DIGITAL ALLY INC
Form 10-K
March 28, 2017

United States

Securities and Exchange Commission

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2016

[ ] 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 [X]

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act 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 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. [ ]

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 [ ]	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]

As of June 30, 2016, the aggregate market value of the Company's common equity held by non-affiliates computed by reference to the closing price ($3.88) of the registrant's most recently completed second fiscal quarter was: $17,605,252.

The number of shares of our common stock outstanding as of March 27, 2017 was: **5,679,731**

Documents Incorporated by Reference: None.

FORM 10-K

DIGITAL ALLY, INC.

DECEMBER 31, 2016

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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 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 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.

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 an in-car digital video/audio recorder contained in a rear-view mirror for use in law enforcement and commercial fleets, a system that provides our law enforcement customers with audio/video surveillance from multiple vantage points and hands-free automatic activation of body-worn cameras and in-car video systems; 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 hand-held laser speed detection device that it is offering primarily to law enforcement agencies; and cloud storage solutions. We have active research and development programs to adapt its technologies to other applications. We have 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. We sell our products to law enforcement agencies and other security organizations, and 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 2017.

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.

Products

We produce and sell digital audio/video recording, storage and other products in law enforcement and commercial applications. These product series have been used primarily in law enforcement and private security applications, both 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 which served to greatly diversify our addressable market. We have launched additional derivative products during 2012 through 2016 that address law enforcement, private security and commercial fleet applications. We also intend to produce and sell other digital video products in the future that will continue to expand our reach beyond the traditional law enforcement, private security and commercial fleet applications. We have developed and continue to develop both local server and cloud based storage, archiving and search capabilities that provide customers with innovative, useful and secure methods to store and maintain their audio/video data. 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. The following describes our product portfolio.

In-Car Digital Video Mirror System for law enforcement – DVM-100, DVM-400, DVM-750, DVM-800 and DVM-800 HD

In-car video systems for patrol cars are now a necessity and have generally become standard. Current systems are primarily digital based systems 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 and transitioned completely to digital video, but some have not transitioned totally to a fully solid-state digital system and continue to rely on hard-drive or DVD based systems which are less reliable and susceptible to heat, cold and vibration.

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;

ability to integrate with body-worn cameras including auto-activation of either system;

archives audio/video data to the cloud, computers (wirelessly) and to compact flash memory, or file servers;

900 MHz audio transceiver with automatic activation;

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.

Compact HD Quality In-Car Digital Video (not in a rear-view mirror)- MicroVu HD for law enforcement

The MicroVu is a compact in-car video system that is mobile (not mounted in a rear-view mirror) which provides up to 1080p HD video recording. The MicroVu is very compact as the complete system is only 4” long by 1” high. The MicroVu is designed for simple installation and features advanced automatic login (RFID log-in) and interoperability with our body cameras through our VuLink products. The primary user of the MicroVu system is law enforcement although derivative models may appeal to the commercial fleet market in particular the over the road trucking market.

In-Car Digital Video “Event Recorder” System –DVM-250 Plus for Commercial Fleets

Digital Ally provides commercial fleets and commercial fleet managers with the digital video tools they need to increase driver safety, track assets in real-time and minimize the company’s liability risk all while enabling fleet managers to operate the fleet at an optimal level. We market a product designed to address these commercial fleet markets with our DVM-250 Plus event recorders that provides all types of commercial fleets with features and capabilities that are fully-customizable, consistent with their specific application and inherent risks. The DVM-250 Plus is a rear-view mirror based digital audio and video recording system with many, but not all of, the features of our DVM-800 law enforcement mirror systems at a lower price point. The DVM-250 Plus is designed to capture “events,” such as wrecks and erratic driving or other abnormal occurrences, for evidentiary or training purposes. These markets may find our units attractive from both a feature and cost perspective, compared to other providers. Our marketing efforts indicate that these commercial fleets are adopting this technology, in particular the ambulance and taxi-cab markets.

Digital Ally offers a suite of data management web-based tools to assist fleet managers in the organization, archival, and management of videos and telematics information. Within the suite, there are powerful mapping and reporting tools that help optimize efficiency, serve as excellent training tools for teams on safety and ultimately generate a significant return on investment for the organization.

Miniature Body-Worn Digital Video System – FirstVU HD for law enforcement and private security

This system is also a derivative of our in-car video systems, but is much smaller and lighter and more rugged and water-resistant to handle a hostile outdoor environment. These systems can be used in many applications in addition to law enforcement and private security 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 offered by competitors 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 HD product is more desirable for potential users than our competitors’ offerings because of its video quality, small size, shape and lightweight characteristics. Our FirstVU HD integrates with our in-car video systems through our patented VuLink system allowing for automatic activation of both systems.

VuLink, VuVault.net and FleetVU Manager

The VuLink system provides our law enforcement customers with audio/video surveillance from multiple vantage points in order to more fully capture an event and it allows the operator to quickly and easily reassemble the various recording devices. The VuLink enables body cameras and in-car video systems to be automatically or manually activated simultaneously.

VuVault.net is a cost-effective, fully expandable, law enforcement cloud storage solution powered by Amazon Web Services that provides CJIS compliant redundant, and security-enhanced storage of all uploaded videos.

FleetVU Manager is our web-based software for commercial fleet tracking and monitoring that features and manages video captured by our Video Event Data Recorders of incidents that require attention, such as accidents. This software solution features our cloud-based web portal that utilizes many of the features of our VUVault.NET law-enforcement cloud-based storage solution.

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 manufactured by a third party vendor for us.

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, mass transit, healthcare, general retail, general consumer and other commercial markets. We have made inroads into certain commercial fleet and the ambulance service provider market, confirming that our DVM-250 Plus product and FleetVU Manager can become a significant revenue producer for us.

Law Enforcement

We believe that law enforcement already recognizes a valuable use of our various digital audio/video products for 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 FirstVU HD may provide recorded evidence of the suspect’s actions and reactions to police intervention.

Additionally, motorcycle patrolmen rarely have video systems. We have developed the DVM-440 Ultra 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 FirstVU may record a significant portion of such evidence at a much lower cost for gathering, analyzing and storing data and evidence.

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.

Schools

We believe our products and offerings may be of benefit in kindergarten through twelve grade school systems. We are currently assessing our entry into this potential market through several pilot tests. Preliminary results have been positive and we believe this new market will represent a substantial new addressable market for our mobile audio/video recording products in 2017.

Medical applications

We believe our products and offerings may be of benefit in hospital and other medical services delivery systems. We are currently assessing our entry into this potential market.

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 FirstVU HD is an excellent management tool for these companies to monitor conduct and timing of security rounds. In addition to the FirstVU HD, 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. Public and private-sector outlays for antiterrorism measures and for protection against other forms of violence are significant. These are 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 also 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 also contract with two manufacturers that have manufacturing facilities in Asia for the production of our DVM-100, DVM-400, DVM-250 Plus, DVM-800 and DVM-800 HD products. The contracts are general in nature addressing confidentiality and other matters, have no minimum purchase requirements and require the acceptance of specific purchase orders to support any product supply acquisitions. We have started using additional contract manufacturers based in the United States for these product lines to further mitigate any supply disruption risk and ensure competitive pricing. We typically perform final assembly, testing and quality control functions for these products in our Lenexa, Kansas facility.

License Arrangements

We have entered into several agreements, including agreements with Sasken-Ingenient Technologies, Inc. (“Sasken”), Lead Technologies (“Lead”) and Pixel Forensics, Inc. (“Pixel), to license 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 or media analytics such as face redaction software. 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.

The following is a summary of our license agreements as of December 31, 2016:

License Type	**Effective Date**	**Expiration Date**	**Terms**
Production software license agreement	April 2005	April 2017	Automatically renews for one year periods unless terminated by either party.
Software sublicense agreement	October 2007	October 2017	Automatically renews for one year periods unless terminated by either party.
Software development and software services agreement	June 2015	June 2017	Renewable by mutual agreement of the parties unless terminated by Digital Ally for convenience.

Sales and Marketing

In recent years, we have changed principally to an employee-based, direct sales force for domestic selling efforts that enables us to control and monitor its daily activities. In this connection, we have reduced the size of certain territories and consequently increased the sales personnel and changed the number of domestic sales territories to 21 in order to better penetrate the market. The direct territory sales team is supported by a team of eight inside sales coordinators, and a telesales specialist and a pre-sales solution design team. We have also added a bid specialist to coordinate large bid opportunities. We believe our employee-based model encourages our sales personnel in lower performing territories to improve their efforts and, consequently, their sales results. Our executive team also supports sales agents with significant customer opportunities by providing pricing strategies and customer presentation assistance. 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 international distributors to market our products. Our key promotional activities include:

- attendance at industry trade shows and conventions;
- direct sales, with a force of industry-specific sales individuals who identify, call upon and build on-going relationships with key purchasers and targeted industries;
- support of our direct sales with passive sales systems, including inside sales and e-commerce;
- print advertising in journals with specialized industry focus;
- direct mail campaigns targeted to potential customers;
- web advertising, including supportive search engines and website and registration with appropriate sourcing entities;
- public relations, industry-specific venues, as well as general media, to create awareness of our brand and our products, including membership in appropriate trade organizations; and
- brand identification through trade names associated with us and our products.

Competition

The law enforcement and security surveillance markets are extremely competitive. Competitive factors in these industries include ease of use, quality, portability, versatility, reliability, accuracy and cost. There are direct companies with competitive technology and products in the law enforcement and surveillance markets for all of our products and those we have in development. Many of these competitors have significant advantages over us, including greater financial, technical, marketing and manufacturing resources, more extensive distribution channels, larger customer bases and faster response times to adapt new or emerging technologies and changes in customer requirements. Our primary competitors include L-3 Mobile-Vision, Inc., Coban Technologies, Inc., Watchguard, Kustom Signals, Panasonic System Communications Company, International Police Technologies, Inc. and a number of other competitors who sell or may in the future sell in-car video systems to law enforcement agencies. Our primary competitors in the body-worn camera market include TASER International, Inc. (“Taser”), Reveal Media and VieVU, Inc. We face similar and intense competitive factors for our event recorders in the mass transit markets as we do in the law enforcement and security surveillance markets. We will also compete with any company making surveillance devices for commercial use. There can be no assurance that we will be able to compete successfully in these markets. Further, there can be no assurance that new and existing companies will not enter the law enforcement and security surveillance markets in the future.

The commercial fleet security and surveillance markets likewise are also very competitive. There are direct competitors for our DVM-250 Plus “event recorders,” which several may have greater financial, technical marketing, and manufacturing resources than we do. Our primary competitors in the commercial fleet sector include Lytx, Inc. (previously DriveCam, Inc.) and SmartDrive Systems.

Intellectual Property

Our ability to compete effectively will depend on our success in protecting our proprietary technology, both in the United States and abroad. We have filed for patent protection in the United States and certain other countries to cover certain design aspects of our products. However, we license the critical technology on which our products are based from third parties, including Sasken-Ingenient Technologies, Inc., Pixel Forensics and Lead Technologies.

Some of our patent applications are still under review by the U.S. Patent Office and, therefore, we have not yet been issued all of the patents that we applied for in the United States. We were issued several patents in recent years, including a patent on our VuLink product which provides automatic bi-directional triggering of our body-worn camera and our in-car video systems. No assurance can be given which, or any, of the patents relating to our existing technology will be issued from the United States or any foreign patent offices. Additionally, no assurance can be given that we will receive any patents in the future based on our continued development of our technology, or that our patent protection within and/or outside of the United States will be sufficient to deter others, legally or otherwise, from developing or marketing competitive products utilizing our technologies.

We have entered into supply and distribution agreements with several companies that produce certain of our products, including our DVM-100, DVM-250, DVM-400, DVM-800 and DVM-800 HD products. These supply and distribution agreements contain certain confidentiality provisions that protect our proprietary technology, as well as that of the third party manufacturers.

In addition to seeking patent protection, we rely on trade secrets, know-how and continuing technological advancement to seek to achieve and thereafter maintain a competitive advantage. Although we have entered into or intend to enter into confidentiality and invention agreements with our employees, consultants and advisors, no assurance can be given that such agreements will be honored or that we will be able to effectively protect our rights to our unpatented trade secrets and know-how. Moreover, no assurance can be given that others will not independently develop substantially equivalent proprietary information and techniques or otherwise gain access to our trade secrets and know-how.

Taser, a competitor in our body-camera market, requested that the United States Patent & Trademark Office ("USPTO") commence an *ex parte* reexamination of our U.S. Patent No. 8,781,292 ('292 Patent). The USPTO granted this request and has completed its reexamination. The USPTO has confirmed the validity of our '292 patent which relates to our auto-activation technology for law enforcement body cameras. We have filed suit in the U.S. District Court for the District of Kansas against Taser, alleging willful patent infringement against Taser's Axon body camera product line. On February 2, 2016, we received notification that the USPTO has issued another patent relating to our auto-activation technology for law enforcement cameras. U.S. Patent No. 9,253,452 ("the '452 patent") generally covers the automatic activation and coordination of multiple recording devices in response to a triggering event, such as a law enforcement officer activating the light bar on the vehicle. We have added Taser's willful infringement of the '452 patent to our existing lawsuit. Taser has recently requested that the USPTO institute new *Inter Partes Reviews* ("IPR") of our '292 patent and we have filed an objection to the USPTO instituting the IPR.

Despite the USPTO's recognition of the validity of the '292 patent and '452 patent, TASER continues to offer for sale, sell, and market its Axon technology in disregard of our federally protected patent rights. As a result, we are aggressively challenging Taser's infringing conduct in our lawsuit against it, seeking both monetary damages and a permanent injunction preventing Taser from continuing to sell its Axon Signal technology.

On May 27, 2016 we filed suit against Enforcement Video, LLC d/b/a WatchGuard Video ("WatchGuard"), alleging patent infringement of our '292 patent based on WatchGuard's VISTA Wifi and 4RE In-Car product lines. We intend to aggressively challenge Watchguard's infringing conduct in our lawsuit against it, seeking both monetary damages and a permanent injunction preventing Watchguard from continuing to sell its auto-activation technology embodied within its body-worn and in-car video systems. The Company is reviewing other competitors products for possible infringement of the '292' patent but have not commenced any additional actions at this point in time.

We believe the outcome of these infringement lawsuits, and in particular the Taser lawsuit will have meaningful effects upon the entire body-worn camera market within the United States over the foreseeable future. The auto-activation technology protected by our '292 patent is quickly becoming standard within the industry, therefore if we are successful in challenging Taser and Watchguard's infringing conduct, it will have a substantial and positive impact upon our future revenue streams.

Employees

We had 154 full-time employees as of December 31, 2016. Our employees are not covered by any collective bargaining agreement and we have never experienced a work stoppage. We believe that our relations with our employees are good.

Item 1A. Risk Factors.

Not applicable.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

We entered into a non-cancellable, long-term facility lease in September 2012 to combine all of our operations into one location, commencing in November 2012. Our facility contains approximately 33,776 square feet and is located at 9705 Loiret Boulevard, Lenexa, Kansas 66219. The lease will terminate on April 1, 2020. The monthly rent ranges from $35,634 to $38,533 over the term.

Item 3. Legal Proceedings.

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 October 25, 2013, the Company filed a complaint in the United States District Court for the District of Kansas (2:13-cv-02550-SAC) 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 the Company’s mobile video surveillance systems do not infringe any claim of the ‘556 Patent. The Company became aware that Utility had mailed letters to current and prospective purchasers of its 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. The Company rejected Utility’s assertion and is vigorously defending 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 District Court’s decision was not a ruling on the merits of the case. The Company appealed the decision and the Federal Circuit affirmed the District Court’s previous decision.

In addition, the Company began 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 (“USPTO”). On July 27, 2015, the USPTO invalidated key claims in Utility’s ‘556 Patent. The Final Decision from the USPTO significantly curtails Utility’s ability to threaten law enforcement agencies, municipalities, and others with infringement of the ’556 Patent. Utility appealed this decision to the United States Court of Appeals for the Federal Circuit. The United States Court of Appeals for the Federal Circuit denied Utility’s appeal and therefore confirmed the ruling of the USPTO. This denial of Utility’s appeal finalized the USPTO’s ruling in Digital’s favor and the matter is now concluded as it relates to the USPTO.

On June 6, 2014 the Company filed an Unfair Competition lawsuit against Utility Associates, Inc. (“Utility”) in the United States District Court for the District of Kansas. In the lawsuit it contends that Utility has defamed the Company and illegally interfered with its contracts, customer relationships and business expectancies by falsely asserting to its customers and others that its products violate the ‘556 Patent, of which Utility claims to be the holder.

The 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 the Company’s employees, in violation of that employee’s Non-Competition and Confidentiality agreements with the Company. In addition to damages, the Company seeks temporary, preliminary, and permanent injunctive relief, prohibiting Utility from, among other things, continuing to threaten or otherwise interfere with the Company’s customers. On March 4, 2015, an initial hearing was held upon the Company’s request for injunctive relief.

Based upon facts revealed at the March 4, 2015 hearing, on March 16, 2015, the Company sought leave to amend its Complaint in the Kansas suit to assert additional claims against Utility. Those new claims include claims of actual or attempted monopolization, in violation of § 2 of the Sherman Act, claims arising under a new Georgia statute that prohibits threats of patent infringement in “bad faith,” and additional claims of unfair competition/false advertising in violation of § 63(a) of the Lanham Act. As these statutes expressly provide, the Company will seek treble damages, punitive damages and attorneys’ fees as well as injunctive relief. The Court concluded its hearing on April 22, 2015, and allowed the Company leave to amend its complaint, but denied its preliminary injunction. The discovery stage of the lawsuit expired in May 2016. Both parties have filed summary judgment motions, which are currently under review and consideration by the court. The jury trial date is scheduled for June 2017. The Company believes that the USPTO’s final decision issued on July 27, 2015 will provide it with substantial basis to pursue its claims either through summary judgment motions prior to trial or the jury trial itself and it intends to pursue recovery from Utility, its insurers and other parties, as appropriate.

On September 13, 2014, Utility filed suit in the United States District Court for the Northern District of Georgia against the Company alleging infringement of the ‘556 Patent. The suit was served on the Company on September 20, 2014. As alleged in the Company’s first filed lawsuit described above, the Company believes that the ‘556 Patent is both invalid and not infringed. Further, the USPTO has issued its final decision invalidating 23 of the 25 claims asserted in the ‘556 Patent, as noted above. The Company believes that the suit filed by Utility is without merit and is vigorously defending the claims asserted against the Company. An adverse resolution of the foregoing litigation or patent proceedings could have a material adverse effect on the Company’s business, prospects, results of operations, financial condition, and liquidity. The Court stayed all proceedings with respect to this lawsuit pending the outcome of the patent review performed by the USPTO and the appellate court. Based on the USPTO’s final decision to invalidate substantially all claims contained in the ‘556 Patent and the United States Court of Appeals for the Federal Circuit full denial of Utility’s appeal, the Company intends to file for summary judgment in its favor if Utility does not request outright dismissal.

The Company received notice in April 2015 that Taser, one of its competitors, had commenced an action in the USPTO for a re-examination of its U.S. Patent No. 8,781,292 (the “ ‘292 Patent”). A re-examination is essentially a request that the USPTO review whether the patent should have issued in its present form in view of the “prior art,” e.g., other patents in the same technology field. The prior art Taser used to request the re-examination is a patent application that never issued into a patent was assigned to an unrelated third party and was not the result of any of Taser’s own research and development efforts.

The Company owns the ‘292 Patent, which is directed to a system that determines when a recording device, such as a law enforcement officer’s body camera or in-car video recorder, begins recording and automatically instructs other recording devices to begin recording. The technology described in the ‘292 Patent is incorporated in the Company’s VuLink product.

On August 17, 2015 the USPTO issued a first, non-final action rejecting all 20 claims of the ‘292 Patent respecting its ‘292 Patent under an *ex parte* re-examination. The Company was provided the opportunity to discuss the merits of the prior art and the scope of the patent claims with the patent Examiner handling the reexamination and to amend the patent claims. On January 14, 2016 the USPTO ultimately rejected Taser’s efforts and confirmed the validity of the ‘292 Patent with 59 claims covering various aspects of the Company’s auto-activation technology. On February 2, 2016 the USPTO issued another patent relating to the Company’s auto-activation technology for law enforcement cameras. U.S. Patent No. 9,253,452 (the “ ‘452 Patent”) generally covers the automatic activation and coordination of multiple recording devices in response to a triggering event, such as a law enforcement officer activating the light bar on the vehicle.

The Company filed suit on January 15, 2016 in the U.S. District Court for the District of Kansas (Case No: 2:16-cv-02032) against Taser, alleging willful patent infringement against Taser’s Axon body camera product line. The lawsuit was initiated after the USPTO reconfirmed the validity of the ‘292 Patent, which covers various aspects of auto-activation and multiple camera coordination for body-worn cameras and in-car video systems. The ‘292 Patent previously was subject to attack by Taser, which tried to invalidate it at the USPTO. The USPTO ultimately rejected

Taser’s efforts and confirmed the validity of the ‘292 Patent with 59 claims covering various aspects of this valuable auto-activation technology. On February 2, 2016 the USPTO issued another patent relating to the Company’s auto-activation technology for law enforcement cameras. This ‘452 Patent generally covers the automatic activation and coordination of multiple recording devices in response to a triggering event such as a law enforcement officer activating the light bar on the vehicle. The Company added the ‘452 patent to its existing lawsuit against Taser seeking both monetary damages and a permanent injunction against Taser for infringement of both the ‘452 and ‘292 Patents.

In addition to the infringement claims, the Company added a new set of claims to the lawsuit alleging that Taser conspired to keep the Company out of the marketplace by engaging in improper, unethical, and unfair competition. The amended lawsuit alleges Taser bribed officials and otherwise conspired to secure no-bid contracts for its products in violation of both state law and federal antitrust law. The Company’s lawsuit also seeks monetary and injunctive relief, including treble damages, for these alleged violations.

The Company filed an amended complaint and Taser filed an answer which denied the patent infringement allegations on April 1, 2016. In addition, Taser filed a motion to dismiss all allegations in the complaint on March 4, 2016 for which the Company filed an amended complaint on March 18, 2016 to address certain technical deficiencies in the pleadings. Taser amended and renewed its motion to seek dismissal of the allegations that it had bribed officials and otherwise conspired to secure no-bid contracts for its products in violation of both state law and federal antitrust law on April 1, 2016. Formal discovery commenced on April 12, 2016 with respect to the patent related claims. In January 2017 the Court granted Taser's motion to dismiss the portion of the lawsuit regarding claims that it had bribed officials and otherwise conspired to secure no-bid contracts for its products in violation of both state law and federal antitrust law. The Company has appealed this decision to the United States Court of Appeals for the Federal Circuit and is awaiting its decision.

In December 2016, Taser announced that it had commenced an action in the USPTO for *inter partes review* of the Company's '292 Patent. Previously Taser had attempted to invalidate the '292 Patent through a re-examination procedure at the USPTO. On January 14, 2016 the USPTO ultimately rejected Taser's efforts and confirmed the validity of the '292 Patent with 59 claims covering various aspects of the Company's auto-activation technology. The USPTO fully rejected all of Taser's previous arguments, concluding all 59 claims in Digital Ally's '292 patent were valid and non-obvious. Taser is again attempting through its recently filed *inter partes review* to convince the USPTO that Digital Ally's patents lack patentability. The USPTO is taking the request under consideration and has not decided whether it will institute the *inter partes review.* In addition, Taser has requested that the patent infringement lawsuit filed by Digital Ally in the U.S. District Court for the District of Kansas (Case No: 2:16-cv-02032) against Taser, be stayed while its *inter partes review* is being considered by the USPTO. Digital Ally has filed a motion to deny the stay and both motions. On March 20, 2017 the Court granted Taser's motion to stay in part and temporarily stayed the proceedings until the Patent Trial and Appeal Board ("PTAB") issues its initial decisions with respect to Taser's petitions for *inter partes review*. The PTAB is scheduled to issue its initial decisions with respect to whether it will institute the requested *inter partes reviews* between June 2017 and August 2017.

On May 27, 2016 the Company filed suit against Enforcement Video, LLC d/b/a WatchGuard Video ("WatchGuard"), (Case No. 2:16-cv-02349-JTM-JPO) alleging patent infringement based on WatchGuard's VISTA Wifi and 4RE In-Car product lines.

The USPTO has granted multiple patents to the Company with claims covering numerous features, such as automatically and simultaneously activating all deployed cameras in response to the activation of just one camera. Additionally, Digital Ally's patent claims cover automatic coordination as well as digital synchronization between multiple recording devices. Digital Ally also has patent coverage directed to the coordination between a multi-camera system and an officer's smartphone, which allows an officer to more readily assess an event on the scene while an event is taking place or immediately after it has occurred.

The Company's lawsuit alleges that WatchGuard incorporated this patented technology into its VISTA Wifi and 4RE In-Car product lines without its permission. Specifically, Digital Ally is accusing WatchGuard of infringing three patents: the '292 and '452 Patents and U.S. Patent No. 9,325,950. The Company is aggressively challenging

WatchGuard's infringing conduct, seeking both monetary damages, as well as seeking a permanent injunction preventing WatchGuard from continuing to sell its VISTA Wifi and 4RE In-Car product lines using Digital Ally's own technology to compete against it. The lawsuit is in the early stages of discovery.

The Company is 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. The Company believes the likely outcome of any other pending cases and proceedings will not be material to its business or its financial condition.

Item 4. Mine Safety Disclosures.

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market Prices

Our common stock commenced trading on the NASDAQ Capital Market on January 2, 2008 under the symbol “DGLY,” and continues to do so. From July 2007 until we became listed on the NASDAQ Capital Market, our common stock was traded on the OTC Bulletin Board and prior to that it was quoted in the “Pink Sheets.”

The high/low closing prices of our common stock were as follows for the periods below. In addition, the quotations below reflect inter-dealer bid prices without retail markup, markdown, or commission and may not represent actual transactions:

Year Ended December 31, 2016	High Close	Low Close
1st Quarter	$6.75	$4.72
2nd Quarter	$4.79	$3.56
3rd Quarter	$6.69	$3.76
4th Quarter	$6.40	$4.15
Year Ended December 31, 2015		
1st Quarter	$15.46	$10.27
2nd Quarter	$18.30	$12.42
3rd Quarter	$13.82	$5.84
4th Quarter	$7.90	$3.99

Holders of Common Stock

As of December 31, 2016, we had approximately 89 shareholders of record for our common stock.

Dividend Policy

To date, we have not declared or paid cash dividends on our shares of common stock. The holders of our common stock will be entitled to non-cumulative dividends on the shares of common stock, when and as declared by our board of directors, in its discretion. We intend to retain all future earnings, if any, for our business and do not anticipate paying cash dividends in the foreseeable future.

Any future determination to pay cash dividends will be at the discretion of our board of directors and will be dependent upon our financial condition, results of operations, capital requirements, general business conditions and such other factors as our board of directors may deem relevant.

Securities Authorized for Issuance under Equity Compensation Plans

Our board of directors adopted the 2005 Stock Option and Restricted Stock Plan (the “2005 Plan”) on September 1, 2005. The 2005 Plan authorized us to reserve 312,500 shares of our common stock for issuance upon exercise of options and grant of restricted stock awards. The 2005 Plan terminated in 2015 with 28 shares reserved for awards that are now unavailable for issuance. Stock options granted under the 2005 Plan that remain unexercised and outstanding as of December 31, 2016 total 26,813.

On January 17, 2006, our board of directors adopted the 2006 Stock Option and Restricted Stock Plan (the “2006 Plan”). The 2006 Plan authorizes us to reserve 187,500 shares for future grants under it. The 2006 Plan terminated in 2016 with 30 shares reserved for awards that are now unavailable for issuance. Stock options granted under the 2006 Plan that remain unexercised and outstanding as of December 31, 2016 total 64,955.

On January 24, 2007, our board of directors adopted the 2007 Stock Option and Restricted Stock Plan (the “2007 Plan”). The 2007 Plan authorizes us to reserve 187,500 shares for future grants under it. At December 31, 2016, there were 9 shares reserved for awards available for issuance under the 2007 Plan.

On January 2, 2008, our board of directors adopted the 2008 Stock Option and Restricted Stock Plan (the “2008 Plan”). The 2008 Plan authorizes us to reserve 125,000 shares for future grants under it. At December 31, 2016, there were 74 shares reserved for awards available for issuance under the 2008 Plan.

On March 18, 2011, our board of directors adopted the 2011 Stock Option and Restricted Stock Plan (the “2011 Plan”). The 2011 Plan authorizes us to reserve 62,500 shares for future grants under it. At December 31, 2016, there were 39 shares reserved for awards available for issuance under the 2011 Plan.

On March 22, 2013, our board of directors adopted the 2013 Stock Option and Restricted Stock Plan (the “2013 Plan”). The 2013 Plan was amended on March 28, 2014 and November 14, 2014 to increase the number of shares authorized and reserved for issuance under the 2013 Plan to a total of 300,000. At December 31, 2016, there were 100 shares reserved for awards available for issuance under the 2013 Plan.

On March 27, 2015, our board of directors adopted the 2015 Stock Option and Restricted Stock Plan (the “2015 Plan”). The 2015 Plan was amended on February 25, 2016 to increase the number of shares authorized and reserved for issuance under the 2015 Plan to a total of 750,000. At December 31, 2016, there were 200,550 shares reserved for awards available for issuance under the 2015 Plan, as amended.

The 2005 Plan, 2006 Plan, 2007 Plan, 2008 Plan, 2011 Plan, 2013 Plan and 2015 Plan are referred to as the “Plans.”

The Plans authorize us to grant (i) to the key employees incentive stock options (except for the 2007 Plan) to purchase shares of common stock and non-qualified stock options to purchase shares of common stock and restricted stock awards, and (ii) to non-employee directors and consultants’ non-qualified stock options and restricted stock. The Compensation Committee of our board of directors administers the Plans by making recommendations to the board or determinations regarding the persons to whom options or restricted stock should be granted and the amount, terms, conditions and restrictions of the awards.

The Plans allow for the grant of incentive stock options (except for the 2007 Plan), non-qualified stock options and restricted stock awards. Incentive stock options granted under the Plans must have an exercise price at least equal to 100% of the fair market value of the common stock as of the date of grant. Incentive stock options granted to any person who owns, immediately after the grant, stock possessing more than 10% of the combined voting power of all classes of our stock, or of any parent or subsidiary corporation, must have an exercise price at least equal to 110% of the fair market value of the common stock on the date of grant. Non-statutory stock options may have exercise prices as determined by our Compensation Committee.

The Compensation Committee is also authorized to grant restricted stock awards under the Plans. A restricted stock award is a grant of shares of the common stock that is subject to restrictions on transferability, risk of forfeiture and other restrictions and that may be forfeited in the event of certain terminations of employment or service prior to the end of a restricted period specified by the Compensation Committee.

We have filed various registration statements on Form S-8 and amendments to previously filed Form S-8's with the SEC which registered a total of 1,925,000 shares issued or to be issued upon exercise of the stock options underlying the various stock option plans

The following table sets forth certain information regarding the stock option plans adopted by the Company as of December 31, 2016:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by stockholders	272,081	$ 18.26	200,763
Equity compensation plans not approved by stockholders	90,359	$ 19.05	9
Total all plans	362,440	$ 18.46	200,772

Recent Sales of Unregistered Securities

On December 30, 2016, the Company completed a Private Placement of $4.0 million in principal amount of 8%Secured Convertible Debentures (the “Debentures”) and common stock warrants (the “Warrants”) to two institutional investors. The Debentures and Warrants were issued pursuant to a Securities Purchase Agreement (the “Purchase Agreement”) between the Company and the purchasers signatory thereto (the “Holders”). The Private Placement resulted in gross proceeds of $4.0 million before placement agent fees and other expenses associated with the transaction which totaled $281,570. The proceeds will be used for general corporate purposes. WestPark Capital acted as Placement Agent for the Company in the transaction and received a fee of $200,000 for its services. In addition, it will receive a fee of 3% of the gross proceeds the Company derives from the exercise of the Warrants.

Prior to the maturity date, the Debentures bear interest at 8% per annum with interest payable in cash quarterly in arrears on the first business day of each calendar quarter following the issuance date. The Debentures rank senior to the Company’s existing and future indebtedness of the Company and are secured by substantially all tangible and certain intangible assets of the Company. The Company agreed to maintain cash balance of $500,000 while the Debentures are outstanding.

The Debentures are convertible at any time six months after their date of issue at the option of the holders into shares of the Company’s common stock at $5.00 per share. The Debentures mature on March 30, 2018. The Warrants are exercisable to purchase up to an aggregate of 800,000 shares of the Company’s common stock commencing on the date of issuance at an exercise price of $5.00 per share. The Warrants will expire on the fifth anniversary of their date of issuance. The conversion price and exercise price are subject to adjustment upon stock splits, reverse stock splits, and similar capital changes.

The offers and sales of securities in the Private Placement were made pursuant to the exemption from registration provided by Section 4(a)(2) of the Securities Act of 1933, as amended, including pursuant to Rule 506 thereunder. Such offers and sales were made solely to “accredited investors” under Rule 506 and were made without any form of general solicitation and with full access to any information requested by the investor regarding the Company or the securities offered in the Private Placement.

(c) Issuer Purchases of Equity Securities

Period	**Total Number of Shares Purchased**	**Average Price Paid per Share [1]**	**(c)Total Number of Shares Purchased as Part of Publicly Announced Plans**	**(d)Maximum number of Shares that May Yet Be Purchased Under**

	[1]		of Programs [1]	the Plans or Programs [2]
August 25 to 31, 2015	—-	—-	—-	—-
September 1 to 30, 2015	—-	—-	—-	—-
October 1 to 31, 2015	—-	—-	—-	—-
November 1 to 30, 2015	—-	—-	—-	—-
December 1 to 31, 2015	—-	—-	—-	—-
January 1 to 31, 2016	—-	—-	—-	—-
February 1 to 29, 2016	—-	—-	—-	—-
March 1 to 31, 2016	—-	—-	—-	—-
April 1 to 30, 2016	—-	—-	—-	—-
May 1 to 31, 2016	—-	—-	—-	—-
June 1 to 30, 2016	—-	—-	—-	—-
July 1 to 31, 2016	—-	—-	—-	—-
August 1 to 31, 2016	—-	—-	—-	—-
September 1 to 30, 2016	—-	—-	—-	—-
October 1 to 31, 2016	—-	—-	—-	—-
November 1 to 30, 2016	—-	—-	—-	—-
December 1 to 31, 2016	—-	—-	—-	—-

[1] On August 25, 2015, the Board of Directors approved the Stock Repurchase Program that authorized the repurchase of up to $2.5 million of the Company's common stock in the open market, or in privately negotiated transactions. No shares have been repurchased under this program as of December 31, 2016. The repurchases, if and when made, will be subject to market conditions, applicable rules of the Securities and Exchange Commission and other factors. Purchases may be commenced, suspended or discontinued at any time.

[2] The Stock Repurchase Program authorizes the repurchase of up to $2.5 million of common stock. The number of shares yet to be purchased is variable based upon the purchase price of the shares at the point in time they are acquired.

Item 6. Selected Financial Data.

Not applicable.

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

This Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The words "believe," "expect," "anticipate," "intend," "estimate," "may," "should," "could," "will," "plan," "future," "continue," and other expressions that are predictions of or indicate future events a trends and that do not relate to historical matters identify 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. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. A wide variety of factors could cause or contribute to such differences and could adversely impact revenues, profitability, cash flows and capital needs. There can be no assurance that the forward-looking statements contained in this document will, in fact, transpire or prove to be accurate.

Factors that could cause or contribute to our actual results differing materially from those discussed herein or for our stock price to be adversely affected include, but are not limited to: (1) our losses in recent years, including fiscal 2015 and 2016; (2) macro-economic risks from the effects of the economic downturn and decrease in budgets for the law-enforcement community; (3) our ability to increase revenues, increase our margins and return to consistent profitability in the current economic and competitive environment; (4) our operation in developing markets and uncertainty as to market acceptance of our technology and new products; (5) the impact of the federal government's stimulus program on the budgets of law enforcement agencies, including the timing, amount and restrictions on funding; (6) our ability to deliver our new product offerings as scheduled and have such new products perform as planned or advertised; (7) whether there will be commercial markets, domestically and internationally, for one or more of our newer products, and the degree to which the interest shown in our products, including the FirstVU HD, VuLink, VuVault.net, FleetVU and MicroVU HD, will translate into sales during 2017; (8) our ability to maintain or expand our share of the market for our products in the domestic and international markets in which we compete, including increasing our international revenues to their historical levels; (9) our ability to produce our products in a cost-effective manner; (10) competition from larger, more established companies with far greater economic and human resources; (11) our ability to attract and retain quality employees; (12) risks related to dealing with governmental entities as customers; (13) our expenditure of significant resources in anticipation of sales due to our lengthy sales cycle and the potential to receive no revenue in return; (14) characterization of our market by new products and rapid technological change; (15) our dependence on sales of our DVM-800, DVM-800 HD, FirstVU, First VU HD and DVM-250 products; (16) potential that stockholders may lose all or part of their investment if we are unable to compete in our markets and return to profitability; (17) defects in our products that could impair our ability to sell our products or could result in litigation and other significant costs; (18) our dependence on key personnel; (19) our reliance on third party distributors and sales representatives for part of our marketing capability; (20) our dependence on a few manufacturers and suppliers for components of our products and our dependence on domestic and foreign manufacturers for certain of our products; (21) our ability to protect technology through patents; (22) our ability to protect our proprietary technology and information as trade secrets and through other similar means; (23) risks related to our license arrangements; (24) our revenues and operating results may fluctuate unexpectedly from quarter to quarter; (25) sufficient voting power by coalitions of a few of our larger stockholders, including directors and officers, to make corporate governance decisions that could have significant effect on us and the other stockholders; (26) sale of substantial amounts of our common stock that may have a depressive effect on the market price of the outstanding shares of our common stock; (27) possible issuance of common stock subject to options and warrants that may dilute the interest of stockholders; (28) our ability to comply with Sarbanes-Oxley Act of 2002 Section 404 as it may be required; (29) our nonpayment of dividends and lack of plans to pay dividends in the future; (30) future sale of a substantial number of shares of our common stock that could depress the trading price of our common stock, lower our value and make it more difficult for us to raise capital; (31) our additional securities available for issuance, which, if issued, could adversely affect the rights of the holders of our common stock; (32) our stock price is likely to be highly volatile due to a number of factors, including a relatively limited public float; (33) whether the legal actions that the Company is taking or has taken against Utility Associates, Taser and WatchGuard will achieve their intended objectives; (34) whether the USPTO rulings will curtail, eliminate or otherwise have an effect on the actions of Taser and Utility Associates respecting us, our products and customers; (35) whether the remaining two claims under the ‘556 Patent have applicability to us or our products; and (36) whether our patented VuLink technology is becoming the *de-facto* “standard” for agencies engaged in deploying state-of-the-art body-worn and in-car camera systems; (37) whether this technology will have a significant impact on our revenues in the long-term; and (38) indemnification of our officers and directors.

Current Trends and Recent Developments for the Company

Overview

We supply technology-based products utilizing our portable digital video and audio recording capabilities, for law enforcement, private security, commercial fleet and mass transit markets. We have the ability to integrate electronic, radio, computer, mechanical, and multi-media technologies to create unique solutions to our customers' requests. We began shipping our flagship digital video mirror product in March 2006. Since then we have developed additional innovative in-car digital video products, including the DVM-100, DVM-400, DVM-800, DVM-800 HD and MicroVU HD, and body worn camera (FirstVU HD) products designed for law enforcement and private security usage. We have also launched the following new products in recent years: the FirstVU HD; DVM-800; DVM-800 HD; the MicroVU HD; the patented VuLink product, which integrates our body-worn cameras with our in-car systems by providing hands-free automatic activation; and the line of digital video mirrors (the DVM-250 and DVM-250 Plus) that serve as "event recorders" for the commercial fleet and mass transit markets in order to expand our customer base beyond the traditional law enforcement agencies. We launched the DVM-800 HD in 2016 and have additional research and development projects that we anticipate will result in several new product launches in 2017 in order to broaden our potential customer base beyond the historical law enforcement, private security and commercial fleet channels. We believe that the launch of these new products will help to diversify and expand the addressable market for our product offerings.

We experienced operating losses for all the quarters during 2016 and 2015. The following is a summary of our recent operating results on a quarterly basis:

	For the Three Months Ended:						
	December 31, 2016	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015	June 30, 2015
Total revenue	$3,445,610	$4,339,527	$4,384,411	$4,404,943	$5,051,119	$5,096,088	$5,634,237
Gross profit	148,807	2,033,571	1,265,236	1,853,619	1,563,647	2,039,774	3,092,194
Gross profit margin percentage	4.3 %	46.9 %	28.9 %	42.1 %	31.0 %	40.0 %	54.9
Total selling, general and administrative expenses	4,162,802	5,275,212	4,157,893	4,191,514	4,264,176	4,180,559	3,909,156
Operating loss	(4,013,995)	(3,241,641)	(2,892,657)	(2,337,895)	(2,700,529)	(2,140,785)	(816,962
Operating margin	(116.5)%	(74.7)%	(66.0)%	(53.1)%	(53.5)%	(42.0)%	(14.5

percentage							
Net loss	$(4,276,900)	$(3,255,579)	$(2,865,084)	$(2,313,125)	$(2,963,629)	$(2,141,163)	$(792,388

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Our business is subject to substantial fluctuations on a quarterly basis as reflected in the significant variations in revenues and operating results in the above table. These variations result from various factors, including but not limited to: 1) the timing of large individual orders; 2) the traction gained by our newer products, such as the FirstVU HD and FleetVU; 3) production, quality and other supply chain issues affecting our cost of goods sold; 4) unusual increases in operating expenses, such as our sponsorship of the Digital Ally Open golf tournament, the timing of trade shows and bonus compensation; and 5) litigation and related expenses respecting outstanding lawsuits. We reported an operating loss of $4,013,995 on revenues of $3,445,610 for fourth quarter 2016, which continued a series of quarterly losses resulting from competitive pressures and infringement of our patents by direct competitors such as Taser and Watchguard that reduced our revenues and product quality issues that hurt our gross margins.

A number of factors and trends affected our recent performance, which include:

Revenues decreased in fourth quarter 2016 to $3,445,610 from $4,339,527 in third quarter 2016, $4,384,411 in second quarter 2016, $4,404,943 in first quarter 2016, $5,051,119 in fourth quarter 2015, $5,096,088 in third quarter 2015 and $5,634,237 in second quarter 2015. We believe the decline in revenues in the last six quarters was attributable in part to Taser stating in a press releases in 2015 that all the claims in one of our patents were determined to be "unpatentable." We believe its press release was misleading and incorrect, causing confusion and concern in our marketplace, customer base and potential customers. Taser also commenced an action in the USPTO for a reexamination of our '292 Patent. A reexamination is essentially a request that the USPTO review whether the patent should have issued in its present form in view of the "prior art," e.g., other patents in the same technology field. The '292 Patent relates to the "automatic trigger" that allows our body camera and in-car system to automatically begin recording without the need for law enforcement officers to manually turn them on. The automatic trigger covered by our '292 Patent is incorporated in our popular VuLink product. We believe the confusion and misinformation caused by our competitor has impacted our revenues of our VuLink product, our body-worn camera product and in-car systems. Ultimately, the USPTO rejected Taser's efforts and reconfirmed the validity of the '292 patent on January 16, 2016 and we have filed suit alleging willful patent infringement against Taser and later against Watchguard. See "*Litigation"* for details. However, we believe we continue to suffer from the ongoing perception issues and confusion caused by Taser's misleading press release and the reexamination of our patent commenced by Taser with the USPTO.

Recognizing a critical limitation in law enforcement camera technology, during 2014 we pioneered the development of our VuLink ecosystem that provided intuitive auto-activation functionality as well as coordination between multiple recording devices. The USPTO has recognized these pioneering efforts by granting us multiple patents with claims covering numerous features, such as automatically activating an officer's cameras when the light bar is activated or a data-recording device such as a smart weapon is activated. Additionally, our patent claims cover automatic coordination between multiple recording devices. Prior to this work, officers were forced to manually activate each device while responding to emergency scenarios - a requirement that both decreased the usefulness of the existing camera systems and diverted officers' attention during critical moments. We believe law enforcement agencies have recognized the value of our VuLink technology and a trend is developing where the agencies are seeking information on "auto-activation" features in requests for bids and requests for information involving the procurement process of body-worn cameras and in-car systems. We believe this trend may result in our patented VuLink technology becoming the *de-facto* "standard" for agencies engaged in deploying state-of-the-art body-worn and in-car camera systems. We expect that this technology will have a significant positive impact on our revenues in the long-term, particularly if we are successful in our prosecution of the patent infringement litigation currently pending with Taser and Watchguard.

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Our newer products including the DVM-800 and FirstVU HD, introduced in 2013, contributed 59% of total sales for the year ended December 31, 2016, compared to 56% for the comparable period ending December 31, 2015. We have recently announced the launch of the DVM-800 HD in-car video system, which we believe will be disruptive in the market and will lead to an expansion of our overall market share. The DVM-800 HD system provides full 1080P high definition video at a cost effective price point.

Service and other revenues increased 35% in the year ended December 31, 2016 from the year ended December 31, 2015. We are concentrating on expanding our recurring service revenue to help stabilize our revenues on a quarterly basis. Revenues from extended warranty services increased approximately $235,000 in 2016. Additionally, installation service and cloud storage revenues increased approximately $115,000 and $90,000, respectively, for the year ended December 31, 2016 compared to 2015. We are pursuing several new market channels that do not involve our traditional law enforcement and private security customers. If successful, we believe that these new market channels could yield substantial recurring service revenues for us in 2017 and beyond. We are testing a new revenue model which involves the long-term lease of our body-worn and/or in-car hardware, together with a monthly subscription for our cloud storage, search and archiving services for the underlying audio and video material. This new service revenue model could have a substantial impact on our revenues and improve the stability of our quarter-to-quarter revenues and operating results. We believe this service revenue model may appeal to our customers, in particular our commercial and other non-law enforcement customers as it reduces the capital outlay up front and eliminates repairs and maintenance in exchange for making level monthly payments for the utilization of the equipment, data storage and management services.

Our gross margins fluctuated significantly because we encountered several product quality issues during 2016. Our gross margin percentage decreased to 4.3% in the fourth quarter 2016 from 46.9% in third quarter 2016, 28.9% in the second quarter 2016, 42.1% in first quarter 2016, 31% in the fourth quarter of 2015 and 40% in the third quarter of 2015. In the fourth quarter 2016, we scrapped approximately $570,000 of inventory, most of which was related to our FirstVU HD product and the product quality issues affecting it. We also increased our reserve for obsolete inventory by approximately $485,000 in fourth quarter 2016 due to newer versions of PCB components making previous versions excess or obsolete and higher levels of used or trade-in inventory and items requiring refurbishment. Our gross margin decline in prior quarters was primarily attributable to the camera cable connector upgrade implemented in the third quarter 2015 to our FirstVU HD product that caused us to rework our entire installed base of FirstVU HD’s and scrap a portion of the original cable assembly. In second quarter 2016, we became aware of workmanship issues on the printed circuit boards (“PCB boards”) used in our FirstVU HD product caused a higher failure rate. The workmanship problems resulted in a higher than normal rate of contaminated PCB boards in our finished goods inventory, as well as deployed units in the field that had to be replaced. The PCB boards were supplied by a contract manufacturer who did not follow our specifications for the flux used in the soldering process for certain of the components utilized in the PCB board assemblies. The contract manufacturer corrected its process and quality control procedures to eradicate this issue.

Our international revenues increased to $1,191,012 (7% of total revenues) during the year ended December 31, 2016, compared to $148,667 (1% of total revenues) during the year ended December 31, 2015. Our 2016 revenues were aided by approximately $760,000 of revenue from the sale of our FirstVU HD body worn cameras, storage systems and extended service agreement to a non-law enforcement international customer that will continue for three years. This order demonstrates the possibilities of deploying our FirstVU HD body cameras across various industries and applications in addition to the traditional law enforcement market.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet debt nor did we have any transactions, arrangements, obligations (including contingent obligations) or other relationships with any unconsolidated entities or other persons that may have material current or future effect on financial conditions, changes in the financial conditions, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses.

We are a party to operating leases, title sponsorship, and license agreements that represent commitments for future payments (described in Note 11 to our consolidated financial statements) and we have issued purchase orders in the ordinary course of business that represent commitments to future payments for goods and services.

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For the Years Ended December 31, 2016 and 2015

Results of Operations

Summarized immediately below and discussed in more detail in the subsequent sub-sections is an analysis of our operating results for the years ended December 31, 2016 and 2015, represented as a percentage of total revenues for each respective year:

	Years Ended December 31,	
	2016	**2015**
Revenue	100 %	100 %
Cost of revenue	68 %	58 %
Gross profit	32 %	42 %
Selling, general and administrative expenses:		
Research and development expense	19 %	15 %
Selling, advertising and promotional expense	25 %	20 %
Stock-based compensation expense	10 %	8 %
General and administrative expense	53 %	37 %
Total selling, general and administrative expense	107 %	80 %
Operating loss	(75 %)	(38 %)
Change in warrant derivative liabilities	— %	2 %
Change in fair value of secured convertible notes payable	— %	(22 %)
Secured convertible debentures issuance expenses	(2)%	(1 %)
Other income and interest expense, net	— %	(1 %)
Loss before income tax benefit	(77 %)	(60 %)
Income tax expense (benefit)	— %	— %
Net loss	(77 %)	(60 %)
Net loss per share information:		
Basic	$(2.38)	$(2.77)
Diluted	$(2.38)	$(2.77)

Revenues

Our current product offerings include the following:

Product Description

		Retail Price
DVM-750	An in-car digital audio/video system that is integrated into a rear view mirror primarily designed for law enforcement customers. We offer local storage as well as cloud storage solutions to manage the recorded evidence. We charge a monthly storage fee for our cloud storage option and a one-time fee for the local storage option.	$4,295
MicroVU HD	A compact in-car digital audio/video system that records in high definition primarily designed for law enforcement customers. This system uses an internal fixed focus camera that records in high definition quality.	$2,595
DVM-100	An in-car digital audio/video system that is integrated into a rear view mirror primarily designed for law enforcement customers. This system uses an integrated fixed focus camera.	$1,895
DVM-400	An in-car digital audio/video system that is integrated into a rear view mirror primarily designed for law enforcement customers. This system uses an external zoom camera.	$2,795
DVM-250 Plus	An in-car digital audio/video system that is integrated into a rear view mirror primarily designed for commercial fleet customers. We offer a web-based, driver management and monitoring analytics package for a monthly service fee that is available for our DVM-250 customers.	$1,295
DVM-800 HD	An in-car digital audio/video system which records in full 1080P high definition video that is integrated into a rear view mirror primarily designed for law enforcement customers. This system can use an internal fixed focus camera or two external cameras for a total of four video streams. We also offer the Premium Package which has additional warranty and retails for $4,795. We offer local storage as well as cloud storage solutions to manage the recorded evidence. We charge a monthly storage fee for our cloud storage option and a one-time fee for the local storage option.	$4,295
DVM-800	An in-car digital audio/video system which records in 480P standard definition video that is integrated into a rear view mirror primarily designed for law enforcement customers. This system can use an internal fixed focus camera or two external cameras for a total of four video streams. We also offer the Premium Package which has additional warranty and retails for $3,995. We offer local storage as well as cloud storage solutions to manage the recorded evidence. We charge a monthly storage fee for our cloud storage option and a one-time fee for the local storage option.	$3,495
Laser Ally	A hand-held mobile speed detection and measurement device that uses light beams rather than sound waves to measure the speed of vehicles.	$1,995
FirstVU HD	A body-worn digital audio/video camera system primarily designed for law enforcement customers. We also offer a cloud based evidence storage and management solution for our FirstVU HD customers for a monthly service fee.	$795
VuLink	An in-car device that enables an in-car digital audio/video system and a body worn digital audio/video camera system to automatically and simultaneously start recording.	$495

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

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

Sales to international customers are made through independent distributors who purchase products from us 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.

We may discount our prices on specific orders based upon the size of the order, the specific customer and the competitive landscape. We believe that our systems are at least comparable to those of our principal competitors and are generally lower priced when considering comparable features and capabilities.

Revenues for the years ended December 31, 2016 and 2015 were derived from the following sources:

	Years ended December 31,	
	2016	2015
DVM-800	41 %	36 %
FirstVu HD	18 %	20 %
DVM-250 Plus	7 %	10 %
DVM-750	6 %	2 %
DVM-100 & DVM-400	3 %	8 %
VuLink	3 %	3 %
DVM-500 Plus	1 %	7 %
Cloud service revenue	1 %	— %
Repair and service	5 %	3 %
Accessories and other revenues	15 %	11 %
	100 %	100 %

We experienced a change in the sales mix of our products for the year ended December 31, 2016 compared to the year ended December 31, 2015. Our newer products, the DVM-800 and the FirstVU HD, contributed 59% of total sales for the twelve months ended December 31, 2016, compared to 56% for the comparable period ending December 31, 2015.

Product revenues for the years ended December 31, 2016 and 2015 were $15,014,647 and $18,878,301, respectively, a decrease of $3,863,654 (20%), due to the following factors:

Our product revenues decreased approximately 20% for the year ended December 31, 2016 compared to the year ended December 31, 2015. We attribute the decrease to ongoing confusion caused by Taser's misleading press release regarding our patents and the product quality problems with our FirstVU HD product. In addition, we believe that Taser conspired to keep us out of the marketplace by engaging in improper, unethical and unfair competition. In that regard, we have amended our patent infringement lawsuit against Taser to include allegations that Taser bribed officials and otherwise conspired to secure no-bid contracts for its products in violation of both state law and federal antitrust law. We expect FirstVU HD sales to recover during 2017 as we prosecute the patent lawsuits against Taser and WatchGuard. We believe the VuLink product differentiates our product offerings from our competitors and customers will become more familiar with our patented "auto-activation" technology.

We shipped ten individual orders in excess of $100,000, for a total of approximately $2,821,000 in revenue for the year ended December 31, 2016 compared to twenty-two individual orders in excess of $100,000, for a total of approximately $3,727,000 in revenue for the year ended December 31, 2015. Our average order size decreased to approximately $2,850 in the year ended December 31, 2016 from $3,060 during the year ended December 31, 2015. Our newer mirror-based products include the DVM-800, which is sold at lower retail pricing levels compared to our legacy products. For certain opportunities that involve multiple units and/or multi-year contracts, we have occasionally discounted our products to gain or retain market share and revenues.

The DVM-800 and FirstVU HD, introduced in 2013, contributed 59% of total sales for the year ended December 31, 2016, compared to 56% for the comparable period ending December 31, 2015. During 2016, we announced the availability of our new DVM-800 HD in-car video system which provides advanced features, such as full 1080p high definition recordings at a competitive price point. We believe that some customers delayed their orders during 2016 to wait for the DVM-800 HD to become available. We believe future quarters will yield increases in the sales of these newer products.

Our international revenues increased to $1,191,012 (7% of total revenues) during the year ended December 31, 2016, compared to $148,667 (1% of total revenues) during the year ended December 31, 2015. Our 2016 revenues were aided by approximately $760,000 of revenue generated by an order from a non-law enforcement international customer for our FirstVU HD body worn cameras, storage systems and extended service agreement. This order demonstrates the possibilities of deploying our FirstVU HD body cameras across various industries and applications in addition to the traditional law enforcement market.

Service and other revenues for the years ended December 31, 2016 and 2015 were $1,559,844 and $1,151,907, respectively, an increase of $407,937 (35%), due to the following factors:

Cloud revenues were $147,277 and $58,580 for the years ended December 31, 2016 and 2015, respectively, an increase of $88,697 (151%).We have seen increased interest in our cloud solutions for law enforcement and several of our commercial customers have implemented our FleetVU and asset tracking solutions, which contributed to our increased cloud revenues in 2016. We believe 2017 will continue the trend of increased cloud service revenues because we were awarded the FleetVU manager cloud storage contract for 1,550 DVM-250 systems in early 2017.

Revenues from extended warranty services were $542,438 and $305,421 for the years ended December 31, 2016 and 2015, respectively, an increase of $237,017 (78%). We have many customers that have purchased extended warranty packages, primarily in our DVM-800 premium service program, and we expect to continue the trend of increased revenues from these services to continue in 2017.

Installation service revenues were $196,810 and $81,920 for the years ended December 31, 2016 and 2015, respectively, an increase of $114,890 (140%). The increase in 2016 was primarily due to the installation of the non-law enforcement international customer systems mentioned above in international revenues. We believe 2017 will continue the trend of increased installation service revenues because we were awarded a commercial contract to install 1,550 three-camera DVM-250 systems in early 2017.

Total revenues for the years ended December 31, 2016 and 2015 were $16,574,491 and $20,030,208, respectively, a decrease of $3,455,717 (17%), due to the reasons noted above.

Cost of Revenue

Cost of product revenue on units sold for the years ended December 31, 2016 and 2015 was $10,461,064 and $11,526,139, respectively, a decrease of $1,065,075 (9%). The decrease in product cost of goods sold is partially due to the 20% decrease in product revenues offset by the workmanship issues on our PCB boards adversely affecting the FirstVU HD product in 2016. The workmanship issues resulted in a higher than normal rate of contaminated PCB boards in our finished goods inventory, as well as deployed units in the field. The PCB boards were supplied by a contract manufacturer who did not follow our specifications for the flux used in the soldering process for certain of the components utilized in the PCB board assemblies. We incurred total charges to cost of sales approximating $650,000 during the year ended December 31, 2016 related to this issue. These charges result from the disassembly of the FirstVU HD, inspection of all PCB boards and replacement of PCB boards exhibiting contamination issues. Additionally, we scrapped approximately $1,580,000 of cable assemblies and older PCB board versions of our products in the year ended December 31, 2016, which also increased our cost of revenues. We increased the reserve for obsolete and excess inventories by approximately $800,000 during the year ended December 31, 2016 due to increased levels of excess component parts of older versions of PCB boards and legacy products and used trade-in inventory that is in need of refurbishment.

Cost of service and other revenue for the years ended December 31, 2016 and 2015 was $812,194 and $154,714, respectively, an increase of $657,480 (425%). The increase in service and other cost of goods sold is partially due to the 33% increase in service and other revenues in the year ended December 31, 2016 and expected warranty exchanges and/or repairs that are expected to be incurred for certain FirstVU HD customers at December 31, 2016. Additionally, there were increased personnel costs in the warranty repair department for the year ended December 31, 2016 compared to 2015.

Total cost of sales as a percentage of revenues increased to 68% during year ended December 31, 2016 compared to 58% for the year ended December 31, 2015. We believe our gross margins should return to more normal levels in future quarters as we improve revenue levels and reduce product quality issues.

We had $1,999,920 and $1,202,411 in reserves for obsolete and excess inventories at December 31, 2016 and December 31, 2015, respectively. Total raw materials and component parts were $4,015,170 and $3,833,873 at December 31, 2016 and December 31, 2015, respectively, an increase of $181,297 (5%). The increase in raw materials was mostly in refurbished parts for FirstVU HD products. Finished goods balances were $7,215,346 and $7,895,663 at December 31, 2016 and December 31, 2015, respectively, a decrease of $680,317 (9%). The decrease in finished goods was primarily in the DVM-750 and FirstVU HD products. The increase in the inventory reserve is primarily due to the change in sales mix of our products, which has resulted in a higher level of excess component parts of the older versions of our PCB boards and legacy products. Additionally, we increased our reserves on trade-in inventory and items needing to be refurbished. We believe the reserves are appropriate given our inventory levels at December 31, 2016.

Gross Profit

Gross profit for the years ended December 31, 2016 and 2015 was $5,301,233 and $8,349,355, respectively, a decrease of $3,048,122 (37%). The decrease is commensurate with the 17% decline in revenues for the year ended December 31, 2016 and the cost of sales as a percentage of revenues increasing to 68% during the year ended December 31, 2016 from 58% for the year ended December 31, 2015. We believe that gross margins will improve in 2017 because we have corrected the workmanship and other issues affecting our FirstVU HD product during recent quarters, including the PCB contamination issue addressed in the second and third quarters 2016. Our goal is to improve our margins to 60% over the longer term based on the expected margins of our newer products, in particular the DVM-800, DVM-800 HD and FirstVU HD, as they continue to gain traction in the marketplace and we increase our commercial market penetration in 2017. In addition, as revenues from these products increase, we will seek to further improve our margins from them through economies of scale and more efficiently utilizing fixed manufacturing overhead components. We plan to continue our initiative on more efficient management of our supply chain through outsourcing production, quantity purchases and more effective purchasing practices.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $17,787,421 and $15,970,826 for the years ended December 31, 2016 and 2015, respectively, an increase of $1,816,595 (11%). Selling, general and administrative expenses as a percentage of sales increased to 107% in 2016 from 80% in 2015. The significant components of selling, general and administrative expenses are as follows:

The significant components of selling, general and administrative expenses are as follows:

	Year ended December 31,	
	2016	2015
Research and development expense	$3,186,137	$2,980,807
Selling, advertising and promotional expense	4,238,895	3,965,400
Stock-based compensation expense	1,592,365	1,623,033
Professional fees and expense	1,930,625	1,368,758
Executive, sales, and administrative staff payroll	4,115,816	2,941,151
Other	2,723,583	3,091,677
Total	$17,787,421	$15,970,826

Research and development expense. We continue to focus on bringing new products to market, including updates and improvements to current products. Our research and development expenses totaled $3,186,137 and $2,980,807 for the years ended December 31, 2016 and 2015, respectively, an increase of $205,330 (7%). We employed a total of 32 engineers at December 31, 2016 compared to 25 engineers at December 31, 2015, most of whom are dedicated to research and development activities for new products. We are increasing our engineering staff of web-based developers as we expand our offerings to include, among other items, cloud-based evidence storage and management for our law enforcement customers (VuVault.net) and our web-based commercial fleet driver monitoring and management tool (FleetVU Manager). Research and development expenses as a percentage of total revenues were 19% in 2016 compared to 15% in 2015. We have active research and development projects on several new products, as well as upgrades to our existing product lines. We consider our research and development capabilities and new product focus to be a competitive advantage and will continue to invest in this area on a prudent basis.

Selling, advertising and promotional expenses. Selling, advertising and promotional expense totaled $4,238,895 and $3,965,400 for the years ended December 31, 2016 and 2015, respectively, an increase of $273,495 (7%). Salaries and commissions to our sales personnel represent the primary components of these costs and were $3,091,676 and $3,116,729 for the years ended December 31, 2016 and 2015, respectively, a decrease of $25,053 (1%). The effective commission rate was 18.6% for the year ended December 31, 2016 compared to 15.6% for the year ended December 31, 2015.

Promotional and advertising expenses totaled $1,147,219 during the year ended December 31, 2016 compared to $848,671 during the year ended December 31, 2015, an increase of $298,548 (35%). The increase is primarily attributable to us becoming the title sponsor in 2015 of the Web.com Tour golf tournament held annually in the Kansas City Metropolitan area. Our net promotional expense related to sponsorship of the 2016 tournament was $499,313 compared to $172,623 for the 2015 tournament, an increase of $326,690 (189%).

Stock-based compensation expense. Stock based compensation expense totaled $1,592,365 and $1,623,033 for the years ended December 31, 2016 and 2015, respectively, a decrease of $30,668 (2%). The decrease is primarily due to the amortization of the restricted stock granted during 2015 and 2016 to our officers, directors, and other employees that had the effect of decreasing the stock compensation expense for the year ended December 31, 2016 compared to 2015.

The total number of restricted shares granted to the Board of Directors, officers and employees decreased to 290,000 shares during the year ended December 31, 2016 compared to 326,500 shares during the year ended December 31, 2015. In addition, the weighted average grant date price of the shares decreased to $4.79 per share during the year ended December 31, 2016 compared to $8.42 per share during the year ended December 31, 2015.

Professional fees and expense. Professional fees and expenses totaled $1,930,625 and $1,368,758 for the years ended December 31, 2016 and 2015, respectively, an increase of $561,867 (41%). Professional fees during 2015 and 2016 were related primarily to normal public company matters, intellectual property matters and litigation matters. The increase in professional fees and expenses in 2016 compared to 2015 is primarily attributable higher board of directors' fees and litigation expenses related to the Utility, Taser, and WatchGuard lawsuits. We expect litigation expense to trend higher during 2017 as we commence the jury trial in the Utility lawsuit and discovery activities in the Taser and WatchGuard lawsuits. We intend to pursue recovery from Utility, Taser, WatchGuard, their insurers and other responsible parties as appropriate.

Executive, sales and administrative staff payroll. Executive, sales and administrative staff payroll expenses totaled $4,115,816 and $2,941,151 for the years ended December 31, 2016 and 2015, respectively, an increase of $1,174,665 (40%). This increase is attributable to the need to hire additional technical support staff to handle field inquiries and installation matters because our installed customer base has expanded and additional technical and marketing support was required for our new products, such as the DVM-800 and FirstVU HD. Additionally, executive payroll increased over prior year levels as key employees and certain executives received raises or bonuses after several years of salaries being frozen. A special bonus of $630,000 was awarded to our CEO in 2016, which did not occur in 2015.

Other. Other selling, general and administrative expenses totaled $2,723,583 and $3,091,677 for the years ended December 31, 2016 and 2015, respectively, a decrease of $368,094 (12%). The decrease in other expenses in 2016 compared to 2015 is primarily attributable to decreased consulting, and contract labor expenses. We utilized consultants to help design, develop and launch a new corporate website in 2015. Additionally, we converted several associates who were contract labor in the technical support area in 2015 to full-time employees in 2016.

Operating Loss

For the reasons previously stated, our operating loss was $12,486,188 and $7,621,471 for the years ended December 31, 2016 and 2015, respectively, a deterioration of $4,864,717 (64%). Operating loss as a percentage of revenues increased to 75% in 2016 from 38% in 2015.

Interest Income

Interest income increased to $26,195 for the year ended December 31, 2016 from $21,156 in 2015.

Change in Warrant Derivative Liabilities

Detachable warrants exercisable to purchase a total of 398,916 common shares, as adjusted, were issued in conjunction with $2.0 million and $4.0 million Secured Convertible Notes during March and August 2014. The warrants were required to be treated as derivative liabilities because of their anti-dilution and down-round provisions. Accordingly, we estimated the fair value of such warrants as of their respective date of issuance and recorded a corresponding derivative liability in the balance sheet. Upon exercise of the warrants we recognized a gain/loss based on the closing market price of the underlying common stock on the date of exercise. In addition, the warrant derivative liability is adjusted to the estimated fair value of any unexercised warrants as of December 31, 2016 and 2015. The warrant derivative liability balance was $33,076 and $67,053 as of December 31, 2016 and 2015, respectively.

The holder of the Secured Convertible Notes exercised a total of 250,095 of its warrants during March 2015 and April 2015. The net change in warrant derivative liabilities resulted in a net gain of $371,006 for the year ended December 31, 2015.

There were no exercises of these warrants during 2016 and there remained warrants outstanding to purchase 12,200 shares of common stock as of December 31, 2016 and 2015 that are treated as derivative liabilities. The changes in the fair value of the warrant derivatives related to unexercised warrants resulted in a gain of $33,977 for the year ended December 31, 2016. The warrant derivative liability balance was $33,076 as of December 31, 2016.

Change in Fair Value of Secured Convertible Notes Payable

We elected to account for and record our $4.0 million Secured Convertible Note issued during August 2014 on its fair value basis. The holder of the $4.0 million Secured Convertible Note exercised its right to convert the remaining principal balance of the note into 655,738 shares of common stock and 5,475 shares for accrued interest thereon at a conversion rate of $7.32 per share in separate transactions between February 13 and 25, 2015. The increase in fair market value of the 655,213 shares over the $3,963,780 principal retired was $4,434,383 representing the increase in our stock price over the conversion rate as of the conversion dates. Accordingly, the total change in fair value of Secured Convertible Notes Payable was a $4,434,383 loss for the twelve months ended December 31, 2015, which was recognized in the Consolidated Statement of Operations.

The Secured Convertible Note Payable issued in August 2014 was fully converted in 2015, therefore there was no change in fair value reflected in 2016. The estimated fair value of the secured convertible debentures issued on December 30, 2016 was considered the same as of December 31, 2016, therefore there was no change in fair value reflected in 2016.

Secured Convertible Debentures Issuance Expense

We elected to account for and record our $4.0 million secured convertible debentures issued during December 2016 and August 2014 on a fair value basis. Accordingly, we were required to expense the related issuance costs to other expense in the consolidated statements of operations. Such costs totaled $281,570 and $93,845 at December 31, 2016 and 2015, respectively. The December 31, 2016 expenses included a $200,000 placement agent fee and the remainder was primarily legal fees. The 2015 expenses were attributable to the proxy costs incurred for our Special Meeting of Shareholders held on February 13, 2015 to approve the issuance of shares above the Nasdaq Cap.

Other Income (Expense)

Other income was $0 for the year ended December 31, 2016 from $1,878 in 2015.

Interest Expense

We incurred interest expense of $3,102 and $282,233 during the years ended December 31, 2016 and 2015. We issued an aggregate of $2.5 million principal amount of subordinated notes during 2011, which bore interest at the rate of 8% per annum until the notes were paid in full on July 24, 2015. On August 28, 2014, we issued the $4.0 million Secured Convertible Note bearing interest at the rate of 6% per annum that remained outstanding until its full conversion in the first quarter 2015.

We amortized to interest expense $0 and $115,411, representing the discount associated with the $2.5 million subordinated note during the years ended December 31, 2016 and 2015, respectively and the remaining unamortized discount was $0 at December 31, 2016 and 2015.

Loss before Income Tax Benefit

As a result of the above, we reported a loss before income tax benefit of $12,710,688 and $12,037,892 for the years ended December 31, 2016 and 2015, respectively, a deterioration of $672,796 (6%).

Income Tax Benefit

We did not record an income tax benefit related to our losses for the years ended December 31, 2016 and 2015, respectively, due to our overall net operating loss carryforwards available. We have further determined to continue providing a full valuation reserve on our net deferred tax assets as of December 31, 2016. During 2016, we increased our valuation reserve on deferred tax assets by $4,350,000 whereby our deferred tax assets continue to be fully reserved due to our recent operating losses.

We had approximately $40,100,000 of net operating loss carryforwards and $1,955,000 of research and development tax credit carryforwards as of December 31, 2016 available to offset future net taxable income.

Net Loss

As a result of the above, we reported net losses of $12,710,688 and $12,037,892 for the years ended December 31, 2016 and 2015, respectively, a deterioration of $672,796 (6%).

Basic and Diluted Loss per Share

The basic and diluted loss per share was $2.38 and $2.77 for the years ended December 31, 2016 and 2015, respectively, for the reasons previously noted. All outstanding stock options and common stock purchase warrants were considered antidilutive and therefore excluded from the calculation of diluted loss per share for the years ended December 31, 2016 and 2015 because of the net loss reported for each period.

Liquidity and Capital Resources

Overall:

On December 30, 2016, we completed a private placement of $4.0 million in principal amount of 8% Secured Convertible Debentures with two institutional investors. Such Debentures bear interest at 8% per annum payable in cash on a quarterly basis and are secured by substantially all of our tangible and certain intangible assets. In addition, we issued the investors warrants to acquire 800,000 shares of common stock at $5.00 per share. The Debentures mature on March 30, 2018 and are convertible at any time six months after their date of issue at the option of the holders into shares of common stock at $5.00 per share. In addition, we can elect to redeem the Debentures at 112% of their outstanding principal balance and could force conversion by the holders if the market price exceeds $7.50 per share for ten consecutive trading days. We are using the proceeds of this private placement for general working capital purposes.

On July 22, 2015, we closed a $12.0 million offering of our common stock and common stock purchase warrants in an at-the-market registered direct offering and a concurrent private placement of two series of common stock purchase warrants with two investors. Proceeds of the offering were used to repay the $2.5 million principal amount of subordinated notes plus accrued interest in full and for working capital purposes.

If we had to supplement our liquidity to support our operations in 2017, given our recent history of net operating losses and negative cash flows we do not believe that traditional banking indebtedness would be available to us given our recent operating history. In the alternative, we have outstanding warrants exercisable to purchase approximately 2,400,000 common shares with a weighted average exercise price of $10.47 per share, including the recently issued 800,000 warrants at an exercise price of $5.00 per share. We could use such warrants to provide near-term liquidity and could induce their holders to exercise their warrants by adjusting/lowering the exercise price on a temporary or permanent basis if the warrants exercise price was below the then market price of our common stock. Ultimately, we must restore profitable operations and positive cash flows to provide liquidity to support our operations and, if necessary, to raise capital on commercially reasonable terms in 2017 and beyond. In addition, if the need arises and we could qualify, we may seek commercial credit facilities, including traditional bank borrowings, to improve our liquidity position and to finance growth opportunities or future capital needs that may arise.

We had warrants outstanding exercisable to purchase 2,379,290 shares of common stock at a weighted average exercise price $10.47 per share outstanding as of December 31, 2016. In addition, there are common stock options outstanding exercisable to purchase 362,440 shares at an average price of $18.46 per share. The exercise of these common stock equivalents would provide us with an additional potential source of liquidity if and when they are exercised.

We had $4,383,124 of available cash and equivalents (including $500,000 of restricted cash) and net working capital of approximately $11.7 million as of December 31, 2016. Net working capital as of December 31, 2016 includes approximately $2.5 million of accounts receivable and $9.6 million of inventory.

Cash and cash equivalents balances: As of December 31, 2016, we had cash and cash equivalents with an aggregate unrestricted balance of $3,883,124, a decrease from a balance of $6,924,079 at December 31, 2015. Summarized immediately below and discussed in more detail in the subsequent subsections are the main elements of the $3,040,955 net decrease in unrestricted cash during the year ended December 31, 2016:

Operating activities:	**$5,902,901** of net **cash used in** operating activities. Net cash used in operating activities was $5,902,901 and $7,686,769 for the year ended December 31, 2016 and 2015, respectively, an improvement of $1,783,868. The improvement was primarily the result of decreases in accounts receivable and inventory, and increases in deferred revenue, accounts payable and accrued expenses. Our goal is to increase revenues, return to profitability and decrease our inventory levels during 2017, thereby providing positive cash flows from operations, although there can be no assurances that we will be successful in this regard.
Investing activities:	**$940,711** of net **cash used in** investing activities. Cash used in investing activities was $940,711 for the year ended December 31, 2016 compared to cash provided by investing activities of $881,047 for the year ended December 31, 2015. In 2016, we incurred costs for tooling of new products and for patent applications on our proprietary technology utilized in our new products and included in intangible assets. In 2015, we incurred costs for new work stations and computers for recently hired associates. In connection with the $4.0 million 8% Secured Convertible Debentures issued in December 2016, we are required to maintain a minimum cash balance of not less than $0.5 million as long as such Debentures remain outstanding. In connection with the $4.0 million Secured Convertible Note issued in August 2014, we were required to maintain a minimum cash balance of not less than $1.5 million until such time as we satisfied all of the "Equity Conditions," as defined in the $4.0 million Secured Convertible Note (see Note 5). We satisfied the "Equity Conditions" on February 13, 2015 and the restriction on the $1.5 million was lifted and the funds became available for working capital.
Financing activities:	**$3,802,657** of net **cash provided by** financing activities. Cash provided by financing activities was $3,802,656 and $10,680,085 for the years ended December 31, 2016 and 2015, respectively. On December 30, 2016 we issued the $4.0 million 8% Secured Convertible Debentures with detachable common stock purchase warrants, the proceeds of which we are using for general working capital purposes. We incurred issuance costs of $281,570 related to the secured convertible debentures in 2016 and $93,845 during 2015 related to the $4.0 million Secured Convertible Note issued in August 2014. We received $119,055 of proceeds in the year ended December 31, 2016 from the exercise of common stock warrants and options compared to $2,133,889 for the year ended December 31, 2015. On July 22, 2015 we closed a $12.0 million offering of our common stock and common stock purchase warrants. After placement agent fees and other estimated offering expenses, the net offering proceeds to us totaled approximately $11.2 million prior to any exercise of the warrants. Proceeds of the offering were used to repay the $2.5 million principal amount of the subordinated notes. During 2015 we acquired capital equipment financed through capital lease obligations and payments on such obligations represented the cash used in financing activities.

The net result of these activities was a decrease in unrestricted cash of $3,040,955 to $3,383,124 for the year ended December 31, 2016.

Commitments:

We had $3,883,124 of cash and cash equivalent balances and net positive working capital approximating $11.7 million as of December 31, 2016. Accounts receivable balances represented $2,519,184 of our net working capital at December 31, 2016. We intend to collect our outstanding receivables on a timely basis and reduce the overall level during 2017, which would help to provide positive cash flow to support our operations during 2017. Inventory represented $9,586,311 of our net working capital at December 31, 2016 and finished goods represented $7,215,346 of total inventory. We are actively managing the level of inventory and our goal is to reduce such levels during 2017 by our sales activities, which should provide additional cash flow to help support our operations during 2017.

Capital Expenditures. We had no material commitments for capital expenditures at December 31, 2016.

Lease commitments-Operating Leases. We have a long-term operating lease agreement for office and warehouse space that expires in April 2020. We have also entered into month-to-month leases for equipment and facilities. Rent expense for the years ended December 31, 2016 and 2015 was $397,924 and $401,845, respectively, related to these leases. Following are our minimum lease payments for each year and in total.

Year ending December 31:	
2017	$445,449
2018	451,248
2019	457,327
2020	154,131
	$1,508,155

License agreements. We have several license agreements under which we have been assigned the rights to certain licensed materials used in our products. Certain of these agreements require us 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 $25,161 and $26,454 for the years ended December 31, 2016 and 2015, respectively.

Following is a summary of our licenses as of December 31, 2016:

License Type	**Effective Date**	**Expiration Date**	**Terms**
	April 2005	April 2017	

Production software license agreement			Automatically renews for one-year periods unless terminated by either party.
Software sublicense agreement	October 2007	October 2017	Automatically renews for one-year periods unless terminated by either party.
Software development and software services agreement	June 2015	June 2017	Renewable by mutual agreement of the parties unless terminated by Digital Ally for convenience.

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 October 25, 2013, the Company filed a complaint in the United States District Court for the District of Kansas (2:13-cv-02550-SAC) 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 the Company's mobile video surveillance systems do not infringe any claim of the '556 Patent. The Company became aware that Utility had mailed letters to current and prospective purchasers of its 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. The Company rejected Utility's assertion and is vigorously defending 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 District Court's decision was not a ruling on the merits of the case. The Company appealed the decision and the Federal Circuit affirmed the District Court's previous decision.

In addition, the Company began 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 (“USPTO”). On July 27, 2015, the USPTO invalidated key claims in Utility’s ‘556 Patent. The Final Decision from the USPTO significantly curtails Utility’s ability to threaten law enforcement agencies, municipalities, and others with infringement of the ’556 Patent. Utility appealed this decision to the United States Court of Appeals for the Federal Circuit. The United States Court of Appeals for the Federal Circuit denied Utility’s appeal and therefore confirmed the ruling of the USPTO. This denial of Utility’s appeal finalized the USPTO’s ruling in Digital’s favor and the matter is now concluded.

On June 6, 2014 the Company filed an Unfair Competition lawsuit against Utility Associates, Inc. (“Utility”) in the United States District Court for the District of Kansas. In the lawsuit it contends that Utility has defamed the Company and illegally interfered with its contracts, customer relationships and business expectancies by falsely asserting to its customers and others that its products violate the ‘556 Patent, of which Utility claims to be the holder.

The 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 the Company’s employees, in violation of that employee’s Non-Competition and Confidentiality agreements with the Company. In addition to damages, the Company seeks temporary, preliminary, and permanent injunctive relief, prohibiting Utility from, among other things, continuing to threaten or otherwise interfere with the Company’s customers. On March 4, 2015, an initial hearing was held upon the Company’s request for injunctive relief.

Based upon facts revealed at the March 4, 2015 hearing, on March 16, 2015, the Company sought leave to amend its Complaint in the Kansas suit to assert additional claims against Utility. Those new claims include claims of actual or attempted monopolization, in violation of § 2 of the Sherman Act, claims arising under a new Georgia statute that prohibits threats of patent infringement in “bad faith,” and additional claims of unfair competition/false advertising in violation of § 63(a) of the Lanham Act. As these statutes expressly provide, the Company will seek treble damages, punitive damages and attorneys’ fees as well as injunctive relief. The Court concluded its hearing on April 22, 2015, and allowed the Company leave to amend its complaint, but denied its preliminary injunction. The discovery stage of the lawsuit expired in May 2016. Both parties have filed summary judgment motions, which are currently under review and consideration by the court. The jury trial date is scheduled for June 2017. The Company believes that the USPTO’s final decision issued on July 27, 2015 will provide it with substantial basis to pursue its claims either through summary judgment motions prior to trial or the jury trial itself and it intends to pursue recovery from Utility, its insurers and other parties, as appropriate.

On September 13, 2014, Utility filed suit in the United States District Court for the Northern District of Georgia against the Company alleging infringement of the ‘556 Patent. The suit was served on the Company on September 20, 2014. As alleged in the Company’s first filed lawsuit described above, the Company believes that the ‘556 Patent is both invalid and not infringed. Further, the USPTO has issued its final decision invalidating 23 of the 25 claims asserted in the ‘556 Patent, as noted above. The Company believes that the suit filed by Utility is without merit and is vigorously defending the claims asserted against the Company. An adverse resolution of the foregoing litigation or patent proceedings could have a material adverse effect on the Company’s business, prospects, results of operations, financial condition, and liquidity. The Court stayed all proceedings with respect to this lawsuit pending the outcome of the patent review performed by the USPTO and the appellate court. Based on the USPTO's final decision to invalidate substantially all claims contained in the '556 Patent and the United States Court of Appeals for the Federal Circuit full denial of Utility's appeal, the Company intends to file for summary judgment in its favor if Utility does not request outright dismissal.

The Company received notice in April 2015 that Taser, one of its competitors, had commenced an action in the USPTO for a re-examination of its U.S. Patent No. 8,781,292 (the " '292 Patent"). A re-examination is essentially a request that the USPTO review whether the patent should have issued in its present form in view of the "prior art," e.g., other patents in the same technology field. The prior art Taser used to request the re-examination is a patent application that never issued into a patent was assigned to an unrelated third party and was not the result of any of Taser's own research and development efforts.

The Company owns the '292 Patent, which is directed to a system that determines when a recording device, such as a law enforcement officer's body camera or in-car video recorder, begins recording and automatically instructs other recording devices to begin recording. The technology described in the '292 Patent is incorporated in the Company's VuLink product.

On August 17, 2015 the USPTO issued a first, non-final action rejecting all 20 claims of the ‘292 Patent respecting its ‘292 Patent under an *ex parte* re-examination. The Company was provided the opportunity to discuss the merits of the prior art and the scope of the patent claims with the patent Examiner handling the reexamination and to amend the patent claims. On January 14, 2016 the USPTO ultimately rejected Taser’s efforts and confirmed the validity of the ‘292 Patent with 59 claims covering various aspects of the Company’s auto-activation technology. On February 2, 2016 the USPTO issued another patent relating to the Company’s auto-activation technology for law enforcement cameras. U.S. Patent No. 9,253,452 (the “ ‘452 Patent”) generally covers the automatic activation and coordination of multiple recording devices in response to a triggering event, such as a law enforcement officer activating the light bar on the vehicle.

The Company filed suit on January 15, 2016 in the U.S. District Court for the District of Kansas (Case No: 2:16-cv-02032) against Taser, alleging willful patent infringement against Taser’s Axon body camera product line. The lawsuit was initiated after the USPTO reconfirmed the validity of the ‘292 Patent, which covers various aspects of auto-activation and multiple camera coordination for body-worn cameras and in-car video systems. The ‘292 Patent previously was subject to attack by Taser, which tried to invalidate it at the USPTO. The USPTO ultimately rejected Taser’s efforts and confirmed the validity of the ‘292 Patent with 59 claims covering various aspects of this valuable auto-activation technology. On February 2, 2016 the USPTO issued another patent relating to the Company’s auto-activation technology for law enforcement cameras. This ‘452 Patent generally covers the automatic activation and coordination of multiple recording devices in response to a triggering event such as a law enforcement officer activating the light bar on the vehicle. The Company added the ‘452 patent to its existing lawsuit against Taser seeking both monetary damages and a permanent injunction against Taser for infringement of both the ‘452 and ‘292 Patents.

In addition to the infringement claims, the Company added a new set of claims to the lawsuit alleging that Taser conspired to keep the Company out of the marketplace by engaging in improper, unethical, and unfair competition. The amended lawsuit alleges Taser bribed officials and otherwise conspired to secure no-bid contracts for its products in violation of both state law and federal antitrust law. The Company’s lawsuit also seeks monetary and injunctive relief, including treble damages, for these alleged violations.

The Company filed an amended complaint and Taser filed an answer which denied the patent infringement allegations on April 1, 2016. In addition, Taser filed a motion to dismiss all allegations in the complaint on March 4, 2016 for which the Company filed an amended complaint on March 18, 2016 to address certain technical deficiencies in the pleadings. Taser amended and renewed its motion to seek dismissal of the allegations that it had bribed officials and otherwise conspired to secure no-bid contracts for its products in violation of both state law and federal antitrust law on April 1, 2016. Formal discovery commenced on April 12, 2016 with respect to the patent related claims. In January 2017 the Court granted Taser’s motion to dismiss the portion of the lawsuit regarding claims that it had bribed officials and otherwise conspired to secure no-bid contracts for its products in violation of both state law and federal antitrust law. The Company has appealed this decision to the United States Court of Appeals for the Federal Circuit and is awaiting its decision.

In December 2016, Taser announced that it had commenced an action in the USPTO for *inter partes review* of the Company's '292 Patent. Previously Taser had attempted to invalidate the '292 Patent through a re-examination procedure at the USPTO. On January 14, 2016 the USPTO ultimately rejected Taser's efforts and confirmed the validity of the '292 Patent with 59 claims covering various aspects of the Company's auto-activation technology. The USPTO fully rejected all of Taser's previous arguments, concluding all 59 claims in Digital Ally's '292 patent were valid and non-obvious. Taser is again attempting through its recently filed *inter partes review* to convince the USPTO that Digital Ally's patents lack patentability. The USPTO is taking the request under consideration and has not decided whether it will institute the *inter partes review.* In addition, Taser has requested that the patent infringement lawsuit filed by Digital Ally in the U.S. District Court for the District of Kansas (Case No: 2:16-cv-02032) against Taser, be stayed while its *inter partes review* is being considered by the USPTO. Digital Ally has filed a motion to deny the stay and both motions. On March 20, 2017 the Court granted Taser's motion to stay in part and temporarily stayed the proceedings until the Patent Trial and Appeal Board ("PTAB") issues its initial decisions with respect to Taser's petitions for *inter partes review*. The PTAB is scheduled to issue its initial decisions with respect to whether it will institute the requested *inter partes reviews* between June 2017 and August 2017.

On May 27, 2016 the Company filed suit against Enforcement Video, LLC d/b/a WatchGuard Video ("WatchGuard"), (Case No. 2:16-cv-02349-JTM-JPO) alleging patent infringement based on WatchGuard's VISTA Wifi and 4RE In-Car product lines.

The USPTO has granted multiple patents to the Company with claims covering numerous features, such as automatically and simultaneously activating all deployed cameras in response to the activation of just one camera. Additionally, Digital Ally's patent claims cover automatic coordination as well as digital synchronization between multiple recording devices. Digital Ally also has patent coverage directed to the coordination between a multi-camera system and an officer's smartphone, which allows an officer to more readily assess an event on the scene while an event is taking place or immediately after it has occurred.

The Company's lawsuit alleges that WatchGuard incorporated this patented technology into its VISTA Wifi and 4RE In-Car product lines without its permission. Specifically, Digital Ally is accusing WatchGuard of infringing three patents: the '292 and '452 Patents and U.S. Patent No. 9,325,950. The Company is aggressively challenging WatchGuard's infringing conduct, seeking both monetary damages, as well as seeking a permanent injunction preventing WatchGuard from continuing to sell its VISTA Wifi and 4RE In-Car product lines using Digital Ally's own technology to compete against it. The lawsuit is in the early stages of discovery.

The Company is 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. The Company believes the likely outcome of any other pending cases and proceedings will not be material to its business or its financial condition.

Sponsorship. On April 16, 2015 we entered into a Title Sponsorship Agreement under which we became the title sponsor for a Web.com Tour golf tournament (the "Tournament") held annually in the Kansas City Metropolitan area. Such Agreement provides us with naming rights and other benefits for the annual Tournament for the years 2015 through 2019 in exchange for the following sponsorship fee:

Year	Sponsorship fee						
2015	$ 375,000						
2016	$ 475,000						
2017	$ 475,000						
2018	$						
Change in inventory	11	(4)	(1)	18	(5)	(1)	27
	274	295	86	124	123	36	576

Change in trade receivables (including long-term amounts)							
Change in other receivables (including long-term amounts)	(48)	(83)	(24)	(28)	(14)	(4)	(34)
Changes in trade payables, accrued expenses and provisions	(103)	26	8	9	(19)	(6)	(185)
Change in other liabilities (including long-term amounts)	(7)	66	19	4	68	20	(33)
Payments for derivative hedging contracts, net	(6)	(6)	(1)	(5)	(1)	-	(17)
Income tax paid	(61)	(55)	(16)	(26)	(25)	(7)	(119)
Income tax received	6	-	-	6	-	-	6
Net cash from operating activities	720	894	260	442	441	128	1,556
Cash flows from investing activities							
Acquisition of property, plant, and equipment	(171)	(127)	(37)	(83)	(63)	(18)	(275)
Acquisition of intangible assets	(48)	(44)	(13)	(22)	(19)	(6)	(90)
Change in current investments, net	(10)	(14)	(4)	(6)	88	26	(16)
Payments for other derivative contracts, net	(5)	(2)	-	(2)	(1)	-	(10)
Proceeds from sale of property, plant and equipment	10	3	1	5	-	-	17
Interest received	19	17	5	8	5	1	29
Dividend received	1	-	-	1	-	-	1
Net cash from (used in) investing activities	(204)	(167)	(48)	(99)	10	3	(344)

Cellcom Israel Ltd.
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Condensed Consolidated Interim Statements of Cash Flows (cont'd)

	For the six months ended June 30,		Convenience translation into US dollar For the six months ended June 30,	For the three months ended June 30,		Convenience translation into US dollar For the three months ended June 30,	For the year ended December 31,
	2013	2014	2014	2013	2014	2014	2013
	NIS millions		US$ millions	NIS millions		US$ millions	NIS millions
Cash flows from financing activities							
Payments for derivative contracts, net	(4)	(14)	(4)	(4)	(13)	(4)	(8)
Repayment of long term loans from banks	-	(11)	(3)	-	-	-	(6)
Repayment of debentures	(561)	(523)	(152)	-	-	-	(1,124)
Dividend paid	-	(4)	(1)	-	-	-	(81)
Interest paid	(180)	(149)	(44)	-	-	-	(350)
Net cash used in financing activities	(745)	(701)	(204)	(4)	(13)	(4)	(1,569)
Changes in cash and cash equivalents	(229)	26	8	339	438	127	(357)
Cash and cash equivalents as at the beginning of the period	1,414	1,057	307	846	645	188	1,414
Cash and cash equivalents as at the end of the period	1,185	1,083	315	1,185	1,083	315	1,057

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Reconciliation for Non-IFRS Measures

EBITDA

The following is a reconciliation of net income to EBITDA:

	Three-month period ended June 30,			Year ended December 31,
			Convenience translation into US dollar	
	2013 NIS millions	2014 NIS millions	2014 US$ millions	2013 NIS millions
Profit for the period	67	79	23	288
Taxes on income	24	13	4	117
Financing income	(42)	(31)	(9)	(156)
Financing expenses	120	95	27	402
Other expenses (income) (*)	(4)	2	1	(1)
Depreciation and amortization	171	155	45	676
Share based payments	3	1	-	9
EBITDA	339	314	91	1,335

(*)Other expenses for the second quarter of 2014 exclude a one-time expense for an employee retirement plan in the amount of approximately NIS 39 million ($11 million).

Free cash flow

The following table shows the calculation of free cash flow:

	Three-month period ended June 30,			Year ended December 31,
			Convenience translation into US dollar	
	2013 NIS millions	2014 NIS millions	2014 US$ millions	2013 NIS millions
Cash flows from operating activities	442	441	128	1,556
Cash flows from investing activities	(99)	10	3	(344)
Short-term Investment in (sale of) tradable debentures and deposits (*)	2	(90)	(26)	(2)

Free cash flow	345	361	105	1,210

(*) Net of interest received in relation to tradable debentures.

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Key financial and operating indicators (unaudited)

NIS millions unless otherwise stated	Q2-2012	Q3-2012	Q4-2012	Q1-2013	Q2-2013	Q3-2013	Q4-2013	Q1-2014	Q2-20
Cellcom service revenues	942	902	828	758	790	789	774	728	728
Netvision service revenues	258	276	260	254	246	251	229	223	220
Cellcom equipment revenues	297	285	310	256	213	205	208	188	221
Netvision equipment revenues	19	15	31	17	13	6	24	15	14
Consolidation adjustments	(18)	(30)	(22)	(27)	(26)	(27)	(26)	(24)	(25
Total revenues	1,498	1,448	1,407	1,258	1,236	1,224	1,209	1,130	1,158
Cellcom EBITDA	399	355	306	251	271	286	258	265	224
Netvision EBITDA	75	75	68	63	68	61	77	75	90
Total EBITDA	474	430	374	314	339	347	335	340	314
Operating profit	282	239	189	139	169	173	170	185	156
Financing expenses, net	117	64	42	46	78	92	30	27	64
Profit for the period	121	124	113	67	67	52	102	114	79
Free cash flow	284	414	288	168	345	389	308	366	361
Cellular subscribers at the end of	3,333	3,338	*3,199	3,166	3,151	3,156	**3,092	3,049	3,029

period (in 000's)									
Monthly cellular ARPU (in NIS)	90.3	86.7	82.4	75.9	79.7	79.6	78.7	74.7	75.4
Churn rate for cellular subscribers (%)	8.1 %	8.6 %	8.7 %	9.4 %	9.0 %	8.9 %	9.9 %	11.1 %	11.1

* After a removal of approximately 138,000 data applications subscribers (M2M) from the Company's cellular subscriber base following a change to the subscribers counting mechanism.

** After a removal of approximately 64,000 pre-paid subscribers from the Company's cellular subscriber base following a change to the subscribers counting mechanism.

Cellcom Israel Ltd.

Disclosure for debenture holders as of June 30, 2014

Aggregation of the information regarding the debenture series issued by the company (1), in million NIS

Series	Original Issuance Date	Principal on the Date of Issuance	As of 30.06.2014					As of 10.08.2014		Interes Rate (fixed)
			Principal Balance on Trade	Linked Principal Balance	Interest Accumulated in Books	Debenture Balance Value in Books(2)	Market Value	Principal Balance on Trade	Linked Principal Balance	
B(4) **	22/12/05 02/01/06* 05/01/06* 10/01/06* 31/05/06*	925.102	555.061	668.025	17.072	685.097	730.350	555.061	669.990	5.30%
D(7) **	07/10/07 03/02/08* 06/04/09* 30/03/11* 18/08/11*	2,423.075	1,938.460	2,276.233	117.813	2,394.046	1,863.684	1,453.845	1,712.196	5.19%
E **	06/04/09 30/03/11* 18/08/11*	1,798.962	899.481	899.481	27.108	926.589	986.012	899.481	899.481	6.25%
F(4)(5)(6)**	20/03/12	714.802	714.802	737.511	16.359	753.870	839.749	714.802	739.680	4.60%

G(4)(5)(6)	20/03/12	285.198	285.198	285.198	9.612	294.810	327.037	285.198	285.198	6.99%
H(4)(5) ***	08/07/14	105,962						105.962	106.274	1.98%
I(4)(5) ***	08/07/14	222,667						222.667	222.667	4.14%
Total		6,475.768	4,393.002	4,866.448	187.964	5,054.412	4,746.832	4,237.016	4,635.486	

Comments:
(1) In the reporting period, the company fulfilled all terms of the debentures. The company also fulfilled all terms of the Indentures. Debentures F and G financial covenants (also included in the indentures of series H and I debentures issued in July 2014) - as of June 30, 2014 the net leverage (net debt to EBITDA excluding one-time events ratio- see definition in the Company's annual report for the year ended December 31, 2013 on Form 20-F, under "Item 5. Operating and Financial Review and Prospects – B. Liquidity and Capital Resources – Debt Service ") was 2.42 (the net leverage without excluding one-time events was 2.45). In the reporting period, no cause for early repayment occurred. (2) Including interest accumulated in the books and excluding net balance of premium on debentures and deferred issuance expenses. (3) Annual payments, excluding series F, G, H and I debentures in which the payments are semi-annual. (4) Regarding Debenture series B, F G, H and I - the company undertook not to create any pledge on its assets, as long as debentures are not fully repaid, subject to certain exclusions. (5) Regarding Debenture series F and G - the company has the right for early redemption under certain terms (see the Company's annual report for the year ended December 31, 2013 on Form 20-F, under "Item 5. Operating and Financial Review and Prospects– B. Liquidity and Capital Resources – Debt Service"). Such provision was also included in the indentures of series H and I debentures issued in July 2014. (6) Regarding Debenture series F and G - in June 2013, following a second decrease of the Company's debenture rating since their issuance, the annual interest rate has been increased by 0.25% to 4.60% and 6.99%, respectively, beginning July 5, 2013. (7) On July 1, 2014, after the end of the reporting period, the Company repaid a principal payment of approximately NIS 569 million (the ex-date of which was June 19, 2014).

(*) On these dates additional debentures of the series were issued. The information in the table refers to the full series.
(**) Series B, D, E and F are material, which represent 5% or more of the total liabilities of the Company, as presented in the financial statements.
(***) Series H and I were issued after the end of the reporting period.

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Cellcom Israel Ltd.

Disclosure for debenture holders as of June 30, 2014 (cont.)

Debentures rating details*

Series	Rating Company	Rating as of 30.06.2014 (1)	Rating as of 10.08.2014	Rating assigned upon issuance of the Series	Recent date of rating as of 10.08.2014	Additional ratings between original issuance and the recent date of rating as of 10.08.2014 (2)	
							Rating
B	S&P Maalot	A+	A+	AA-	06/2014	5/2006, 9/2007, 1/2008, 10/2008, 3/2009, 9/2010, 8/2011, 1/2012, 3/2012, 5/2012, 11/2012, 6/2013, 6/2014	AA-,AA,AA-,A+ (2)
D	S&P Maalot	A+	A+	AA-	06/2014	1/2008, 10/2008, 3/2009, 9/2010, 8/2011, 1/2012, 3/2012, 5/2012, 11/2012, 6/2013, 6/2014	AA-, AA,AA-,A+ (2)
E	S&P Maalot	A+	A+	AA	06/2014	9/2010, 8/2011, 1/2012, 3/2012, 5/2012, 11/2012, 6/2013, 6/2014	AA,AA-,A+ (2)
F	S&P Maalot	A+	A+	AA	06/2014	5/2012, 11/2012, 6/2013, 6/2014	AA,AA-,A+ (2)
G	S&P Maalot	A+	A+	AA	06/2014	5/2012, 11/2012, 6/2013, 6/2014	AA,AA-,A+ (2)
H (3)	S&P Maalot		A+	A+	06/2014	6/2014	
I (3)	S&P Maalot		A+	A+	06/2014	6/2014	

(1) In June 2013, S&P Maalot updated the Company's rating from an "ilAA-/negative" to an “ilA+/stable”.

(2) In September 2007, S&P Maalot issued a notice that the AA- rating for debentures issued by the Company was in the process of recheck with positive implications (Credit Watch Positive). In October 2008, S&P Maalot issued a

notice that the AA- rating for debentures issued by the Company is in the process of recheck with stable implications (Credit Watch Stable). This process was withdrawn upon assignment of AA rating in March 2009. In August 2011, S&P Maalot issued a notice that the AA rating for debentures issued by the Company is in the process of recheck with negative implications (Credit Watch Negative). In May 2012, S&P Maalot updated the Company's rating from an "ilAA/negative" to an “ilAA-/negative”. In November 2012, S&P Maalot affirmed the Company's rating of “ilAA-/negative”. In June 2013, S&P Maalot updated the Company's rating from an "ilAA-/negative" to an “ilA+/stable”. For details regarding the rating of the debentures see the S&P Maalot report dated June 20, 2013. In June 2014, S&P Maalot Issued a notice of "ilA+" ranking for new series H and I debentures issued in July 2014.

(3) Series H and I were issued after the end of the reporting period.

* A securities rating is not a recommendation to buy, sell or hold securities. Ratings may be subject to suspension, revision or withdrawal at any time, and each rating should be evaluated independently of any other rating.

Cellcom Israel Ltd.

Summary of Financial Undertakings (according to repayment dates) as of June 30, 2014

a. Debentures issued to the public by the Company and held by the public, excluding such debentures held by the Company's parent company, by a controlling shareholder, by companies controlled by them, or by companies controlled by the Company, based on the Company's "solo" financial data (in thousand NIS).

	Principal payments					Gross interest payments (without deduction of tax)
	ILS linked to CPI	ILS not linked to CPI	Euro	Dollar	Other	
First year	749,854	298,019	-	-	-	253,818
Second year	749,854	298,019	-	-	-	196,041
Third year	820,966	354,771	-	-	-	138,265
Fourth year	751,733	141,880	-	-	-	73,251
Fifth year and on	426,670	85,128	-	-	-	35,391
Total	3,499,077	1,177,817	-	-	-	696,766

b. Private debentures and other non-bank credit, excluding such debentures held by the Company's parent company, by a controlling shareholder, by companies controlled by them, or by companies controlled by the Company, based on the Company's "solo" financial data (in thousand NIS) – None

c. Credit from banks in Israel based on the Company's "solo" financial data (in thousand NIS) - None

d. Credit from banks abroad based on the Company's "solo" financial data (in thousand NIS) - None

e. Total of sections a - d above, total credit from banks, non-bank credit and debentures based on the Company's "solo" financial data (in thousand NIS).

	Principal payments					Gross interest payments (without deduction of tax)
	ILS linked to CPI	ILS not linked to CPI	Euro	Dollar	Other	
First year	749,854	298,019	-	-	-	253,818
Second year	749,854	298,019	-	-	-	196,041
Third year	820,966	354,771	-	-	-	138,265
Fourth year	751,733	141,880	-	-	-	73,251
Fifth year and on	426,670	85,128	-	-	-	35,391
Total	3,499,077	1,177,817	-	-	-	696,766

f. Out of the balance sheet Credit exposure based on the Company's "solo" financial data - None

g. Out of the balance sheet Credit exposure of all the Company's consolidated companies, excluding companies that are reporting corporations and excluding the Company's data presented in section f above (in thousand NIS) - None

h. Total balances of the credit from banks, non-bank credit and debentures of all the consolidated companies, excluding companies that are reporting corporations and excluding Company's data presented in sections a - d above (in thousand NIS).

Cellcom Israel Ltd.

Summary of Financial Undertakings (according to repayment dates) as of June 30, 2014 (cont.)

	Principal payments					Gross interest payments (without deduction of tax)
	ILS linked to CPI	ILS not linked to CPI	Euro	Dollar	Other	
First year	-	1,100	-	-	-	49
Second year	-	-	-	-	-	-
Third year	-	-	-	-	-	-
Fourth year	-	-	-	-	-	-
Fifth year and on	-	-	-	-	-	-
Total	-	1,100	-	-	-	49

i. Total balances of credit granted to the Company by the parent company or a controlling shareholder and balances of debentures offered by the Company held by the parent company or the controlling shareholder (in thousand NIS) - None

j. Total balances of credit granted to the Company by companies held by the parent company or the controlling shareholder, which are not controlled by the Company, and balances of debentures offered by the Company held by companies held by the parent company or the controlling shareholder, which are not controlled by the Company (in thousand NIS).

	Principal payments					Gross interest payments (without deduction of tax)
	ILS linked to CPI	ILS not linked to CPI	Euro	Dollar	Other	
First year	41,879	1,808	-	-	-	9,803
Second year	41,879	1,808	-	-	-	7,504
Third year	44,518	2,096	-	-	-	5,205
Fourth year	38,578	719	-	-	-	2,764
Fifth year and on	15,837	432	-	-	-	1,123
Total	182,691	6,863	-	-	-	26,399

k. Total balances of credit granted to the Company by consolidated companies and balances of debentures offered by the Company held by the consolidated companies (in thousand NIS) - None

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Item 2

Cellcom Israel Ltd.
and Subsidiaries

Condensed Consolidated
Interim Financial Statements
As at June 30, 2014
(Unaudited)

Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Financial Statements as at June 30, 2014

Contents	Page

Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Financial position

	June 30, 2013	June 30, 2014	Convenience translation into US dollar (Note 2D) June 30, 2014	December 31, 2013
	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Audited)
Assets				
Cash and cash equivalents	1,185	1,083	315	1,057
Current investments, including derivatives	500	520	151	513
Trade receivables	1,837	1,541	448	1,731
Other receivables	96	132	38	63
Inventory	100	88	26	84
Total current assets	3,718	3,364	978	3,448
Trade and other receivables	999	784	228	854
Property, plant and equipment, net	1,969	1,796	522	1,865
Intangible assets, net	1,452	1,339	390	1,390
Deferred tax assets	28	22	7	22
Total non- current assets	4,448	3,941	1,147	4,131
Total assets	8,166	7,305	2,125	7,579
Liabilities				
Current maturities of debentures and long term loans and short term credit	1,091	1,093	318	1,100
Trade payables and accrued expenses	657	630	183	582
Current tax liabilities	75	86	25	99
Provisions	177	170	50	187
Other payables, including derivatives	466	420	122	398
Total current liabilities	2,466	2,399	698	2,366
Long-term loans from banks	10	-	-	5
Debentures	4,865	3,791	1,103	4,332
Provisions	20	21	6	21
Other long-term liabilities	13	15	4	10

Liability for employee rights upon retirement, net	16	12	4	13
Deferred tax liabilities	140	139	40	122
Total non- current liabilities	5,064	3,978	1,157	4,503
Total liabilities	7,530	6,377	1,855	6,869
Equity attributable to owners of the Company				
Share capital	1	1	-	1
Cash flow hedge reserve	(16)	(6)	(2)	(13)
Retained earnings	648	920	268	719
Non-controlling interest	3	13	4	3
Total equity	636	928	270	710
Total liabilities and equity	8,166	7,305	2,125	7,579

Date of approval of the condensed consolidated financial statements: August 10, 2014.

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

2

Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Income

	For the six months ended June 30, 2013	For the six months ended June 30, 2014	Convenience translation into US dollar (Note 2D) For the six months ended June 30, 2014	For the three months ended June 30, 2013	For the three months ended June 30, 2014	Convenience translation into US dollar (Note 2D) For the three months ended June 30, 2014	For the year ended December 31, 2013
	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Audited)
Revenues	2,494	2,288	665	1,236	1,158	337	4,927
Cost of revenues	(1,533)	(1,335)	(388)	(749)	(671)	(195)	(2,990)
Gross profit	961	953	277	487	487	142	1,937
Selling and marketing expenses	(356)	(334)	(97)	(175)	(170)	(50)	(717)
General and administrative expenses	(300)	(238)	(69)	(147)	(120)	(35)	(570)
Other income (expenses), net	3	(40)	(12)	4	(41)	(12)	1
Operating profit	308	341	99	169	156	45	651
Financing income	83	63	19	42	31	9	156
Financing expenses	(207)	(154)	(45)	(120)	(95)	(27)	(402)
Financing expenses, net	(124)	(91)	(26)	(78)	(64)	(18)	(246)
Profit before taxes on income	184	250	73	91	92	27	405
Taxes on income	(50)	(57)	(17)	(24)	(13)	(4)	(117)
Profit for the period	134	193	56	67	79	23	288
Attributable to:							
Owners of the Company	133	193	56	66	79	23	287
Non-controlling interests	1	-	-	1	-	-	1

Profit for the period	134	193	56	67	79	23	288
Earnings per share							
Basic earnings per share (in NIS)	1.34	1.94	0.56	0.67	0.79	0.23	2.89
Diluted earnings per share (in NIS)	1.33	1.91	0.56	0.66	0.78	0.23	2.86

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

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Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Comprehensive Income

	For the six months ended June 30, 2013	2014	Convenience translation into US dollar (Note 2D) For the six months ended June 30, 2014	For the three months ended June 30, 2013	2014	Convenience translation into US dollar (Note 2D) For the three months ended June 30, 2014	For the year ended December 31, 2013
	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Audited)
Profit for the period	134	193	56	67	79	23	288
Other comprehensive income items that after initial recognition in comprehensive income were or will be transferred to profit or loss							
Changes in fair value of cash flow hedges transferred to profit or loss	5	9	2	4	4	1	14
Changes in fair value of cash flow hedges	(10)	-	-	(2)	-	-	(16)
Tax on other comprehensive income items that were or will be transferred to profit or loss in subsequent periods	1	(2)	-	(1)	(1)	-	1
Total other comprehensive income (loss) for the period that after initial recognition in comprehensive income was or will be transferred to profit or loss, net of tax	(4)	7	2	1	3	1	(1)
Other comprehensive income items that will not be transferred to profit or loss							
Actuarial losses on defined benefit plan	-	-	-	-	-	-	(1)
	-	-	-	-	-	-	(1)

Total other comprehensive loss for the period that will not be transferred to profit or loss, net of tax							
Total other comprehensive income (loss) for the period, net of tax	(4)	7	2	1	3	1	(2)
Total comprehensive income for the period	130	200	58	68	82	24	286
Total comprehensive income attributable to:							
Owners of the Company	129	200	58	67	82	24	285
Non-controlling interests	1	-	-	1	-	-	1
Total comprehensive income for the period	130	200	58	68	82	24	286

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

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Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Changes in Equity

	Attributable to owners of the Company				Non-controlling interests	Total equity	Convenience translation into US dollar (Note 2D)
	Share capital	Capital reserve	Retained earnings	Total			
	NIS millions						US$ millions
For the six months ended June 30, 2014 (Unaudited)							
Balance as of January 1, 2014 (Audited)	1	(13)	719	707	3	710	206
Comprehensive income for the period							
Profit for the period	-	-	193	193	-	193	56
Other comprehensive income for the period, net of tax							
Net changes in fair value of cash flow hedges	-	7	-	7	-	7	2
Transactions with owners, recognized directly in equity							
Share based payments	-	-	2	2	-	2	1
Expiration of put option over non-controlling interests in a consolidated company	-	-	6	6	10	16	5
Balance as of June 30, 2014 (Unaudited)	1	(6)	920	915	13	928	270

	Attributable to owners of the Company				Non-controlling interests	Total equity	Convenience translation into US dollar (Note 2D)
	Share capital	Capital reserve	Retained earnings	Total			
	NIS millions						US$ millions

For the six months ended June 30, 2013 (Unaudited)							
Balance as of January 1, 2013 (Audited)	1	(12)	509	498	2	500	145
Comprehensive income for the period							
Profit for the period	-	-	133	133	1	134	39
Other comprehensive loss for the period, net of tax							
Net changes in fair value of cash flow hedges	-	(4)	-	(4)	-	(4)	(1)
Transactions with owners, recognized directly in equity							
Share based payments	-	-	6	6	-	6	2
Balance as of June 30, 2013 (Unaudited)	1	(16)	648	633	3	636	185

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

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Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Changes in Equity (cont'd)

	Attributable to owners of the Company				Non-controlling interests	Total equity	Convenience translation into US dollar (Note 2D)
	Share capital	Capital reserve	Retained earnings	Total			
			NIS millions				US$ millions
For the three months ended June 30, 2014 (Unaudited)							
Balance as of April 1, 2014 (Unaudited)	1	(9)	834	826	3	829	241
Comprehensive income for the period							
Profit for the period	-	-	79	79	-	79	23
Other comprehensive income for the period, net of tax							
Net changes in fair value of cash flow hedges	-	3	-	3	-	3	1
Transactions with owners, recognized directly in equity							
Share based payments	-	-	1	1	-	1	-
Expiration of put option over non-controlling interests in a consolidated company	-	-	6	6	10	16	5
Balance as of June 30, 2014 (Unaudited)	1	(6)	920	915	13	928	270

	Attributable to owners of the Company		Non-controlling interests	Total equity	Convenience translation into US dollar (Note 2D)
	Share capital	Total			

		Capital reserve	Retained earnings				
			NIS millions				US$ millions
For the three months ended June 30, 2013 (Unaudited)							
Balance as of April 1, 2013 (Unaudited)	1	(17)	579	563	2	565	164
Comprehensive income for the period							
Profit for the period	-	-	66	66	1	67	20
Other comprehensive income for the period, net of tax							
Net changes in fair value of cash flow hedges	-	1	-	1	-	1	-
Transactions with owners, recognized directly in equity							
Share based payments	-	-	3	3	-	3	1
Balance as of June 30, 2013 (Unaudited)	1	(16)	648	633	3	636	185

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Changes in Equity (cont'd)

	Attributable to owners of the Company				Non-controlling interests	Total equity	Convenience translation into US dollar (Note 2D)
	Share capital	Capital reserve	Retained earnings	Total			
	NIS millions						US$ millions
For the year ended December 31, 2013 (Audited)							
Balance as of January 1, 2013 (Audited)	1	(12)	509	498	2	500	145
Comprehensive income for the year							
Profit for the year	-	-	287	287	1	288	84
Other comprehensive loss for the year, net of tax							
Net changes in fair value of cash flow hedges	-	(1)	-	(1)	-	(1)	-
Actuarial losses on defined benefit plan	-	-	(1)	(1)	-	(1)	-
Transactions with owners, recognized directly in equity							
Share based payments	-	-	9	9	-	9	3
Dividend paid in cash	-	-	(85)	(85)	-	(85)	(25)
Balance as of December 31, 2013 (Audited)	1	(13)	719	707	3	710	207

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Cash Flows

	For the six months ended June 30, 2013	2014	Convenience translation into US dollar (Note 2D) For the six months ended June 30, 2014	For the three months ended June 30, 2013	2014	Convenience translation into US dollar (Note 2D) For the three months ended June 30, 2014	For the year ended December 31, 2013
	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Audited)
Cash flows from operating activities							
Profit for the period	134	193	56	67	79	23	288
Adjustments for:							
Depreciation and amortization	342	310	90	171	155	45	676
Share based payment	6	2	-	3	1	-	9
Loss on sale of property, plant and equipment	1	2	-	-	2	-	2
Income tax expense	50	57	17	24	13	4	117
Financing expenses, net	124	91	26	78	64	18	246
Other income	(3)	-	-	(3)	-	-	(3)
Changes in operating assets and liabilities:							
Change in inventory	11	(4)	(1)	18	(5)	(1)	27
Change in trade receivables (including long-term amounts)	274	295	86	124	123	36	576
Change in other receivables (including long-term amounts)	(48)	(83)	(24)	(28)	(14)	(4)	(34)
Changes in trade payables, accrued expenses and provisions	(103)	26	8	9	(19)	(6)	(185)
Change in other liabilities (including	(7)	66	19	4	68	20	(33)

long-term amounts)							
Payments for derivative hedging contracts, net	(6)	(6)	(1)	(5)	(1)	-	(17)
Income tax paid	(61)	(55)	(16)	(26)	(25)	(7)	(119)
Income tax received	6	-	-	6	-	-	6
Net cash from operating activities	720	894	260	442	441	128	1,556
Cash flows from investing activities							
Acquisition of property, plant, and equipment	(171)	(127)	(37)	(83)	(63)	(18)	(275)
Acquisition of intangible assets	(48)	(44)	(13)	(22)	(19)	(6)	(90)
Change in current investments, net	(10)	(14)	(4)	(6)	88	26	(16)
Payments for other derivative contracts, net	(5)	(2)	-	(2)	(1)	-	(10)
Proceeds from sale of property, plant and equipment	10	3	1	5	-	-	17
Interest received	19	17	5	8	5	1	29
Dividend received	1	-	-	1	-	-	1
Net cash from (used in) investing activities	(204)	(167)	(48)	(99)	10	3	(344)

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

Cellcom Israel Ltd. and Subsidiaries

Condensed Consolidated Interim Statements of Cash Flows (cont'd)

	For the six months ended June 30, 2013	2014	Convenience translation into US dollar (Note 2D) For the six months ended June 30, 2014	For the three months ended June 30, 2013	2014	Convenience translation into US dollar (Note 2D) For the three months ended June 30, 2014	For the year ended December 31, 2013
	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Unaudited)		US$ millions (Unaudited)	NIS millions (Audited)
Cash flows from financing activities							
Payments for derivative contracts, net	(4)	(14)	(4)	(4)	(13)	(4)	(8)
Repayment of long term loans from banks	-	(11)	(3)	-	-	-	(6)
Repayment of debentures	(561)	(523)	(152)	-	-	-	(1,124)
Dividend paid	-	(4)	(1)	-	-	-	(81)
Interest paid	(180)	(149)	(44)	-	-	-	(350)
Net cash used in financing activities	(745)	(701)	(204)	(4)	(13)	(4)	(1,569)
Changes in cash and cash equivalents	(229)	26	8	339	438	127	(357)
Cash and cash equivalents as at the beginning of the period	1,414	1,057	307	846	645	188	1,414
Cash and cash equivalents as at the end of the period	1,185	1,083	315	1,185	1,083	315	1,057

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

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Note 1 - Reporting Entity

Cellcom Israel Ltd. ("the Company") is a company incorporated and domiciled in Israel and its official address is 10 Hagavish Street, Netanya 4250708, Israel. The condensed consolidated interim financial statements of the Group as at June 30, 2014, comprise the Company and its subsidiaries (together referred to as the "Group"). The Group operates and maintains a cellular mobile telephone system in Israel and provides cellular and landline telecommunications services, internet connectivity services (ISP) and international calls services. The Company is a consolidated subsidiary of Discount Investment Corporation (the parent company "DIC").

In May 2014, the creditors' arrangement for IDB Holding Corporation Ltd. was completed and the control in IDB Development Corporation Ltd. (DIC's parent company) was transferred to two companies, one controlled by Mr. Eduardo Elsztain and one by Mr. Mordechay Ben-Moshe. As a result, the indirect control in the Company was transferred to such entities.

Note 2 - Basis of Preparation

A. Statement of compliance

These condensed consolidated interim financial statements have been prepared in accordance with IAS 34 Interim Financial Reporting and do not include all of the information required for full annual financial statements. They should be read in conjunction with the financial statements as at and for the year ended December 31, 2013 (hereinafter - “the annual financial statements”).

These condensed consolidated interim financial statements were authorized for issue by the Company’s Board of Directors on August 10, 2014.

B. Functional and presentation currency

These condensed consolidated financial statements are presented in New Israeli Shekels ("NIS"), which is the Group's functional currency, and are rounded to the nearest million. NIS is the currency that represents the primary economic environment in which the Group operates.

C. Basis of measurement

These condensed consolidated financial statements have been prepared on the basis of historical cost except for following assets and liabilities: current investments and derivative financial instruments that are measured at fair value through profit or loss, financial instruments that are measured at fair value through OCI, inventory that is measured at the lower of cost or net realizable value, deferred tax assets and liabilities, assets and liabilities in respect of employee benefits and provisions.

The value of non-monetary assets and equity items that were measured on the basis of historical cost were adjusted for changes in the general purchasing power of the Israeli currency - NIS, based upon changes in the Israeli Consumer Price Index (“CPI”) until December 31, 2003, as until that date the Israeli economy was considered hyperinflationary.

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Note 2 - Basis of Preparation (cont'd)

D. Convenience translation into U.S. dollars ("dollars" or "$")

For the convenience of the reader, the reported NIS figures as of June 30, 2014, and for the six and three month periods then ended, have been presented in dollars, translated at the representative rate of exchange as of June 30, 2014 (NIS 3.438 = US$ 1.00). The dollar amounts presented in these financial statements should not be construed as representing amounts that are receivable or payable in dollars or convertible into dollars, unless otherwise indicated.

E. Use of estimates and judgments

The preparation of the condensed consolidated interim financial statements in conformity with IFRSs requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

The preparation of accounting estimates used in the preparation of the Group's financial statements requires management to make assumptions regarding circumstances and events that involve considerable uncertainty. Management of the Group prepares the estimates on the basis of past experience, various facts, external circumstances and reasonable assumptions according to the pertinent circumstances of each estimate.

The estimates and underlying assumptions that were applied in the preparation of these interim financial statements are consistent with those applied in the preparation of the annual financial statements.

F. Exchange rates and known Consumer Price Indexes are as follows:

	Exchange rates of US$	Consumer Price Index (points)*
As of June 30, 2014	3.438	223.14
As of June 30, 2013	3.618	220.95
As of December 31, 2013	3.471	223.58
Increase (decrease) during the period:		
Six months ended June 30, 2014	(0.95%)	(0.20%)
Six months ended June 30, 2013	(3.08%)	0.71%
Three months ended June 30, 2014	(1.41%)	0.49%
Three months ended June 30, 2013	(0.82%)	0.70%
Year ended December 31, 2013	(7.02%)	1.91%

*According to 1993 base index.

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Note 3 - Significant Accounting Policies

Except as described below, the accounting policies of the Group in these condensed consolidated interim financial statements are the same as those applied in the annual financial statements.

Below is a description of the essence of the changes made in the accounting policies used in the condensed consolidated interim financial statement and their effect:

A.Application of a new amendment for the first time

As from January 1, 2014, the Group applies the new amendment detailed below:

Amendment to IAS 32, Financial Instruments: Presentation

The amendment to IAS 32 clarifies that an entity currently has a legally enforceable right to set-off amounts that were recognized, if that right is not contingent on a future event and it is enforceable both in the normal course of business and in the event of default, insolvency or bankruptcy of the entity and all its counterparties. The amendment to IAS 32 has been applied retrospectively. The application of the amendment had no material impact on the Company's consolidated financial statements.

B.New standards not yet adopted

1. IFRS 15, Revenue from Contracts with Customers

IFRS 15 replaces the current guidance regarding recognition of revenues and presents a new model for recognizing revenue from contracts with customers. IFRS 15 provides two approaches for recognizing revenue: at a point in time or over time. The model includes five steps for analyzing transactions so as to determine when to recognize revenue and at what amount. Furthermore, IFRS 15 provides new and more extensive disclosure requirements than those that exist under current guidance.

IFRS 15 is applicable for annual periods beginning on or after January 1, 2017 and earlier application is permitted. IFRS 15 includes various alternative transitional provisions, so that companies can choose between one of the following alternatives at initial application: full retrospective application, full retrospective application with practical expedients, or application as from the mandatory effective date, with an adjustment to the balance of retained earnings at that date in respect of transactions that are not yet complete.

The Group is examining the effects of IFRS 15 on the financial statements.

2.IFRS 9 (2014), Financial Instruments

A final version of the standard, which includes revised guidance on the classification and measurement of financial instruments, and a new model for measuring impairment of financial assets. This guidance has been added to the chapter dealing with general hedge accounting requirements issued in 2013.

Classification and measurement

In accordance with IFRS 9 (2014), there are three principal categories for measuring financial assets: amortized cost, fair value through profit and loss and fair value through other comprehensive income. The basis of classification for debt instruments is the entity's business model for managing financial assets and the contractual cash flow characteristics of the financial

Note 3 - Significant Accounting Policies (cont'd)

2.IFRS 9 (2014), Financial Instruments (cont'd)

asset. Investments in equity instruments will be measured at fair value through profit and loss (unless the entity elected at initial recognition to present fair value changes in other comprehensive income).
IFRS 9 (2014) requires that changes in fair value of financial liabilities designated at fair value through profit or loss that are attributable to changes in its credit risk, should usually be recognized in other comprehensive income.

Hedge accounting – general
Under IFRS 9 (2014), additional hedging strategies that are used for risk management will qualify for hedge accounting. IFRS 9 (2014) replaces the present 80%-125% test for determining hedge effectiveness, with the requirement that there be an economic relationship between the hedged item and the hedging instrument, with no quantitative threshold. In addition, IFRS 9 (2014) introduces new models that are alternatives to hedge accounting as regards credit exposures and certain contracts outside the scope of IFRS 9 (2014) and sets new principles for accounting for hedging instruments. In addition, IFRS 9 (2014) provides new disclosure requirements.

Impairment of financial assets
IFRS 9 (2014) presents a new 'expected credit loss' model for calculating impairment. For most assets, the new model presents a dual measurement approach for impairment: if the credit risk of a financial asset has not increased significantly since its initial recognition, an impairment provision will be recorded in the amount of the expected credit losses that result from default events that are possible within the twelve months after the reporting date.
If the credit risk has increased significantly, in most cases the impairment provision will increase and be recorded at the level of lifetime expected credit losses of the financial asset.

IFRS 9 (2014) is effective for annual periods beginning on or after January 1, 2018 with early adoption being permitted. It will be applied retrospectively with some exemptions.

The Group has not yet commenced examining the effects of adopting IFRS 9 (2014) on the financial statements.

Note 4 - Operating segments

The Group operates in two reportable segments, as described below, which are the Group's strategic business units. The strategic business unit's allocation of resources and evaluation of performance are managed separately. The operating segments were determined based on internal management reports reviewed by the Group's chief operating decision maker (CODM). The CODM does not examine assets or liabilities for those segments and therefore, they are not presented.

— Cellcom - the segment includes Cellcom Israel Ltd. and its subsidiaries, excluding Netvision Ltd. and its subsidiaries.

— Netvision - the segment includes Netvision Ltd. and its subsidiaries.

The accounting policies of the reportable segments are the same as described in the annual financial statements in Note 3, regarding significant accounting policies.

Information regarding the results of each reportable segment is included below based on the internal management reports that are reviewed by the CODM.

Note 4 - Operating segments (cont'd)

	Six-month period ended June 30, 2014 NIS millions (Unaudited)			
	Cellcom	Netvision	Reconciliation for consolidation	Consolidated
External revenues	1,841	447	-	2,288
Inter-segment revenues	24	25	(49)	-
EBITDA*	489	165	-	654
Reconciliation of reportable segment EBITDA to profit for the period				
Depreciation and amortization	(240)	(44)	(26)	(310)
Taxes on income	(41)	(23)	7	(57)
Financing income				63
Financing expenses				(154)
Other expenses				(1)
Share based payments				(2)
Profit for the period	119	100	(26)	193

	Six-month period ended June 30, 2013 NIS millions (Unaudited)			
	Cellcom	Netvision	Reconciliation for consolidation	Consolidated
External revenues	1,991	503	-	2,494
Inter-segment revenues	26	27	(53)	-
EBITDA*	522	131	-	653
Reconciliation of reportable segment EBITDA to profit for the period				
Depreciation and amortization	(252)	(52)	(38)	(342)
Taxes on income	(38)	(22)	10	(50)
Financing income				83
Financing expenses				(207)
Other income				3

Share based payments				(6)
Profit for the period	102	60	(28)	134

Cellcom Israel Ltd. and Subsidiaries

Notes to the Condensed Consolidated Interim Financial Statements

Note 4 - Operating segments (cont'd)

	Three-month period ended June 30, 2014 NIS millions (Unaudited)			
	Cellcom	Netvision	Reconciliation for consolidation	Consolidated
External revenues	937	221	-	1,158
Inter-segment revenues	12	13	(25)	-
EBITDA*	224	90	-	314
Reconciliation of reportable segment EBITDA to profit for the period				
Depreciation and amortization	(121)	(21)	(13)	(155)
Taxes on income	(6)	(11)	4	(13)
Financing income				31
Financing expenses				(95)
Other expenses				(2)
Share based payments				(1)
Profit for the period	31	56	(8)	79

	Three-month period ended June 30, 2013 NIS millions (Unaudited)			
	Cellcom	Netvision	Reconciliation for consolidation	Consolidated
External revenues	992	244	-	1,236
Inter-segment revenues	11	15	(26)	-
EBITDA*	271	68	-	339
Reconciliation of reportable segment EBITDA to profit for the period				
Depreciation and amortization	(126)	(26)	(19)	(171)
Taxes on income	(17)	(12)	5	(24)
Financing income				42
Financing expenses				(120)
Other income				4

Share based payments				(3)
Profit for the period	48	33	(14)	67

Note 4 - Operating segments (cont'd)

	Year ended December 31, 2013 NIS millions (Audited)			
	Cellcom	Netvision	Reconciliation for consolidation	Consolidated
External revenues	3,944	983	-	4,927
Inter-segment revenues	50	56	(106)	-
EBITDA*	1,066	269	-	1,335
Reconciliation of reportable segment EBITDA to profit for the year				
Depreciation and amortization	(504)	(96)	(76)	(676)
Taxes on income	(91)	(45)	19	(117)
Financing income				156
Financing expenses				(402)
Other income				1
Share based payments				(9)
Profit for the year	210	135	(57)	288

* EBITDA as reviewed by the Group's CODM, represents earnings before interest (financing expenses, net), taxes, other income (expenses) (except for a one-time expense in the amount of approximately NIS 39 million in respect of voluntary retirement plan for employees, which has been recorded in the second quarter of 2014. See also Note 7, regarding Other Expenses), depreciation and amortization and share based payments, as a measure of operating profit. EBITDA is not a financial measure under IFRS and may not be comparable to other similarly titled measures for other companies.

Note 5 - Debentures

In July 2014, after the end of the reporting period, the Company issued two new Series of debentures:

a. Series H debentures to the public in Israel in the aggregate principal amount of NIS 106 million in exchange for net consideration of NIS 105 million. The debentures are payable in seven annual installments: three equal payments of 12% of the principal on July 5 of each of the years 2018 through and including 2020, and four equal annual installments of 16% of the principal on July 5 of each of the years 2021 through and including 2024. The debentures bear annual interest of 1.98%. The interest is to be paid in 20 semi-annual installments on January 5 and on July 5, of each calendar year commencing January 5, 2015 through and including July 5, 2024. The debentures (principal amount and interest) are linked to the CPI which was published on June 15, 2014, for May 2014.

b. Series I debentures to the public in Israel in the aggregate principal amount of NIS 223 million in exchange for net consideration of NIS 221 million. The debentures are payable in eight annual installments: three equal payments of 10% of the principal on July 5 of each of the years 2018 through and including 2020, and five equal annual installments of 14% of the principal on July 5 of each of the years 2021 through and including 2025. The debentures bear annual interest of 4.14%. The interest is to be paid in 22 semi-annual installments on January 5 and on July 5 of each calendar year commencing January 5, 2015 through and including July 5, 2025. The debentures (principal amount and interest) are without any linkage.

The debentures were offered and sold pursuant to a supplemental shelf offering report which was published by the Company in July 2014 and were listed for trading on the Tel Aviv Stock Exchange. The offering was made pursuant to the Company's Israeli shelf prospectus which was published in June 2014.

The Indenture of the new Series of debentures, or the New Indenture, provides for additional undertakings the Company undertook in regard to such new series, in addition to those previously undertaken by the Company in its Series F and G indenture, or the Existing Indenture (as reported in Note 17 to the annual financial statements, regarding Debentures and Loans from Banks), including: (1) in addition to being an event of default in its existing indenture, meeting the financial covenants previously undertaken by the Company (a maximum net leverage ratio (Net Debt to EBITDA ratio) in excess of 5.0:1, or in excess of 4.5:1 for four consecutive quarters) would be a condition for dividend distribution; and (2) meeting such financial covenants would also be a condition for the issuance of additional debentures of each of the two new series.

The New Indenture contains substantially similar events of default to those found in the Existing Indenture, with the exception of certain new events of default that do not appear in the Existing Indenture as well as certain modifications to the events of default that are found in the Existing Indenture, including: (1) breach of the above limitation on dividend distributions; (2) the minimum amount required for triggering a cross default shall not apply to a cross default triggered by another series of debentures; (3) the existence of a real concern that the Company shall not meet its material undertakings towards the debenture holders; (4) the inclusion in the Company's financial statements during a period of two consecutive quarters of a note regarding the existence of significant doubt as to the Company's ability to continue as a going concern; and (5) breach of the Company's undertakings regarding the issuance of additional debentures.

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Note 6 - Financial Instruments

Fair value

(1)Financial instruments measured at fair value for disclosure purposes only

The book value of certain financial assets and liabilities, including cash and cash equivalents, trade and other receivables, current investments, including derivatives, short-term credit and loans, trade and other payables, including derivatives, long-term loans from banks and other long-term liabilities, are equal or approximate to their fair value.

The fair values of the remaining financial liabilities and their book values as presented in the consolidated statements of financial position are as follows:

	June 30, 2013		June 30, 2014		December 31, 2013	
	Book value	Fair value	Book value	Fair value *	Book value	Fair value
	NIS millions		NIS millions		NIS millions	
Debentures including current maturities and accrued interest	(6,179)	(6,632)	(5,071)	(5,461)	(5,631)	(6,098)

* The fair value as of June 30, 2014, includes principal and interest in a total sum of approximately NIS 714 million, paid in July 2014.

(2)Fair value hierarchy of financial instruments measured at fair value

The table below analyses financial instruments carried at fair value, using a valuation method in accordance with the fair value hierarchy level. The different levels have been defined as follows:

Level 1: quoted prices (unadjusted) in active markets for identical instruments.
Level 2: inputs other than quoted prices included within Level 1 that are observable, either directly or indirectly.
Level 3: inputs that are not based on observable market data (unobservable inputs).

	June 30, 2014			
	Level 1	Level 2	Level 3	Total
	NIS millions			
Financial assets at fair value through profit or loss				
Current investments in debt securities	518	-	-	518
Long-term receivables	-	49	-	49
Derivatives	-	2	-	2
Total assets	518	51	-	569
Financial liabilities at fair value				
Derivatives at fair value through profit or loss	-	(28)	-	(28)

Total liabilities	-	(28	)	-	(28	)

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Note 6 - Financial Instruments (cont'd)

(2)Fair value hierarchy of financial instruments measured at fair value (cont'd)

	June 30, 2013			
	Level 1	Level 2	Level 3	Total
	NIS millions			
Financial assets at fair value through profit or loss				
Current investments in debt securities	496	-	-	496
Long-term receivables	-	44	-	44
Derivatives	-	4	-	4
Total assets	496	48	-	544
Financial liabilities at fair value				
Derivatives at fair value through profit or loss	-	(28)	-	(28)
Forward foreign currency contracts used for hedging	-	(12)	-	(12)
Total liabilities	-	(40)	-	(40)

	December 31, 2013			
	Level 1	Level 2	Level 3	Total
	NIS millions			
Financial assets at fair value through profit or loss				
Current investments in debt securities	509	-	-	509
Long-term receivables	-	47	-	47
Derivatives	-	4	-	4
Total assets	509	51	-	560
Financial liabilities at fair value				
Derivatives at fair value through profit or loss	-	(24)	-	(24)
Forward foreign currency contracts used for hedging	-	(6)	-	(6)
Total liabilities	-	(30)	-	(30)

During the reporting period, there have been no transfers between Levels 1 and 2.

(3)Valuation methods to determine fair value

US$/NIS forward contracts - fair value is measured on the basis of the capitalization of the difference between the forward price in the contract and the current forward price for the residual period until redemption, using appropriate interest curves used for derivative pricing.

CPI/NIS forward contracts - fair value is measured on the basis of the capitalization of the difference between the transaction price and the future expected CPI, using appropriate NIS yield curve based on government and short-term bonds.

Note 7 - Other Expenses

In June 2014, the Company offered its employees a voluntary retirement plan, which included a one-time grant to each employee who chose to participate in this plan. The Company has recorded a one-time expense in the amount of approximately NIS 39 million, in the Statements of Income under "Other Expenses", in respect of the grants for the employees who decided to join the said plan.

Note 8 - Income Tax

Further to that mentioned in the annual financial statements in Note 27 regarding Income Tax with respect to Amendment 174 to the Income Tax Ordinance (New Version) – 1961 (hereinafter – “the Ordinance”), regarding the non-application of Israeli Accounting Standard No. 29 Adoption of International Financial Reporting Standards (IFRS) when determining the taxable income (hereinafter – “the Temporary Order”), on July 31, 2014, Amendment 202 to the Ordinance was issued, by which the Temporary Order was extended to the 2012 and 2013 tax years, effective retroactively as from January 1, 2012.

Note 9 - Commitments

(1) As reported in Note 29(4) to the annual financial statements, subsequent to the network sharing policy published by the Israeli Ministry of Communications or the MOC, in May 2014, the Company entered a new 4G network sharing agreement with Golan Telecom Ltd. or Golan, after concluding that the previous 4G network sharing agreement with Pelephone Communications Ltd., or Pelephone, and Golan does not meet the policy principles and therefore will not be approved by the MOC. In July 2014, the MOC published a tender for 1800MHz frequencies, for 4G technologies (such as LTE, LTE Advanced). The tender documents include a draft license amendment which sets certain specific requirements for the approval of such network sharing and coverage and quality requirements for the 4G network. The Company is in the process of adjusting and making changes to its network sharing agreements with Golan, in light of said requirements, including to the 4G network sharing agreement with Golan, among others, in order to increase Golan's economic stake in the shared network.

(2) In April 2014, the Company entered an agreement with Nokia Solutions and Networks Israel Ltd., of Nokia Solutions and Networks group, a worldwide leading network manufacturer, for the supply of its 4G network, which also supports LTE Advanced technology. The operation of the network as well as its LTE Advanced qualities is subject to the regulator's approvals and availability of spectrum. The agreement is a framework agreement and the total commitment amount depends on the amount of sites which will be supplied. As of the financial statements signing date, the aggregate commitments under the agreement amounts to approximately NIS 51 million.

Note 10 - Contingent Liabilities

In the ordinary course of business, the Group is involved in various lawsuits against it. The costs that may result from these lawsuits are only accrued for when it is more likely than not that a liability, resulting from past events, will be incurred and the amount of that liability can be quantified or estimated within a reasonable range. The amount of the provisions recorded is based on a case-by-case assessment of the risk level, while events that occur in the course of the litigation may require a reassessment of this risk. The Group’s assessment of risk is based both on the advice of its legal counsels and on the Group's estimate of the probable settlements amounts that are expected to be incurred, if such settlements will be agreed by both parties. The provision recorded in the condensed consolidated interim financial statements in respect of all lawsuits against the Group amounts to approximately NIS 62 million.

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Note 10 - Contingent Liabilities (cont'd)

Described hereunder are details regarding new purported class actions which have been added during the reporting period or updates on lawsuits which were included in the annual financial statements. The amounts presented below are calculated based on the claims amounts as of the date of their submission to the Group and refer to the sum estimated by the plaintiffs, if the lawsuit is certified as a class action.

Consumer claims

In the ordinary course of business, lawsuits have been filed against the Group by its customers. These are mostly requests for approval of class action lawsuits, particularly concerning allegations of illegal collection of funds, unlawful conduct or breach of license, or a breach of agreements with customers, causing monetary and non-monetary damage to them. During the reporting period, ten purported class actions for a total sum of approximately NIS 390 million (one of which was included in Note 30(1) to the annual financial statements), were filed against the Group. At this early stage it is not possible to assess the chances of success for nine of the purported class actions for a total sum of approximately NIS 373 million. In addition, three purported class actions, in which the amount claimed has not been specified, were filed against the Group, and another purported class action was filed against the Group and another defendant together, in which the amount claimed has not been specified (two of which were included in Note 30(1) to the annual financial statements). At this early stage it is not possible to assess the chances of success of two purported class actions. In addition, an appeal was filed challenging the dismissal of a purported class action against the Company for a total amount of at least hundreds of millions of NIS.

After the end of the reporting period, three purported class actions for a total sum of approximately NIS 55 million have been filed against the Group. In addition, a purported class action was filed against the Group and other defendants together for a total sum of approximately NIS 100 million. At this early stage it is not possible to assess their chances of success.

During the reporting period, ten purported class actions for a total sum of approximately NIS 577 million were dismissed (four of which were reported as dismissed in Note 30(1) to the annual financial statements). In addition, two purported class action against the Group, in which the plaintiffs have not specified the amount claimed (one of which was reported as dismissed in Note 30(1) to the annual financial statements), were dismissed.

During the reporting period (and as reported in Note 30(1) to the annual financial statements), the Supreme Court annulled the previously reported District Court judgment from December 2011 against the Company in a class action, and approved a settlement agreement according to which the Company shall repay the sum of approximately NIS 11 million plus interest and CPI linkage differences. An additional 12.5% of the sum will be paid to the plaintiffs and their attorneys. The class action was filed against the Company in March 2008, for an estimated sum of NIS 440 million and alleged that the Company breached the agreements with its subscribers by charging them for a call detail service that was previously provided free of charge, without obtaining their consent. The Company has recorded an appropriate provision in its financial statements.

Note 10 - Contingent Liabilities (cont'd)

Environmental claims

Described hereunder are outstanding purported class actions against the Group, in which the amount claimed in each one of them as of June 30, 2014, was above NIS 1 billion (which were included in note 30(2) to the annual financial statements).

In July 2014, after the end of the reporting period, the Court dismissed the motion to certify the class actions dated May 2010 and June 2011 (and heard together) with prejudice except in respect of three issues that were detailed in settlements of similar class action claims made against Pelephone Communications Ltd. and Partner Communications Ltd. and approved by the court, which the Company was willing to adopt as well. These three issues relate to the cellular operators undertaking to provide certain information regarding non-ionizing radiation, sell certain accessories at a discount and conduct certain tests to handsets at certain circumstances.

Other claims

During the reporting period, a claim against the Group and other defendants together was filed with regards to allegations of contributing copyright infringement of the plaintiff's rights, for a total sum of approximately NIS 10 million, in which the amount claimed from the Group has not been quantified.

Note 11 - An event during the reporting period

In June 2014, the Company's Board of Directors resolved that the Company would enter the field of television over the internet services (known as Over the Top TV, or OTT TV). In preparation for the Company's launch of its OTT TV solution, the Company has entered into agreements for the procurement of equipment and content and ancillary services. Entering a new and penetrated market will require substantial investment and additional operating expenses.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

		CELLCOM ISRAEL LTD.		
Date:	August 11, 2014	By:	/s/ Liat Menahemi Stadler	
			Name:	Liat Menahemi Stadler
			Title:	General Counsel