawsuit, we believe the ’556 patent is both invalid and not infringed. Further, proceedings seeking to invalidate the ’556 patent already have begun at the United State Patent and Trademark Office where the Company. We believe that this suit is without merit and will vigorously defend the claims asserted against us. An adverse resolution of the foregoing litigation or patent proceedings could have a material adverse effect on our business, prospects, results of operations, financial condition, and liquidity.

On or about May 22, 2014, Stephen Gans, a former director and former principal shareholder of us filed a complaint in the Eighth Judicial District Court, Clark County, Nevada that asserts claims against us and Stanton E. Ross, Leroy C. Richie, Daniel F. Hutchins and Elliot M. Kaplan (the “Defendant Directors”), who are members of its Board of Directors. We were served with the complaint on May 28, 2014. Among other things, the complaint alleges (i) that the Defendant Directors breached their fiduciary duties by failing to consider a financing proposal offered by Mr. Gans and his affiliates; and (ii) that the Defendant Directors, acting at the direction of Stanton E. Ross, did not independently and objectively evaluate Mr. Gans’ protestations about certain alleged transactions between us and

Infinity Energy Resources, Inc., and by so doing, breached their fiduciary duties. We and the Defendant Directors will vigorously defend the claims asserted against us and them. We and the Defendant Directors have filed a response denying all of the Plaintiff's allegations and have asserted counter-claims that allege that Gans committed improper acts that included: (a) failing to disclose the nature and substance of an SEC investigation of Gans; (b) engaging in potential insider trading; (c) misappropriating our confidential information; (d) attempting to use his position as a director to personally enrich himself; and (e) making unauthorized, misleading, and factually inaccurate filings to the SEC about us.

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 $78,734 and $52,7