DIGITAL ALLY INC
Form 10-K
March 27, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

þ ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2012

¨ TRANSITION REPORT UNDER 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)

Registrant's telephone, including area code: (913) 814-7774

Securities registered under Section 12(b) of the Exchange Act: None.

Securities registered under Section 12(g) of the Exchange Act:

Common Stock, $0.001 par value	NASDAQ
(Title of class)	(Name of each exchange on which registered)

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

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

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 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 þ 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 þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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 the Exchange Act.

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer (Do not check if a smaller reporting company)	o	Smaller reporting company	þ

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

As of June 30, 2012, the aggregate market value of the Company's common equity held by non-affiliates computed by reference to the closing price ($3.52) of the registrant's most recently completed second fiscal quarter was: $5,609,758.

The number of shares of our common stock outstanding as of March 15, 2013 was: 2,075,564.

Documents Incorporated by Reference: None.

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Note Regarding Forward Looking Statements

This annual report on Form 10-K contains forward-looking statements as that term is defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. In some cases, you can identify forward-looking statements by terminology such as "may," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential," "continue," "intends," and other variations of these words or comparable words. In addition, any statements that refer to expectations, projections or other characterizations of events, circumstances or trends and that do not relate to historical matters are forward-looking statements. These forward-looking statements are based largely on our expectations or forecasts of future events, can be affected by inaccurate assumptions, and are subject to various business risks and known and unknown uncertainties, a number of which are beyond our control. Therefore, actual results could differ materially from the forward-looking statements contained in this document, and readers are cautioned not to place undue reliance on such forward-looking statements. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including the risks in the section entitled “Risk Factors” that may cause our or our industry’s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. Except as required by law, we do not undertake to update or revise any of the forward-looking statements to conform these statements to actual results, whether as a result of new information, future events or otherwise.

As used in this annual report, “Digital Ally,” the “Company,” “we,” “us,” or “our” refer to Digital Ally, Inc., unless otherwise indicated.

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PART I

ITEM 1. BUSINESS.

Overview

Digital Ally 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 in the body of the digital video rear view mirror, officer-worn video and audio system and 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. We have several new and derivative products in research and development that we anticipate will begin commercial production during 2013.

Corporate History

We were incorporated in Nevada on December 13, 2000 as Vegas Petra, Inc. From that date until November 30, 2004, when we entered into a Plan of Merger with Digital Ally, Inc., a Nevada corporation which was formerly known as Trophy Tech Corporation (the "Acquired Company"), we had not conducted any operations and were a closely-held company. In conjunction with the merger, we were renamed Digital Ally, Inc.

The Acquired Company, which was incorporated on May 16, 2003, engaged in the design, development, marketing and sale of bow hunting-related products. Its principal product was a digital video recording system for use in the bow hunting industry. It changed its business plan in 2004 to adapt its digital video recording system for use in the law enforcement and security markets. We began shipments of our in-car digital video rear view mirror in March 2006.

On January 2, 2008, we commenced trading on the NASDAQ Capital Market under the symbol "DGLY." We conduct our business from 9705 Loiret Boulevard, Lenexa, Kansas 66219. Our telephone number is (913) 814-7774.

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Products

We produce and sell digital audio/video recording, storage and other products, including the following product series:

in-car, digital audio/video system that is integrated into a rear view mirror which is designed for law enforcement purposes. Products using this system are marketed under the DVM-100, DVM-400, DVM-500Plus and DVM-750 series;

in-car, digital audio/video system that is integrated into a rear view mirror that serves as an "event recorder" for commercial fleet and mass transit applications, such as ambulances, taxis and buses. Products using this system are marketed under the DVM-250 and DVM-250Plus series;

all-weather, mobile digital audio/video system that is designed for motorcycle, ATV and boat uses and marketed as the DV-500Ultra;

miniature, body-worn digital audio/video camera marketed as the FirstVU system;

hand-held, speed detection system known based on LIDAR (Light Detection and Ranging) and marketed as our Laser Ally system; and

digital audio/video system that is integrated into a large law-enforcement style flashlight and marketed as our DVF-500 system.

Historically, these product series were used primarily in law enforcement applications, all of which use the core competency of our technology in digital video compression, recording and storage. During 2011, we completed the launch of several derivative products as "event recorders" that can be used in taxi cab, limousine, ambulance and other commercial fleet vehicle applications. We plan to launch additional derivative products in 2013 primarily in the in-car video and body worn systems. We also intend to produce and sell other digital video devices in the future. These products incorporate our standards-based digital compression capability that allows the recording of significant time periods on a chip and circuit board which can be designed into small forms and stored. In addition to selling our products directly to our customers, we may in the future sell assemblies or complete units containing our technology incorporating digital video and sound recording for use in non-competing products to OEM (original equipment manufacturer) customers.

In-Car Digital Video System – DVM-100, DVM-400, DVM-500Plus and DVM-750

In-car video systems for patrol cars are now a necessity and have generally become standard. Current systems are digital and VHS-based with cameras mounted on the windshield and the recording device generally in the trunk, headliner, dashboard, console or under the seat of the vehicle. Most manufacturers have already developed or at least have begun transitioning to digital video, but some have had problems obtaining the appropriate technology.

Our digital video rear view mirror unit is a self-contained video recorder, microphone and digital storage system that is integrated into a rear-view mirror, with a monitor, GPS and 900 MHz audio transceiver. Our system is more compact and unobtrusive than certain of our competitors because it requires no recording equipment to be located in other parts of the vehicle.

Our in-car digital video rear view mirror has the following features:

wide angle zoom color camera;

standards-based video and audio compression and recording;

system is concealed in the rear view mirror, replacing factory rear view mirror;

monitor in rear-view mirror is invisible when not activated;

eliminates need for analog tapes to store and catalogue;

easily installs in any vehicle;

archives to computers (wirelessly) and to DVDs, CD-ROMs, or file servers;

900 MHz audio transceiver with automatic activation;

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marks exact location of incident with integrated GPS;

playback using Windows Media Player;

optional wireless download of stored video evidence;

proprietary software protects the chain of custody; and

records to rugged and durable solid state memory.

In-Car Digital Video"Event Recorder" System – DVM-250 and DVM-250Plus

We believe there are several other markets and industries which may find our in-car digital video rear view mirror unit useful, such as the ambulance, school bus, mass transit and delivery service industries. We market a product that we believe addresses these commercial fleet markets with the DVM-250 and DVM-250Plus Event Recorders. The DVM-250 is a rear-view mirror based digital audio and video recording system with many, but not all of, the features of our DVM-500Plus and DVM-750 mirror systems at a lower price point. The DVM-250 is designed to capture "events" such as wrecks and erratic driving or other abnormal occurrences, for evidentiary or training purposes. These potential markets may find our units attractive from both a feature and cost perspective, compared to other providers. Our preliminary marketing efforts indicate that these commercial fleets are adopting this technology, in particular the ambulance and taxi-cab markets.

All-Weather Mobile Digital Video System – DV-500Ultra

This system is a derivative of our in-car video systems, but is more rugged and water-proofed to handle a more hostile outdoor environment. These systems can be used in many applications and are designed specifically for use on motorcycles, ATVs and boats. Current systems are digital and VHS-based with cameras mounted in the frame of the motorcycle, ATV or boat and the recording device generally in the saddle-bag or other compartment. Most manufacturers have already developed or at least have begun transitioning to digital video, but many have had problems obtaining the appropriate technology. We are developing a new product for this market, which we believe is more compact and rugged than our current system and those of our competitors.

Miniature Body-Worn Digital Video System - FirstVU

This system is also a derivative of our in-car video systems, but is much smaller and lighter, more rugged and water-proofed to handle a more hostile outdoor environment. These systems can be used in many applications and are designed specifically to be clipped to an individual's pocket or other outer clothing. The unit is self-contained and requires no external battery or storage devices. Current systems are digital based but generally require a battery pack and/or storage device to be connected to the camera by wire or other means. We believe that our FirstVU product is more desirable for potential users than our competitors' offerings because of its small size, shape and lightweight characteristics. We plan to launch our next generation FirstVU HD product that will improve the video quality, battery life, and the weight of our body-worn camera later in 2013.

Hand-Held Speed Detection System – Laser Ally

This system is a lightweight, hand-held speed detection device that uses LIDAR (Light Detection and Ranging) technology rather than the traditional radar systems, which use sound waves. LIDAR systems are used in high congestion traffic areas that require extreme accuracy and identification of the subject vehicles. This system uses new technology that prevents the Laser Ally from being detected by current detectors or jammed by current jamming

devices. This system was developed and is being manufactured by a third party vendor for us.

Digital Video Flashlight – DVF-500

The digital video flashlight is a high-quality police-type flashlight with a built-in digital video and audio recording system. All recorded data is stored in an on-board flash memory for later download to a computer. From the computer, the images and sound can be stored, reviewed or burned to a DVD or CD. Storage can take place at the police station or transmitted through the internet to a service provider or central storage and recording facility. Each frame of the video can be date and time stamped to provide evidence that protects the officer and the individual involved. Thus, there is a proprietary chain of custody software to protect delivery of data back to the police station.

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The unit is a high-quality, water-resistant, machined aluminum body, law enforcement-style flashlight that integrates a complete digital video and audio recording system. The system is so compact that the size, shape and weight of the digital video flashlight are virtually the same as a traditional flashlight. This allows the continued use of the flashlight as a standard tactical flashlight or as a defensive baton if necessary. As a self-contained unit, the digital video flashlight does not rely on transmitters, cables, external batteries or a separate recorder. The digital video flashlight provides room for the digital video system by replacing regular flashlight bulbs with new ultra-bright light-emitting diode ("LED") technology, as opposed to fragile conventional lamps. The small physical size and mechanical ruggedness of the LED makes it ideal for use in professional flashlights.

We believe that the brightness and light quality of the LED is superior to incandescent bulbs. Our digital video recording system is easy to use and requires only one button to start and stop recording. It has one button operation and thus there are no complicated controls or distracting displays to interfere with a police officer's normal activities or compromise his or her safety. All internal settings are controlled through an on-board USB interface or by plugging into an external video monitor. The digital video flashlight includes proprietary software for downloading and managing video and each frame of video can be date and time stamped.

In addition to law enforcement, the digital video flashlight has potential applications in lighter-duty activities that require a less rugged flashlight as compared to law enforcement applications. Such lighter-duty applications include private security, the insurance industry, homeland security, home inspections and underground inspections of telephone, cable, water and sewer lines. Other potential users are the military, fire departments, Coast Guard, border patrol and customs inspectors.

Other Products

During the last year, we have focused our research and development efforts to meet the varying needs of our customers, enhance our existing products and commence development of new products and product categories. Our research and development efforts are intended to maintain and enhance our competitiveness in the market niche we have carved out, as well as positioning us to compete in diverse markets outside of law enforcement.

Market and Industry Overview

Historically, our primary market has been domestic and international law enforcement agencies. In 2012, we expanded our scope by pursuing the commercial fleet vehicle and mass transit markets. In the future, given sufficient capital and market opportunity, we may address markets for private security, homeland security, general consumer and commercial and the original equipment manufacturers. We have made inroads into the ambulance service provider market which has confirmed that our DVM-250 product series can become a significant revenue producer for us.

Law Enforcement

We believe that a valuable use of our various digital audio/video products may be the recording of roadside sobriety tests. Without some form of video or audio recording, court proceedings usually consist of the police officer's word against that of the suspect. Records show that conviction rates increase substantially where there is video evidence to back up officer testimony. Video evidence also helps to protect police departments against frivolous lawsuits.

The largest source of police video evidence today is in-car video. Unfortunately, some police cars still do not have in-car video, and in those that do, the camera usually points forward rather than to the side of the road where the sobriety test takes place. The in-car video is typically of little use for domestic violence investigations, burglary or theft investigations, disorderly conduct calls or physical assaults. In all of these cases, the digital video flashlight and the FirstVU may provide recorded evidence of the suspect's actions and reactions to police intervention.

Additionally, motorcycle patrolmen rarely have video systems. We believe that the digital video flashlight can become an essential tool for the motorcycle policeman to provide evidence not previously available. We also have developed the DV-500Ultra as a mobile application of our digital video recording system that can be used by motorcycle police and water patrol.

Crime scene investigations, including detailed photography, are typically a large part of the budgets of metropolitan police forces. The digital video flashlight and the FirstVU may record a significant portion of such evidence at a much lower cost for gathering, analyzing and storing data and evidence.

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Commercial and Other Markets

There are numerous potential applications for our digital audio/video camera products. We believe that other markets for our digital video systems, including the derivatives currently being developed, include private investigators, SWAT team members, over-the-road trucking fleets, airport security, municipal fire departments, and the U.S. military. Other commercial markets for our digital video systems include real estate appraisers, plumbers and electricians.

Private Security Companies

There are thousands of private security agencies in the United States employing a large number of guards. Police forces use video systems for proof of correct conduct by officers, but private security services usually have no such tool. We believe that the digital video flashlight and the FirstVU are excellent management tools for these companies to monitor conduct and timing of security rounds. In addition to the digital video flashlight and FirstVU, the digital video security camera can provide fill-in security when guards have large areas to cover or in areas that do not have to be monitored around the clock.

Homeland Security Market

In addition to the government, U.S. corporations are spending heavily for protection against the potential of terrorist attacks. Private-sector outlays for antiterrorism measures and for protection against other forms of violence have increased significantly since September 11, 2001. Further, federal, state and local government expenditures for security have increased substantially since such date. These are all potential markets for our products.

Manufacturing

We have entered into contracts with manufacturers for the assembly of the printed circuit boards used in our products. Dedicated circuit board manufacturers are well-suited to the assembly of circuit boards with the complexity found in our products. Dedicated board manufacturers can spread the extensive capital equipment costs of circuit board assembly among multiple projects and customers. Such manufacturers also have the volume to enable the frequent upgrade to state-of-the-art equipment. We have identified multiple suppliers who meet our quality, cost, and performance criteria. We intend to use more than one source for circuit board assembly to ensure a reliable supply over time. We use contract manufacturers to manufacture our component subassemblies and may eventually use them to perform final assembly and testing. Due to the complexity of our products, we believe that it is important to maintain a core of knowledgeable production personnel for consistent quality and to limit the dissemination of sensitive intellectual property and will continue this practice. In addition, such technicians are valuable in our service and repair business to support our growing installed customer base. We have a non-exclusive supply and distribution agreement with DragonEye Technology, LLC regarding the sale and distribution of our Laser Ally product. This vendor developed and is the only manufacturer of this product. The agreement has specified terms and requires us to purchase minimum quantities over a 42-month period ending February 2014. We have purchased approximately $2,470,000 of product under this agreement as of December 31, 2012 and we have remaining obligations to purchase approximately $987,000 from January 1, 2013 through its expiration in February 2014. The agreement is renewable thereafter on an annual basis unless either of the parties determines not to renew it and provided the parties are in compliance with the agreement. We also contract with a manufacturer in Asia for the production of our DVM-100, DVM-400, DVM-250, DVM-250Plus and FirstVU products. The contract provides for no minimum purchase requirements and has an initial term through July 2016 with Digital Ally having the right to exercise three additional options to extend the contract for three additional years each.

License Arrangements

We have entered into several software license agreements with Sasken-Ingenient Technologies, Inc. (“Ingenient”), and Nuvation Research Corporation (“Nuvation”) regarding the license of certain software products to be used in our video products. The licensors have written certain software for specific Texas Instrument chips which are included in our products. The licenses generally require upfront payments and contain automatic renewal provisions unless either party notifies the other of its intent to not renew prior to expiration or unless the agreement is terminated due to a material breach by the other party.

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The following is a summary of our license agreements as of December 31, 2012:

License Type	Effective Date	Expiration Date	Terms
Production software license agreement	April 2005	April 2013	Automatically renews for one year periods unless terminated by either party.
Software sublicense agreement	October 2007	October 2013	Automatically renews for one year periods unless terminated by either party.
Technology license agreement	July 2007	July 2013	Automatically renews for one year periods unless terminated by either party.
Development, license and manufacturing agreement	July 2011	July 2016	We have three successive options to renew for three years periods each, unless terminated by either party.
Limited license agreement	August 2008	Perpetual	May be terminated by either party.

Sales and Marketing

We reorganized our domestic sales force and organization for our law enforcement channel. Traditionally, we used third party sales agents to market our law enforcement products domestically. We have principally changed to an employee-based, direct sales force that provides us with more control and monitoring of our sales force and its daily activities. Additionally, we reduced the size of certain territories and consequently increased the overall number of domestic sales territories and sales personnel from 15 at the beginning of the 2012 to 22 currently in order to better penetrate the market. During 2012, we converted one third party sales agent to be an employee-based direct sales person and replaced the remaining third party sales agents with new employee sales personnel. Our objective with this new employee-based model, including the replacement of the sales agents, was to encourage our sales personnel in lower performing territories to improve their efforts and, consequently, their sales results. We believe a portion of the revenue decrease in 2011 and 2012 was due to third party sales agents reducing their sales efforts because they did not have the financial resources to travel, meet and market directly to their customers as a result of the difficult economic conditions. We believe that our reorganization has addressed these concerns. Our executive team also supports sales agents with significant customer opportunities by providing pricing strategies and customer presentation support. Our technical support personnel may also provide sales agents with customer presentations and product specifications in order to facilitate sales activities.

We use our direct sales force and our international distributors to market our products. Our key promotional activities include: