DIGITAL ALLY INC
Form 10-Q
November 14, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017.

or

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

For the transition period from __________ to __________.

Commission File Number: 001-33899

Digital Ally, Inc.

(Exact name of registrant as specified in its charter)

Nevada	**20-0064269**

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

9705 Loiret Blvd, Lenexa, KS 66219

(Address of principal executive offices) (Zip Code)

(913) 814-7774

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

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

Yes [X] No [ ]

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

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

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

Yes [ ] No [X]

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

Class	Outstanding at November 1, 2017
Common Stock, $0.001 par value	6,979,731

FORM 10-Q

DIGITAL ALLY, INC.

SEPTEMBER 30, 2017

(Unaudited)

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PART I – FINANCIAL INFORMATION

Item 1 – Financial Statements.

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

SEPTEMBER 30, 2017 AND DECEMBER 31, 2016

	September 30, 2017 (Unaudited)	**December 31, 2016**
Assets		
Current assets:		
Cash and cash equivalents	$316,174	$3,883,124
Accounts receivable-trade, less allowance for doubtful accounts of $70,000 – 2017 and 2016	1,861,009	2,519,184
Accounts receivable-other	434,891	341,326
Inventories, net	10,061,991	9,586,311
Restricted cash	500,000	—
Prepaid expenses	451,787	402,158
Total current assets	13,625,852	16,732,103
Furniture, fixtures and equipment, net	778,095	873,902
Restricted cash	—	500,000
Intangible assets, net	511,141	467,176
Other assets	141,853	261,915
Total assets	$15,056,941	$18,835,096
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$2,732,336	$2,455,579
Accrued expenses	1,161,985	1,542,729
Derivative liabilities	15,729	33,076
Capital lease obligation-current	16,866	32,792
Deferred revenue-current	1,258,226	925,932
Subordinated notes payable, net of discount of $117,000-2017 and $0-2016	533,000	—
Secured convertible debentures, at fair value	3,183,210	—
Income taxes payable	10,143	7,048

Total current liabilities	8,911,495	4,997,156
Long-term liabilities:		
Secured convertible debentures, at fair value	—	4,000,000
Capital lease obligation-less current portion	—	8,492
Deferred revenue-long term	2,077,479	2,073,176
Total liabilities	10,988,974	11,078,824
Commitments and contingencies		
Stockholders’ Equity:		
Common stock, $0.001 par value; 25,000,000 shares authorized; shares issued: 7,065,249– 2017 and 5,552,449 – 2016	7,065	5,552
Additional paid in capital	63,728,254	59,565,288
Treasury stock, at cost (63,518 shares)	(2,157,226)	(2,157,226)
Accumulated deficit	(57,510,126)	(49,657,342)
Total stockholders’ equity	4,067,967	7,756,272
Total liabilities and stockholders’ equity	$15,056,941	$18,835,096

See Notes to Condensed Consolidated Financial Statements.

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DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND NINE MONTHS ENDED

SEPTEMBER 30, 2017 AND 2016

(Unaudited)

	Three months ended September 30, 2017	Three months ended September 30, 2016	Nine months ended September 30, 2017	Nine months ended September 30, 2016
Revenue:				
Product	$2,521,663	$3,836,691	$10,263,833	$11,946,100
Service and other	461,914	502,836	1,436,106	1,182,781
Total revenue	2,983,577	4,339,527	11,699,939	13,128,881
Cost of revenue:				
Product	1,709,046	2,235,489	6,450,570	7,487,747
Service and other	265,918	70,467	790,691	488,708
Total cost of revenue	1,974,964	2,305,956	7,241,261	7,976,455
Gross profit	1,008,613	2,033,571	4,458,678	5,152,426
Selling, general and administrative expenses:				
Research and development expense	831,573	731,077	2,495,924	2,353,081
Selling, advertising and promotional expense	1,048,334	1,369,244	3,036,168	3,295,743
Stock-based compensation expense	478,863	422,246	981,652	1,203,312
General and administrative expense	1,766,538	2,752,645	5,356,439	6,772,483
Total selling, general and administrative expenses	4,125,308	5,275,212	11,870,183	13,624,619
Operating loss	(3,116,695)	(3,241,641)	(7,411,505)	(8,472,193)
Interest income	1,761	5,913	10,619	22,103
Interest expense	(375,048)	(776)	(536,035)	(2,438)
Change in warrant derivative liabilities	3,628	(19,075)	17,347	18,740
Change in fair value of secured convertible notes payable	(6,952)	—	66,790	—
Loss before income tax expense	(3,493,306)	(3,255,579)	(7,852,784)	(8,433,788)
Income tax (expense) benefit	—	—	—	—
Net loss	$(3,493,306)	$(3,255,579)	$(7,852,784)	$(8,433,788)
Net loss per share information:				
Basic	$(0.56)	$(0.61)	$(1.34)	$(1.59)
Diluted	$(0.56)	$(0.61)	$(1.34)	$(1.59)

Weighted average shares outstanding:

Basic	6,249,116	5,380,855	5,851,428	5,315,646
Diluted	6,249,116	5,380,855	5,851,428	5,315,646

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2017
(Unaudited)

	Common Stock		**Additional Paid In**	**Treasury**	**Accumulated**	
	Shares	Amount	Capital	stock	deficit	Total
Balance, December 31, 2016	5,552,449	$ 5,552	$ 59,565,288	$ (2,157,226)	$ (49,657,342)	$ 7,756,272
Stock-based compensation	—	—	981,652	—	—	981,652
Restricted common stock grant	522,000	522	(522)	—	—	—
Restricted common stock forfeitures	(9,200)	(9)	9	—	—	—
Issuance of common stock purchase warrants related to issuance of subordinated notes payable	—	—	405,895	—	—	405,895
Issuance of common stock and warrants, net of issuance costs of $223,068	940,000	940	2,775,392	—	—	2,776,332
Issuance of common stock upon exercise of common stock purchase warrants	60,000	60	540	—	—	600
Net loss	—	—	—	—	(7,852,784)	(7,852,784)
Balance, September 30, 2017	7,065,249	$ 7,065	$ 63,728,254	$ (2,157,226)	$ (57,510,126)	$ 4,067,967

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ALLY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2017 AND 2016
(Unaudited)

	2017	2016
Cash Flows From Operating Activities:		
Net loss	$(7,852,784)	$(8,433,788)
Adjustments to reconcile net loss to net cash flows used in operating activities:		
Depreciation and amortization	507,358	430,537
Stock-based compensation	981,652	1,203,312
Change in derivative liabilities	(17,347)	(18,740)
Change in fair value of secured convertible debentures	(66,790)	—
Provision for inventory obsolescence	417,732	253,048
Amortization of discount on subordinated note payable	288,895	—
Provision for doubtful accounts receivable	—	(4,997)
Change in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable - trade	658,175	856,388
Accounts receivable - other	(93,565)	(147,047)
Inventories	(893,412)	(3,558)
Prepaid expenses	(49,629)	(47,746)
Other assets	120,062	24,527
Increase (decrease) in:		
Accounts payable	276,757	403,607
Accrued expenses	(380,744)	311,666
Income taxes payable	3,095	(3,091)
Deferred revenue	336,597	449,271
Net cash used in operating activities	(5,763,948)	(4,726,611)
Cash Flows from Investing Activities:		
Purchases of furniture, fixtures and equipment	(316,751)	(284,644)
Additions to intangible assets	(138,765)	(89,263)
Net cash used in investing activities	(455,516)	(373,907)
Cash Flows from Financing Activities:		
Proceeds from issuance of subordinated notes payable	1,000,000	—
Proceeds from issuance of common stock and warrants, net of issuance costs	2,776,332	—
Principal payment on secured convertible debentures	(750,000)	—
Principal payment on subordinated notes payable	(350,000)	—
Proceeds from exercise of stock options and warrants	600	19,055
Principal payments on capital lease obligation	(24,418)	(26,917)

Net cash provided by (used in) financing activities	2,652,514	(7,862)
Net decrease in cash and cash equivalents	(3,566,950)	(5,108,380)
Cash and cash equivalents, beginning of period	3,883,124	6,924,079
Cash and cash equivalents, end of period	$316,174	$1,815,699
Supplemental disclosures of cash flow information:		
Cash payments for interest	$166,138	$2,425
Cash payments for income taxes	$6,906	$10,591
Supplemental disclosures of non-cash investing and financing activities:		
Restricted common stock grant	$522	$200
Restricted common stock forfeitures	$9	$—

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ALLY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

Nature of Business:

Digital Ally, Inc. and subsidiaries (collectively, “Digital Ally,” “Digital,” the “Company,” “we,” “ours” and “us”) produces dig video imaging and storage products for use in law enforcement, security and commercial applications. Its 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 its 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 miniature digital video system designed to be worn on an individual’s body; a weather-resistant mobile digital video recording system for use on motorcycles, ATV’s and boats; a hand-held laser speed detection device that it is offering primarily to law enforcement agencies; and cloud storage solutions. The Company has active research and development programs to adapt its technologies to other applications. It can integrate electronic, radio, computer, mechanical, and multi-media technologies to create unique solutions to address needs in a variety of other industries and markets, including mass transit, school bus, taxi cab and the military. The Company sells its products to law enforcement agencies and other security organizations and consumer and commercial fleet operators through direct sales domestically and third-party distributors internationally.

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

Management’s Liquidity Plan

The Company incurred substantial operating losses in the nine months ended September 30, 2017 and recent years primarily due to reduced revenues and gross margins caused by specific product quality issues resulting in the significant delays in customer orders and product rework expenditures. In addition, the Company accessed the public and private capital markets to raise debt and equity of approximately $300,000 on September 29, 2017, $3.0 million on August 23, 2017, $700,000 on June 30, 2017, $4.0 million in December 2016 and $11.0 million in 2015 to fund its operations until it achieves positive cash flows from operations. As of September 30, 2017, the Company had an accumulated deficit of $57.5 million and has financed its recent operations primarily through debt and equity financings. During the nine months ended September 30, 2017 and year ended December 31, 2016, the Company incurred net losses of approximately $7.85 and $12.7 million, respectively, and used cash in operating activities of $5.8 million and $5.9 million, respectively. The $300,000 principal amount of subordinated notes payable (the “Notes”) matures on November 30, 2017 and the remaining $350,000 principal amount matures on December 31, 2017. Additionally, the $4.0 million principal amount of 8% Secured Convertible Debentures (the “Debentures”) matures in March 2018 unless the Debentures are converted by their holders ($5.00 per share conversion rate) before maturity. The Notes and Debentures represent current liabilities as of September 30, 2017 and will require the Company to raise substantial funds to liquidate if operating results do not improve before the maturity dates of such Notes and Debentures. These conditions indicate that there is substantial doubt about the Company’s ability to continue as a going concern within one year after the date that the financial statements are issued.

The Company will need to restore positive operating cash flows and profitability over the next twelve months and/or raise additional capital to fund operations, accommodate the potential liquidity needs to retire the Debentures at their maturity, meet its payment obligations and execute its business plan. There can be no assurance that it will be successful in restoring positive cash flows and profitability, or that it can raise additional financing if and when needed, and obtain it on terms acceptable or favorable to the Company.

Management has implemented a quality control function that is tasked with the detection and correction of product issues before they result in significant rework expenditures affecting the Company’s gross margins. In addition, the Company has undertaken cost reduction initiatives, including restructuring its direct sales force and reducing other selling, general and administrative costs. The Company has introduced a new full high definition in-car video system (DVM-800 HD), which is intended to help it regain market share and improve revenues in its law enforcement division. The Company has increased its addressable market to non-law enforcement customers and obtained significant new non-law enforcement contracts in 2017, which contracts include recurring revenue over the 2017 to 2019 period. Management believes that its quality control and cost cutting initiatives, introduction of the DVM-800 HD for law enforcement and expansion to non-law enforcement sales channels will restore positive operating cash flows and profitability during the next year, although it can offer no assurances in this regard. The Company’s plan also includes raising additional capital if required. The Company has demonstrated its ability to raise new debt or equity capital in recent years and believes that it could raise additional capital during the next 12 months if required, but again can offer no assurances in this regard. Based on the uncertainties described above, the Company believes its business plan does not alleviate the existence of substantial doubt about its ability to continue as a going concern within one year after the date that the financial statements in this Report.

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

Basis of Consolidation:

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

The Company formed Digital Ally International, Inc. during August 2009 to facilitate the export sales of its products. In addition, Medical Devices Ally, LLC was formed in July 2014, MP Ally, LLC was formed in July 2015, and Digitaldeck, LLC was formed in June 2017, all of which have been inactive since formation.

Fair Value of Financial Instruments:

The carrying amounts of financial instruments, including cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term nature of these items. The Company accounts for its derivative liabilities and its secured convertible debentures on a fair value basis.

Revenue Recognition:

Revenues from the sale of products are recorded when the product is shipped, title and risk of loss has transferred to the purchaser, payment terms are fixed or determinable and payment is reasonably assured. Customers do not have a right to return the product other than for warranty reasons for which they would only receive repair services or replacement product.

The Company sells its products and services to law enforcement and commercial customers in the following manner:

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

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

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

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

Service and other revenue is comprised of revenues from extended warranties, repair services, cloud revenue and software revenue. Revenue is recognized upon shipment of the product and acceptance of the service or materials by the end customer for repair services. Revenue for extended warranty, cloud service or other software-based are treated as deferred revenue and recognized over the term of the contracted warranty or service period on a straight-line method.

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

Multiple element arrangements consisting of product, software, cloud and extended warranties are offered to our customers. Revenue arrangements with multiple deliverables are divided into separate units and revenue is allocated using the relative selling price method based upon vendor-specific objective evidence of selling price or third-party evidence of the selling prices if vendor-specific objective evidence of selling prices does not exist. If neither vendor-specific objective evidence nor third-party evidence exists, management uses its best estimate of selling price. The majority of the Company's allocations of arrangement consideration under multiple element arrangements are performed using vendor-specific objective evidence by utilizing prices charged to customers for deliverables when sold separately. The Company's multiple element arrangements may include future in-car or body-worn camera devices to be delivered at defined points within a multi-year contract, and in those arrangements, the Company allocates total arrangement consideration over the life of the multi-year contract to future deliverables using management's best estimate of selling price. The Company has not utilized third-party evidence of selling price.

Sales returns and allowances aggregated $12,390 and $61,673 for the three months ended September 30, 2017 and 2016, respectively, and $(15,195) and $263,663 for the nine months ended September 30, 2017 and 2016, respectively. Obligations for estimated sales returns and allowances are recognized at the time of sales on an accrual basis. The accrual is determined based upon historical return rates adjusted for known changes in key variables affecting these return rates. A customer paid under a sales transaction in March 2017 that had been accrued to be returned at December 31, 2016, which the caused the negative sales returns for the nine months ended September 30, 2017.

Use of Estimates:

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents:

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

Cash and cash equivalents that are restricted as to withdrawal or use under the terms of the secured convertible debentures are presented as restricted cash separate from cash and cash equivalents on the accompanying balance sheet.

Accounts Receivable:

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