GRAINGER DAVID W
Form 4
December 08, 2005

FORM 4

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

OMB APPROVAL

OMB Number:	3235-0287
Expires:	January 31, 2005
Estimated average burden hours per response...	0.5

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
GRAINGER DAVID W

(Last) (First) (Middle)

100 GRAINGER PARKWAY

(Street)

LAKE FOREST, IL 60045-5201

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
GRAINGER W W INC [GWW]

3. Date of Earliest Transaction (Month/Day/Year)
12/07/2005

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	12/07/2005		S		4,800	D	$ 70	6,912,755	D	
Common Stock	12/07/2005		S		1,200	D	$ 70.01	6,911,555	D	
Common Stock	12/07/2005		S		800	D	$ 70.02	6,910,755	D	
Common Stock	12/07/2005		S		700	D	$ 70.03	6,910,055	D	
Common Stock	12/07/2005		S		1,100	D	$ 70.04	6,908,955	D	
	12/07/2005		S		900	D		6,908,055	D	

Common Stock					$ 70.05		
Common Stock	12/07/2005	S	500	D	$ 70.06	6,907,555	D
Common Stock	12/07/2005	S	1,100	D	$ 70.07	6,906,455	D
Common Stock	12/07/2005	S	1,100	D	$ 70.08	6,905,355	D
Common Stock	12/07/2005	S	2,100	D	$ 70.09	6,903,255	D
Common Stock	12/07/2005	S	500	D	$ 70.1	6,902,755	D
Common Stock	12/07/2005	S	600	D	$ 70.11	6,902,155	D
Common Stock	12/07/2005	S	200	D	$ 70.12	6,901,955	D
Common Stock	12/07/2005	S	500	D	$ 70.13	6,901,455	D
Common Stock	12/07/2005	S	100	D	$ 70.14	6,901,355	D
Common Stock	12/07/2005	S	100	D	$ 70.17	6,901,255	D
Common Stock	12/07/2005	S	100	D	$ 70.21	6,901,155	D
Common Stock	12/07/2005	S	400	D	$ 70.22	6,900,755	D
Common Stock	12/07/2005	S	300	D	$ 70.23	6,900,455	D
Common Stock	12/07/2005	S	200	D	$ 70.24	6,900,255	D
Common Stock	12/07/2005	S	2,100	D	$ 70.25	6,898,155	D
Common Stock	12/07/2005	S	700	D	$ 70.26	6,897,455	D
Common Stock	12/07/2005	S	200	D	$ 70.27	6,897,255	D
Common Stock	12/07/2005	S	200	D	$ 70.28	6,897,055	D
Common Stock	12/07/2005	S	600	D	$ 70.29	6,896,455	D
	12/07/2005	S	200	D	$ 70.3	6,896,255	D

Common Stock								
Common Stock	12/07/2005		S	100	D	$ 70.31	6,896,155	D
Common Stock	12/07/2005		S	300	D	$ 70.32	6,895,855	D
Common Stock	12/07/2005		S	300	D	$ 70.33	6,895,555	D
Common Stock	12/07/2005		S	500	D	$ 70.34	6,895,055	D

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
								Date Exercisable	Expiration Date	Title	Amount or Number of Shares		
				Code	V	(A)	(D)						

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
GRAINGER DAVID W 100 GRAINGER PARKWAY LAKE FOREST, IL 60045-5201	X			

Signatures

L. M. Trusdell, as attorney-in-fact	12/08/2005

**Signature of Reporting Person Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Remarks:
This Form 4 is the first of two Forms 4 to report all December 7, 2005 transactions for the reporting person.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. uct and developing our commercial fleet sales channel. The largest component of selling, promotional and advertising expense is commissions paid to our independent agents that represent our sales force in the domestic market. These agents generally receive a commission on sales ranging from 5.0% to 12% of the gross sales price to the end customer. Sales commissions totaled $567,795 and $532,580 for the three months ended September 30, 2011 and 2010, respectively, an increase of $35,215 (7%), which is the result of costs associated with the restructuring of our sales agents in our law enforcement sales channel and the salesman hired to launch the new DVM-250 product line. We have changed sales agents in four territories in our law enforcement sales channel and has hired five new salesmen focused on the DVM-250 sales launch, which represents our new commercial sales channel. Sales commissions as a percentage of overall sales increased to 9.8% during the three months ended September 30, 2011 compared to 7.6% for the three months ended September 30, 2010.

Promotional and advertising expenses totaled $87,472 during the three months ended September 30, 2011 compared to $136,636 during the three months ended September 30, 2010, a decrease of $49,164 (36%). The decrease is attributable to our cost containment and reduction initiative during 2011, which resulted in a reduction in our attendance at trade shows particularly at international venues. We expect increases in expenses for brochures and other marketing initiatives designed to help launch the DVM-250 event recorder and the DVM-100 during the balance of 2011.

Stock-based compensation expense. Stock based compensation expense totaled $192,221 and $387,674 for the three months ended September 30, 2011 and 2010, respectively, a decrease of $195,453 (50%). The decrease was primarily attributable to stock options issued in January 2011 to directors and officers with longer four-year vesting periods compared to the restricted stock grant to officers and directors in January 2010 with shorter one-year vesting periods. Therefore, the longer amortization period related to such stock option grants in January 2011 resulted in reduced stock-based compensation expense in the three months ended September 30, 2011 compared to 2010. We believe this trend will continue for the balance of 2011 and 2012 based on the projected amortization of currently outstanding stock options.

Professional fees and expense. Professional fees and expenses totaled $145,874and $343,261for the three months ended September 30, 2011 and 2010, respectively, a decrease of $197,387 (58%). Professional fees during 2011 were related primarily to normal public company matters, intellectual property matters and litigation matters. The decrease in professional fees and expenses is attributable to the settlement of certain litigation during the third quarter 2010 and less activity regarding existing litigation in the third quarter 2011.

Executive, sales and administrative staff payroll. Executive, sales and administrative staff payroll expenses totaled $698,612 and $939,717 for the three months ended September 30, 2011 and 2010, respectively, a decrease of $241,105 (26%). This decrease is attributable to the cost containment initiative that resulted in headcount reductions, including the elimination of the Vice President of Operations position during January 2011. The base salaries of our officers were reduced by at least 30% effective January 1, 2011, which contributed to the reduction in executive payroll costs. Management anticipates that the reduction in executive, sales and administrative payroll will continue during the balance of 2011 as the full benefit of the headcount reductions are in effect. However, such reductions

may be offset partially because we may find it necessary to hire additional technical support staff during the balance of 2011 to handle field inquiries, wireless download and installation matters as our installed customer base continues to increase and to handle inquiries related to our new products, such as the DVM-250 and DVM-100.

Other. Other selling, general and administrative expenses totaled $670,189 and $636,568 for the three months ended September 30, 2011 and 2010, respectively, an increase of $33,621 (5%). The slight increase in 2011 was attributable to substantial increases in our insurance expense; in particular medical insurance offset by our cost containment measures, which measures reduced the cost of information technology, telephone and internet services as we negotiated better contract rates or moved to new service providers. We expect reductions in property insurance and facility-related expenses during the balance of 2011 as we decreased the amount of leased space for our engineering and distribution departments effective July 1, 2011. We plan to continue our cost containment initiatives for the balance of 2011 and expect the improvement in our overhead costs will continue.

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Operating Loss

For the reasons previously stated, our operating loss was $92,440 and $592,001 for the three months ended September 30, 2011 and 2010, respectively, an improvement of $499,561 (84%). Operating loss as a percentage of revenues decreased to 2% in 2011 compared to 8% in 2010.

Interest Income

Interest income increased to $5,703 in the three months ended September 30, 2011 from $4,623 in 2010. The increase in interest income was a result of our increased average cash balances during the three months ended September 30, 2011 compared to 2010.

Interest Expense

We incurred interest expense of 76,181 and $4,583 during the three months ended September 30, 2011 and 2010, respectively. We began drawing on our line of credit during the third quarter 2010 to fund our operating losses and the repurchase of $469,761 of common stock during 2010. We issued a subordinated note payable in the principal amount of $1.5 million during the second quarter 2011, the proceeds of which were used to repay the outstanding line of credit. The subordinated note payable bears interest at 8% per annum and we are amortizing the discount over the term of the note. The outstanding balance on our subordinated note payable was $1.5 million as of September 30, 2011 less the unamortized discount of $84,274.

Loss before Income Tax Benefit

As a result of the above, we reported a loss before income tax benefit of $162,918 and $591,961 for the three months ended September 30, 2011 and 2010, respectively, an improvement of $429,043 (72%).

Income Tax Benefit

We recorded no income tax benefit related to our losses for the three months ended September 30, 2011 due to management's decision to continue providing a full valuation reserve on our net deferred tax assets as of September 30, 2011. Our income tax benefit was $153,000 for the three months ended September 30, 2010. During 2011, we increased our valuation reserve on deferred tax assets whereby our deferred tax assets continued to be fully reserved due to our recent operating losses.

We had approximately $5,370,000 of net operating loss carryforwards and $915,000 of research and development tax credit carryforwards as of September 30, 2011 available to offset future net taxable income.

Net Loss

As a result of the above, for the three months ended September 30, 2011 and 2010, we reported a net loss of $162,918 and $438,961, respectively, an improvement of $276,043 (63%).

Basic and Diluted Loss per Share

The basic and diluted loss per share was $0.01 and $0.03 for the three months ended September 30, 2011 and 2010, respectively, for the reasons previously noted. All outstanding stock options were considered antidilutive and therefore excluded from the calculation of diluted loss per share for the three months ended September 30, 2011 and 2010 because of the net loss reported for each period.

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For the Nine months ended September 30, 2011 and 2010

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 nine months ended September 30, 2011 and 2010, represented as a percentage of total revenues for each respective year:

	Nine months ended September 30,			
	2011		2010	
Revenue	100	%	100	%
Cost of revenue	55	%	50	%
Gross profit	45	%	50	%
Selling, general and administrative expenses:				
Research and development expense	14	%	14	%
Selling, advertising and promotional expense	11	%	11	%
Stock-based compensation expense	4	%	7	%
General and administrative expense	31	%	30	%
Total selling, general and administrative expenses	60	%	62	%
Operating loss	(15	%)	(12	%)
Interest income (expense)	(1	%)	—	%
Loss before income tax benefit	(16	%)	(12	%)
Income tax benefit	—	%	4	%
Net loss	(16	%)	(8	%)
Net loss per share information:				
Basic	$(0.15	)	$(0.09	)
Diluted	$(0.15	)	$(0.09	)

Revenues

We sold a total of 2,876 and 3,982 DVM units during the nine months ended September 30, 2011 and 2010, respectively. Our DVM-500 and DVM-500 Plus models on a combined basis represented approximately 73% and 78% of total unit sales during the nine months ended September 30, 2011 and 2010, respectively.

Revenues for the nine months ended September 30, 2011 and 2010 were $15,290,839 and $18,853,038, respectively, a decrease of $3,562,199 (19%), due to the following factors:

We experienced a decrease in revenues due to the challenging economy that negatively impacted state, county and municipal budgets. We believe that current and potential customers may have delayed or reduced the size of their orders due to a number of factors, including their local budget reductions and anticipation of receiving the federal government's stimulus funds in order to preserve their currently available funding and budgets. Our average order size decreased from approximately $5,800 in the nine months ended September 30, 2010 to $3,500 during the nine

months ended September 30, 2011. We shipped eleven orders in excess of $100,000 for a total of $3,305,000 in revenue in the nine months ended September 30, 2011 compared to seventeen orders individually in excess of $100,000 for total revenue of approximately $4,495,000 in the nine months ended September 30, 2010. We believe that this reflects reduced law enforcement budgets where the customers are covering only the minimum required needs rather than full fleet deployments. In addition, the new products we introduced in 2010 and 2011 (FirstVU, Laser Ally, Thermal Ally, DVM-250 and DVM-100) all have lower average selling prices than our digital video mirror lines. Repair orders at lower average invoice amounts have also increased as our installed base comes off of warranty. We are hopeful that the balance of 2011 will see an easing of such budgetary constraints and that a normal purchasing pattern will resume, although we can make no assurances in this regard.

Our international revenues increased to $1,786,641, representing 12% of total revenues during the nine months ended September 30, 2011 compared to $676,069, representing 4% of total revenues during the nine months ended September 30, 2010. Despite the improvement in international revenues, such revenues are substantially less than our expectations. Sales to certain countries that were strong revenue sources for us on an historic basis were negatively impacted by political and social unrest, economic recession and a weakening of their currency exchange rate versus the U.S. dollar. During the third quarter 2011 we shipped several significant orders to customers in Central America and the previously announced order to the Turkish Gendarmerie that contributed to the improvement in international revenues. We have experienced an increase in inquiries and bid activity from international customers in late 2011; however, international sale cycles generally take longer than domestic business. We also believe that our new products may appeal to international customers in particular the DVM-100 and DVM-250 which could generate additional international revenues for the balance of 2011 and 2012.

We maintained consistent retail pricing on our DVM-500 models during the first half of 2011 and do not plan any material changes in pricing during the balance of 2011 for the DVM-500 Plus product or the new products recently introduced. Our newer mirror-based products include the DVM-500 Ultra model and the DVM-750, which will be sold at higher retail pricing levels compared to the legacy products during 2011 due to increased features. We are, however, experiencing some price competition and discounting from our competitors as they attempt to regain market share. 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.

Cost of Revenue

Cost of revenue on units sold for the nine months ended September 30, 2011 and 2010 was $8,360,013 and $9,354,883, respectively, a decrease of $994,870 (11%). The decrease in costs of goods sold is primarily due to the 19% decrease in revenues during the nine months ended September 30, 2011 compared to 2010 offset by an increase in the cost of goods sold as a percent of revenues. Cost of sales as a percentage of revenues increased to 55% during the nine months ended September 30, 2011 compared to 50% for the nine months ended September 30, 2010. Our goal is to reduce cost of sales as a percentage of revenues to 40% during the balance of 2011 and beyond. The cost of WTMs substantially increased our cost of sales during 2011 as we upgraded many existing and new customers to a new WTM solution, which was substantially more costly than our previous solution. We were unable to pass the increased cost on to our customers for this WTM upgrade, which negatively impacted our cost of sales. Our manufacturing overhead rates also increased during 2011, primarily due to the slowing of production rates to allow for the reduction of overall inventory levels. Improving gross margins through reductions in conversion costs (engineering changes and rework) and manufacturing inefficiencies related to our base products, such as the DVM-750 and DVM-500 Plus, are main focuses of management and engineering at the current time. In addition, we continue to reorganize our production and manufacturing operations by placing a greater emphasis upon contract manufacturers, including those located offshore. Uncertainties regarding the size and timing of large international orders make it difficult for us to maintain efficient production and staffing levels if all orders are processed through our manufacturing facility. By outsourcing more of our production requirements to contract manufacturers, we believe that we can benefit from greater volume purchasing and production efficiencies, while at the same time reducing our fixed and semi-fixed overhead costs. We believe that the selected contract manufacturers will be able to ramp up production quickly in order to meet the varying demands of our international customers. We expect that our newer product offerings, in particular the DVM-100 and DVM-250, will likely improve our cost of goods sold as a percentage of sales during the balance of 2011. We do not expect to incur significant capital expenditures to ramp up production of the new products because our internal process is largely assembling subcomponents, testing and shipping of completed products or we use contract manufacturers. We rely on our subcontractors to produce finished circuit boards that represent the primary components in our products, thereby reducing our need to purchase capital equipment.

We had $747,240 and $733,578 in reserves for obsolete and excess inventories at September 30, 2011 and December 31, 2010, respectively. We had no remaining units of the legacy DVM-500 units in finished goods at September 30, 2011 and have discontinued it. Component parts specific to the DVM-500 remain in inventory at levels that are reasonably expected to be consumed for service and repair demands. Total raw materials and component parts were $2,369,509 and $4,272,304 at September 30, 2011 and December 31, 2010, respectively, a decrease of $1,902,795 (45%). The decrease in raw materials and component parts reflects our focus on the reduction of overall inventory levels in 2011 to improve our liquidity position. We believe that introduction of new parties to our supply chain will continue to help reduce cost of sales as a percent of revenues during the balance of 2011. Finished goods balances were $5,011,235 and $6,460,924 at September 30, 2011 and December 31, 2010, respectively. The decrease in finished goods was primarily in the DVM-500 Plus products because management focused on reducing overall inventory levels to improve our liquidity position. Finished goods at September 30, 2011 are primarily in the DVM-750, the DVM-500 Plus and Laser Ally, products which will be used to fulfill international and domestic orders

during the balance of 2011 and 2012. Finished goods also included supplies of our other new products including the FirstVU, Thermal Ally, DVM-250 and DVM-100 at September 30, 2011. We believe that our obsolescence risk was less at September 30, 2011 compared to December 31, 2010 because we have no remaining DVM-500 legacy systems in finished goods inventory, the reduction in raw material and component parts inventory balances and the overall increase in our reserve for obsolete inventory. We believe these reserves are appropriate given our inventory levels at September 30, 2011.

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Gross Profit

Gross profit for the nine months ended September 30, 2011 and 2010 was $6,930,826 and $9,498,155, respectively, a decrease of $2,567,329 (27%). The significant decrease is commensurate with the 19% decline in revenues and increase in cost of revenues as a percent of sales that we experienced during the nine months ended September 30, 2011 compared to 2010. Our gross profit percentage decreased to 45% for the nine months ended September 30, 2011 from 50% for the nine months ended September 30, 2010. We expect that our margins will be higher than normal on revenues contributed by our new products in particular the DVM-100 and DVM-250 as we gain traction in the marketplace and increase commercial production during the balance of 2011 and in 2012. In addition, as revenues increase from these products, we will seek to further improve our margins from these new products through economies of scale and more effectively utilizing fixed manufacturing overhead components. We plan to concentrate 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 $ 9,253,383and $ 11,816,226 for the nine months ended September 30, 2011 and 2010, respectively, a decrease of $2,562,843 (22%). Overall selling, general and administrative expenses as a percentage of sales improved to 60% in 2011 compared to 62% in 2010. The significant components of selling, general and administrative expenses are as follows:

	Nine months ended September 30,	
	2011	2010
Research and development expense	$2,139,277	$2,595,801
Selling, advertising and promotional expense	1,664,584	2,108,208
Stock-based compensation expense	636,069	1,370,346
Professional fees and expense	559,816	839,018
Executive, sales and administrative staff payroll	2,201,063	2,877,384
Other	2,052,574	2,025,469
Total	$9,253,383	$11,816,226

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 $2,139,277 and $2,595,801 for the nine months ended September 30, 2011 and 2010, respectively, a decrease of $456,524 (18%). We believe that our cost trends have improved substantially in the nine months ended September 30, 2011 because of our cost containment efforts and increased scrutiny of engineering resources by our Vice President of Engineering. His efforts have greatly improved the development cycle and costs associated with our new products, including line extensions for our current products that we plan to bring to market in the future. We employed a total of 21 engineers at September 30, 2011, most of whom are dedicated to research and development activities for new products. Research and development expenses as a percentage of total revenues were 14% in 2011 and 14% in 2010, illustrating our commitment to bringing new products to market and expanding our current product line. We have active research and development projects on several new products, as well as upgrades to our existing product lines. During the first quarter 2011, we introduced the DVM-250 event recorder, which is targeting commercial fleet operators, and the DVM-100 in the third quarter 2011. The DVM-750, FirstVU, DVM-100 and DVM-250 products are the result of our current research and development efforts. We purchase and resell the Thermal Ally and Laser Ally products under our name from third parties who developed them. The number of engineers devoted to research and development activities is expected to decrease during the balance of 2011 because several of our development projects are now completed and the engineers necessary to support our DVM-500 Plus and DVM-750 products decline. 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 $1,664,584 and $2,108,208 for the nine months ended September 30, 2011 and 2010, respectively, a decrease of $443,624 (21%), which is commensurate with the 19% decrease in revenues and the result of our cost containment measures. The largest component of selling, promotional and advertising expense is commissions paid to our independent agents that represent our sales force in the domestic market. These agents generally receive a commission on sales ranging from 5.0% to 12% of the gross sales price to the end customer. Sales commissions totaled $1,453,042 and $1,609,820 for the nine months ended September 30, 2011 and 2010, respectively, a decrease of $156,778 (10%), which is commensurate with the 19% sales decrease in 2011 compared to 2010 offset by the costs of reorganizing our law enforcement sales agents and the establishment of our direct sales force to address the sale of the our new DVM-250 product through the commercial fleet sales channel. Sales commissions increased during 2011 by costs associated with the restructuring of our sales agents within our law enforcement sales channel and the new salesman hired to launch the new DVM-250 product line. We have changed sales agents in four territories for our law enforcement sales channel and has hired five new salesman focused on the DVM-250 sales launch, which represents our new commercial sales channel. Sales commissions as a percentage of overall sales increased to 9.5% during the nine months ended September 30, 2011 compared to 8.5% for the nine months ended September 30, 2010.

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Promotional and advertising expenses totaled $211,542 during the nine months ended September 30, 2011 compared to $498,388 during the nine months ended September 30, 2010, a decrease of $286,846 (58%). The decrease is attributable to our cost containment and reduction initiative during 2011, which resulted in a reduction in our attendance at trade shows particularly at international venues. We expect increases in expenses for brochures and other marketing initiatives designed to help launch the DVM-250 event recorder and the DVM-100 during the balance of 2011.

Stock-based compensation expense. Stock based compensation expense totaled $636,069 and $1,370,346 for the nine months ended September 30, 2011 and 2010, respectively, a decrease of $734,277 (54%). The decrease was primarily attributable to stock options issued in January 2011 to directors and officers with longer four-year vesting periods compared to the restricted stock grant to officers and directors in January 2010 with shorter one-year vesting periods. The longer amortization period related to such stock option grants in January 2011 resulted in reduced stock-based compensation expense in the nine months ended September 30, 2011 compared to 2010. We expect this trend to continue during the balance of 2011 and 2012.

Professional fees and expense. Professional fees and expenses totaled $559,816 and $839,018 for the nine months ended September 30, 2011 and 2010, respectively, a decrease of $279,202 (33%). Professional fees during 2011 were related primarily to normal public company matters, intellectual property matters and litigation matters. The decrease in professional fees and expenses is primarily attributable to the Company’s cost containment measures coupled with the 2010 settlement of certain litigation. We expect increased legal research and consultation regarding several patents and trademarks that have been or may be filed on the Company’s new products and litigation expense during the balance of 2011.

Executive, sales and administrative staff payroll. Executive, sales and administrative staff payroll expenses totaled $2,201,063and $2,877,384for the nine months ended September 30, 2011 and 2010, respectively, a decrease of $676,321 (24%). This decrease is attributable to the cost containment initiative that resulted in headcount reductions, including the elimination of the Vice President of Operations position during January 2011. The base salaries of our officers were reduced by at least 30% effective January 1, 2011, which contributed to the reduction in executive payroll costs. Severance costs charged to executive, sales and administrative payroll exceeded $150,000 during the nine months ended September 30, 2011, which offset the overall decrease in such payroll costs. Management anticipates that the reduction in executive, sales and administrative payroll will continue for the balance of 2011 as the full benefit of the headcount reductions are in effect. However, such reductions may be offset partially because we may find it necessary to hire additional technical support staff during the balance of 2011 to handle field inquiries, wireless download and installation matters as our installed customer base continues to increase and additional technical support is required for our new products, such as the DVM-250 and DVM-100.

Other. Other selling, general and administrative expenses totaled $2,052,574and $2,025,469 for the nine months ended September 30, 2011 and 2010, respectively, an increase of $27,105 (1%). The increase in 2011 was attributable to substantial increases in our overall insurance expense offset by our cost containment measures that generally reduced the cost of information technology, telephone and internet services as we negotiated better contracts rates or moved to new service providers. We expect reductions in property insurance and facility-related expenses during the balance of 2011 as we decreased the amount of leased space for our engineering and distribution departments effective September 30, 2011. We plan to continue our cost containment initiatives for the balance of 2011 and expect the improvement in our overhead costs will continue.

Operating Loss

For the reasons previously stated, our operating loss was $2,322,557 and $2,318,071 for the nine months ended September 30, 2011 and 2010, respectively, a slight deterioration of $4,486 (0.2%). Operating loss as a percentage of

revenues increased to 15% in 2011 compared to 12% in 2010.

Interest Income

Interest income decreased to $12,464 in the nine months ended September 30, 2011 from $18,864 in 2010. The decrease in interest income was a result of our decreased average cash balances and significantly lower average interest rate earned on such balances during the nine months ended September 30, 2011 compared to 2010.

Interest Expense

We incurred interest expense of $135,017 and $4,583during the nine months ended September 30, 2011 and 2010, respectively. We began drawing on our line of credit during the third quarter 2010 to fund our operating losses and the repurchase of $469,761 of common stock during 2010. We issued a subordinated note in the principal amount of $1.5 million during the second quarter 2011, the proceeds of which were used to repay the outstanding line of credit. The subordinated note payable bears interest at 8% per annum and we are amortizing the discount over the term of the note. The outstanding balance on our subordinated note payable was $1.5 million as of September 30, 2011 less the unamortized discount of $84,274.

Loss before Income Tax Benefit

As a result of the above, we reported a loss before income tax benefit of $2,445,110 and $2,303,790 for the nine months ended September 30, 2011 and 2010, respectively, a deterioration of $141,320 (6%).

Income Tax Benefit

We recorded no income tax benefit related to our losses for the nine months ended September 30, 2011 due to management's decision to continue providing a full valuation reserve on our net deferred tax assets as of September 30, 2011. Our income tax benefit was $748,000 for the nine months ended September 30, 2010. During 2011, we increased our valuation reserve on deferred tax assets by $760,000 whereby our deferred tax assets continued to be fully reserved due to our recent operating losses as of September 30, 2011.

We had approximately $5,370,000 of net operating loss carryforwards and $915,000 of research and development tax credit carryforwards as of September 30, 2011 available to offset future net taxable income.

Net Loss

As a result of the above, for the nine months ended September 30, 2011 and 2010, we reported a net loss of $2,445,110 and $1,555,790, respectively, a deterioration of $889,320 (57%).

Basic and Diluted Loss per Share

The basic and diluted loss per share was $0.15 and $0.09 for the nine months ended September 30, 2011 and 2010, respectively, for the reasons previously noted. All outstanding stock options were considered antidilutive and therefore excluded from the calculation of diluted loss per share for the nine months ended September 30, 2011 and 2010 because of the net loss reported for each period.

Liquidity and Capital Resources

Overall: Prior to 2010, we principally funded our operations internally through cash flow from operations and available cash balances; however, in 2010, we found it necessary to draw $1.5 million on our bank line of credit to supplement our cash needs. The borrowings during 2010 were used primarily to cover operating losses and working capital needs in particular inventory purchases, payment of accrued commissions and treasury stock acquisitions.

On May 31, 2011, we borrowed $1.5 million under an unsecured credit facility with a private, third-party lender. The loan is represented by a promissory note, bears interest at the rate of 8% per annum and is payable, interest only on a monthly basis. The loan is due and payable in full on May 30, 2012 and may be prepaid without penalty at any time. The note is subordinated to all existing and future senior indebtedness, as such term is defined in the note. We

used the loan proceeds to pay the outstanding borrowings under its line of credit with a bank. The bank line of credit was retired as of May 31, 2011.

We may seek additional credit facilities to complement the subordinated note payable and provide us with funding should the need arise to finance growth or other expenditures. It will be difficult to obtain a new line of credit facility given our recent operating losses and the current banking environment. Any new credit facility, if obtained, may not be on terms favorable to us.

We have over $1,304,000 of available cash and equivalents and net working capital of approximately $9,094,000 as of September 30, 2011. Net working capital as of September 30, 2011 includes approximately $4.0 million of accounts receivable and $6.7 million of inventory. Management has focused on reducing both accounts receivable and inventory to generate cash to meet our short term funding needs. We have reduced such balances by approximately $4.2 million during the nine months ended September 30, 2011, which has provided adequate funding to support its operations. Management believes that it can continue to reduce inventory levels during the balance of 2011 to provide funding for operations; however no assurances can be given in that regard.

We do not consider raising capital through an equity offering to be a viable alternative to supplement working capital needs, given our current public equity valuation. However, we may find it necessary to raise additional capital if we do not regain profitability during the balance of 2011, are unable to improve liquidity through a reduction in our inventory and accounts receivable levels in the near term and do not have other means to support our planned operating activities. Our ability to obtain such capital, if required, would have a material adverse impact on our business, operations and financial condition, including our ability to continue operating as a going concern. Further such capital, if available, most likely would not be on terms favorable to us and our shareholders.

Cash and cash equivalents balances: As of September 30, 2011, we had cash and cash equivalents with an aggregate balance of $1,304,290, an increase from a balance of $623,475 at December 31, 2010. Summarized immediately below and discussed in more detail in the subsequent subsections are the main elements of the $680,815 net increase in cash during the nine months ended September 30, 2011:

Operating activities: $1,009,347 of net cash provided by operating activities through collections of accounts receivables and decreases in inventory levels, offset by our net losses and the payment of accounts payable. Non-cash charges to income, such as the depreciation and amortization, increase in inventory obsolescence reserves and stock-based compensation also contributed to net cash provided by operating activities.

Investing activities: $253,532 of net cash used in investing activities, primarily to acquire test and quality control equipment to supply our contract manufacturers and the costs to acquire patents on our proprietary technology utilized in our new products.

Financing activities: $75,000 of net cash used in financing activities resulting from the payment of debt issuance costs related to the issuance of the $1.5 million subordinated note payable during 2011. The proceeds of the subordinated note payable were used to retire the outstanding balance on the Company’s bank line of credit.

Operating activities: Net cash provided by operating activities was $1,009,347 for the nine months ended September 30, 2011 compared to net cash used in operating activities of $679,014 for the nine months ended September 30, 2010, an improvement of $1,688,361. The improvement in cash flow from operations for 2011 was primarily the result of collections of accounts receivable, the 2010 deferred tax provision and substantial decreases in inventory offset by our net losses and the payment of accounts payable. During the nine months ended September 30, 2011, management focused on improving liquidity by reducing inventory levels and the collection of accounts receivable to fund payments to vendors and to build cash reserves. We are hopeful that we will increase revenues, return to profitability and decrease our inventory levels during the balance of 2011, thereby providing positive cash flows from operations, although there can be no assurances in that regard.

Investing activities: Cash used in investing activities was $253,532 and $284,064 for the nine months ended September 30, 2011 and 2010, respectively. In both 2011 and 2010, we purchased production and research and development equipment to support our activities. In 2011 the purchases were focused on acquiring test and quality control equipment to be used by our contract manufacturers. During 2011 and 2010, we also incurred costs for patent applications on our proprietary technology utilized in our new products and included in intangible assets.

Financing activities: During the nine months ended September 30, 2011, we issued a subordinated note payable in the principal amount of $1.5 million, the proceeds of which were used to repay the outstanding balance on our bank line of credit. We paid $75,000 of debt issuance costs related to the subordinated note payable during 2011. There were no stock option exercises or similar transactions during the nine months ended September 30, 2011, which is attributable to the depressed value of our common stock. Net cash provided by financing activities during the nine months ended September 30, 2010 was $80,301, which is attributable to proceeds received from the exercise of stock options and their related tax benefits.

The net result of these activities was an increase in cash of $680,815 to $1,304,290 for the nine months ended September 30, 2011.

Commitments:

We had $1,304,290 of cash and cash equivalent balances and net positive working capital approximating $9.1 million as of September 30, 2011. Accounts receivable balances represented $3,957,363 of our net working capital at September 30, 2011. We intend to collect our outstanding receivables on a timely basis and reduce the overall level substantially during the balance of 2011, which would help to provide positive cash flow to support our operations during 2011. Inventory represented $6,714,903 of our net working capital at September 30, 2011 and finished goods represented $5,011,235 of total inventory. We expect that finished goods will be converted to cash quickly when customer orders are received and shipments occur during the balance of 2011 and 2012. We are actively managing the overall level of inventory and believe that such levels will be reduced during the balance of 2011 by our sales activities, which should provide additional cash flow to help support our operations during 2011.

Capital Expenditures. We had no material commitments for capital expenditures at September 30, 2011.

Lease commitments. We have several non-cancelable long-term operating lease agreements for office space and warehouse space. The agreements expire at various dates through December 2012. We have also entered into month-to-month leases for equipment and facilities. Rent expense for the three months ended September 30, 2011 and 2010 was $85,049 and $104,020, respectively, related to these leases. Rent expense for the nine months ended September 30, 2011 and 2010 was $298,481 and $303,289, respectively, related to these leases. The future minimum amounts due under the leases are as follows:

Year ending December 31:		
2011 (October 1, 2011 through December 31, 2011)	$	87,456
2012		250,053
2013		—
2014		—
2015 and thereafter		—
	$	337,509

License agreements. We have several license agreements whereby we have been assigned the rights to certain licensed materials used in its 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 $7,250 and $7,975 for the three months ended September 30, 2011 and 2010 and $23,802 and $17,164 for the nine months ended September 30, 2011 and 2010, respectively.

Following is a summary of our licenses as of September 30, 2011:

License Type	Effective Date	Expiration Date	Terms
Production software license agreement	April, 2005	April, 2012	Automatically renews for one year periods unless terminated by either party.
Software sublicense agreement	October, 2007	October, 2012	Automatically renews for one year periods unless terminated by either party.
Technology license agreement	July, 2007	July, 2012	Automatically renews for one year periods unless terminated by either party.
Development, license and manufacturing agreement	July, 2011	July, 2016	Company has option to renew for three successive options to renew for three years periods unless terminated by either party.
Limited license agreement	August, 2008	Perpetual	May be terminated by either party.

During April 2009, we terminated two license agreements because of failure of the counterparty to deliver the required materials and refusal to honor warranty provisions. In addition, one of the agreements was never approved by the Company. Both of these terminations are in dispute and we have filed a lawsuit to enforce our rights and protect our interests pursuant to these agreements. See “Litigation” below.

Supply and distribution agreements. We entered into a supply and distribution agreement on May 1, 2010 under which it was granted the exclusive worldwide right to sell and distribute a proprietary law enforcement speed measurement device to its customers. The term of the agreement is 42 months after the date the supplier begins full scale production of the product. Full scale production commenced in August 2010 and final certification of the product was obtained. After the initial term has expired, the parties may continue on a month-to-month basis and is terminable by either party upon 30 days advance notice. The contract may be terminated earlier in case of material breach by either party that is not cured within thirty days of notice of the breach.

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The agreement contains required minimum order quantities and fixed prices per unit according to the following schedule:

	Minimum order commitment amount (in dollars)		
Commitment time period	Original Commitment	Purchases	Remaining Commitment
August 2010 through February 2012	$1,763,000	$1,182,473	$ 580,527
March 2012 through February 2013	1,763,000	—	1,763,000
March 2012 through February 2014	1,763,000	—	1,763,000
	$5,289,000	$1,182,473	$ 4,106,527

The supplier is responsible for all warranty, damage or other claims, losses or liabilities related to the product and is obligated to defend and indemnify us against such risks. The Company holds approximately $610,000 of such products in finished goods inventory as of September 30, 2011.

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

On June 8, 2009, the Company filed suit against Z3 Technologies, LLC ("Z3") in Federal Court for the District of Kansas claiming breach of a production software license agreement entered into during October 2008 and the rescission of a second limited license agreement entered into during January 2009. Among various other claims, the Company has asserted that Z3 failed to deliver the material required under the contracts, the product that was delivered by Z3 is defective and/or unusable and that the January 2009 contract should be rescinded and declared void, unenforceable and of no force or effect. The Company paid license fees and made other payments to Z3 totaling $265,000 to-date under these contracts. Z3 has denied the Company's claims and has filed counterclaims that allege the Company did not have the right to terminate the contracts and therefore Z3 has been damaged for loss of profits and related damages. The Company believes that it has insurance coverage under its director and officer liability insurance policy relative to a portion or all of the counterclaims, although no assurance can be offered in this regard. The Company has filed a legal action to establish whether it has coverage from such counterclaims under its director and officer liability insurance policy. Discovery and depositions by both parties have commenced and no trial date has been set.

On October 23, 2009, the Circuit Court of Jackson County, Missouri awarded the Company an interlocutory judgment against a former contract manufacturer. The Company had filed for and received a temporary restraining order in June 2009 that forbids the supplier from engaging in certain actions involving the Company. The interlocutory judgment was entered in favor of the Company against the supplier that in effect cancelled all purchase orders and confirmed that the Company has no further obligations, whether monetary or otherwise, to the supplier. The Company received a notice of the filing of bankruptcy under Chapter 7 effective October 26, 2009 by this supplier. On May 28, 2010, the court granted a default judgment awarding the Company damages and legal fees totaling $11,166,686. The Company will pursue collection from the bankruptcy estate and applicable insurance policies. Management believes that the ultimate collection of any award of damages over and above the $72,000 in unpaid invoices is uncertain at this time because of the current financial status of the supplier in the pending bankruptcy proceedings and the uncertainty of insurance coverage. The Company has filed a garnishment claim against all insurance proceeds from policies issued and in force covering the contract manufacturer when these actions occurred.

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.

401 (k) Plan. In July 2008, the Company amended and restated its 401(k) retirement savings plan. The amended plan requires the Company to provide 100% matching contributions for employees who elect to contribute up to 3% of their compensation to the plan and 50% matching contributions for employee's elective deferrals on the next 2% of their contributions. The Company has made matching contributions totaling $29,397 and $41,611 for the three months ended September 30, 2011 and 2010, respectively. The Company has made matching contributions totaling $97,555 and $123,662 for the nine months ended September 30, 2011 and 2010, respectively. Each participant is 100% vested at all times in employee and employer matching contributions.

Stock Repurchase Program. During June 2008, the Board of Directors approved a program that authorized the repurchase of up to $10 million of the Company's common stock in the open market, or in privately negotiated transactions, through July 1, 2010. The Board of Directors approved an extension of this program to July 1, 2012. The Company made no purchases under this program during the nine months ended September 30, 2011. The Company has repurchased 508,145 shares at a total cost of $2,157,226 (average cost of $4.25 per share) under this program from inception to September 30, 2011.

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Standby Letters of Credit. The Company is contingently liable as of September 30, 2011 for standby letters of credit issued by a bank for an aggregate amount of $211,348 to certain customers as security if the Company does not honor its contractual warranty obligations on the products delivered to such customers. The outstanding standby letters expire in May 2012 and the Company has never had a beneficiary demand funding related to such standby letters of credit.

CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are summarized in note 1 to our condensed consolidated financial statements included in Item 1, “Financial Statements”, of this report. While the selection and application of any accounting policy may involve some level of subjective judgments and estimates, we believe the following accounting policies are the most critical to our financial statements, potentially involve the most subjective judgments in their selection and application, and are the most susceptible to uncertainties and changing conditions:

Revenue Recognition/ Allowance for Doubtful Accounts;

Allowance for Excess and Obsolete Inventory;

Warranty Reserves;

Stock-based Compensation Expense; and

Accounting for Income Taxes.

Revenue Recognition / Allowances for Doubtful Accounts.

Revenue is recognized for the shipment of products or delivery of service when all four of the following conditions are met:

(i) Persuasive evidence of an arrangement exists;

(ii) Delivery has occurred;

(iii) The price is fixed or determinable; and

(iv) Collectability is reasonably assured.

We review all significant, unusual or nonstandard shipments of product or delivery of services as a routine part of our accounting and financial reporting process to determine compliance with these requirements.

Our primary customers are state, local and federal law enforcement agencies, which historically have been low risks for uncollectible accounts. However, we do have commercial customers and international distributors that present a greater risk for uncollectible accounts than such law enforcement customers and we consider a specific reserve for bad debts based on their individual circumstances. Our historical bad debts have been negligible with less than $50,000 charged off as uncollectible on cumulative revenues of $122.9 million since we commenced deliveries during 2006. As of September 30, 2011 and December 31, 2010, we have recorded a reserve for doubtful accounts of $114,700 and $110,000, respectively.

We periodically perform a specific review of significant individual receivables outstanding for risk of loss due to uncollectibility. Based on our specific review, we consider our reserve for doubtful accounts to be adequate as of September 30, 2011. However, should the balance due from any significant customer ultimately become uncollectible then our allowance for bad debts will not be sufficient to cover the charge-off and we will be required to record additional bad debt expense in our statement of operations.

Allowance for Excess and Obsolete Inventory. We record valuation reserves on our inventory for estimated excess or obsolete inventory items. The amount of the reserve is equal to the difference between the cost of the inventory and the estimated market value based upon assumptions about future demand and market conditions. On a quarterly basis, management performs an analysis of the underlying inventory to identify reserves needed for excess and obsolescence.
Management uses its best judgment to estimate appropriate reserves based on this analysis. In addition, we adjust the carrying value of inventory if the current market value of that inventory is below its cost.

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Inventories consisted of the following at September 30, 2011 and December 31, 2010:

	September 30, 2011	December 31, 2010
Raw material and component parts	$ 2,369,509	$ 4,272,304
Work-in-process	81,399	88,635
Finished goods	5,011,235	6,460,924
Subtotal	7,462,143	10,821,863
Reserve for excess and obsolete inventory	(747,240)	(733,578)
Total	$ 6,714,903	$ 10,088,285

We balance the need to maintain strategic inventory levels to ensure competitive delivery performance to our customers against the risk of inventory obsolescence due to changing technology and customer requirements. As reflected above, our inventory reserves represented 10.0% of the gross inventory balance at September 30, 2011, compared to 6.8% of the gross inventory balance at December 31, 2010. Our finished goods are composed primarily of our new DVM-750 system, the DVM-500 Plus, the FirstVU, the Laser Ally, the Thermal Ally, the DVM-250 event recorder and the DVF 500 flashlight products, none of which are considered excess or obsolete. We have reduced the finished goods inventory related to the legacy DVM-500 system to zero as of September 30, 2011 and therefore it does not represent an obsolescence risk. Raw material and component part inventory balances were substantially decreased at September 30, 2011, compared to December 31, 2010, as we focused on reducing our overall inventory levels. In 2011, we are focused on outsourcing more component part production and increasing our efforts to carry efficient levels of raw materials and component parts commensurate with current sales forecasts. We will continue our efforts to reduce overall inventory levels during the balance of 2011. We have inventory reserves for pending changes to the product line, engineering upgrades and design changes that alter the demand for component parts and a shift of production to outsourcing.

If actual future demand or market conditions are less favorable than those projected by management or significant engineering changes to our products that are not anticipated and appropriately managed, additional inventory write-downs may be required in excess of the inventory reserves already established.

Warranty Reserves. We generally provide a two-year parts and labor warranty on our products to our customers. Provisions for estimated expenses related to product warranties are made at the time products are sold. These estimates are established using historical information on the nature, frequency, and average cost of claims. We actively study trends of claims and take action to improve product quality and minimize claims. Our warranty reserves were decreased to $201,165 as of September 30, 2011 compared to $228,233 as of December 31, 2010, which reflects the decreased number of units under warranty and the resolution of the wireless transfer module failures experienced during early 2011. Our new DVM-750 product failure rate has improved significantly during 2010 and 2011, which has contributed to the relatively stable level of warranty reserves. We have recently introduced several new products, including the FirstVU, Laser Ally, DVM-100, DVM-250 and Thermal Ally, for which we have limited exposure since the third party manufacturers of these products are responsible for all warranty claims. There is a risk that we will have higher warranty claim frequency rates and average cost of claims than our history has indicated on our legacy mirror products. Actual experience could differ from the amounts estimated requiring adjustments to these liabilities in future periods.

Stock-based Compensation Expense. We grant stock options to our employees and directors and such benefits provided are share-based payment awards which require us to make significant estimates related to determining the

value of our share-based compensation. Our expected stock-price volatility assumption is based on historical volatilities of the underlying stock which are obtained from public data sources. There were 667,500 options granted during the nine months ended September 30, 2011. The assumptions used for the determining the grant-date fair value of options granted during the nine months ended September 30, 2011 are reflected in the following table:

	Nine months ended September 30, 2011	
Expected term of the options in years	0-5 years	
Expected volatility of Company stock	67% - 70	%
Expected dividends	None	
Risk-free interest rate	0.20% - 1.98	%
Expected forfeiture rate	5% - 10	%

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If factors change and we develop different assumptions in future periods, the compensation expense that we record in the future may differ significantly from what we have recorded in the current period. There is a high degree of subjectivity involved when using option pricing models to estimate share-based compensation. Changes in the subjective input assumptions can materially affect our estimates of fair values of our share-based compensation. Certain share-based payment awards, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, values may be realized from these instruments that are significantly in excess of the fair values originally estimated on the grant date and reported in our financial statements. Although the fair value of employee share-based awards is determined using an established option pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

In addition, we are required to net estimated forfeitures against compensation expense. This requires us to estimate the number of awards that will be forfeited prior to vesting. If actual forfeitures in future periods are different than our initial estimate, the compensation expense that we ultimately record may differ significantly from what was originally estimated. The estimated forfeiture rate for unvested options outstanding as of September 30, 2011 range from 0% to 10%.

Accounting for Income Taxes. Accounting for income taxes requires significant estimates and judgments on the part of management. Such estimates and judgments include, but are not limited to, the effective tax rate anticipated to apply to tax differences that are expected to reverse in the future, the sufficiency of taxable income in future periods to realize the benefits of net deferred tax assets and net operating losses currently recorded and the likelihood that tax positions taken in tax returns will be sustained on audit.

As required by authoritative guidance, we record deferred tax assets or liabilities based on differences between financial reporting and tax bases of assets and liabilities using currently enacted rates that will be in effect when the differences are expected to reverse. Authoritative guidance also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized. As of December 31, 2010, cumulative valuation allowances in the amount of $4,495,000 were recorded in connection with the net deferred income tax assets. Based on a review of our deferred tax assets and recent operating performance, we determined that our valuation allowance should be increased to $4,495,000 to fully reserve our deferred tax assets at December 31, 2010. We determined that it was appropriate to continue to provide a full valuation reserve on our net deferred tax assets as of September 30, 2011 because of the losses we incurred during the nine months ended September 30, 2011. We expect to continue to maintain a full valuation allowance until we determine that we can sustain a level of profitability that demonstrates our ability to realize these assets. To the extent we determine that the realization of some or all of these benefits is more likely than not based upon expected future taxable income, a portion or all of the valuation allowance will be reversed. Such a reversal would be recorded as an income tax benefit and, for some portion related to deductions for stock option exercises, an increase in shareholders' equity.

As required by authoritative guidance, we have performed a comprehensive review of our portfolio of uncertain tax positions in accordance with recognition standards established by the FASB, an uncertain tax position represents the Company’s expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. We have no recorded liability as of September 30, 2011 representing uncertain tax positions.

We have generated substantial deferred income tax assets related to our operations primarily from the charge to compensation expense taken for stock options, certain tax credit carryforwards and net operating loss carryforwards. For us to realize the income tax benefit of these assets, we must generate sufficient taxable income in future periods when such deductions are allowed for income tax purposes. In some cases where deferred taxes were

the result of compensation expense recognized on stock options, our ability to realize the income tax benefit of these assets is also dependent on our share price increasing to a point where these options have intrinsic value at least equal to the grant date fair value and are exercised. In assessing whether a valuation allowance is needed in connection with our deferred income tax assets, we have evaluated our ability to generate sufficient taxable income in future periods to utilize the benefit of the deferred income tax assets. We continue to evaluate our ability to use recorded deferred income tax asset balances. If we fail to generate taxable income for financial reporting in future years, no additional tax benefit would be recognized for those losses, since we will not have accumulated enough positive evidence to support our ability to utilize net operating loss carryforwards in the future. Therefore we may be required to increase our valuation allowance in future periods should our assumptions regarding the generation of future taxable income not be realized.

Inflation and Seasonality

Inflation has not materially affected us during the past fiscal year. We do not believe that our business is seasonal in nature however; generally we generate higher revenues during the second half of the calendar year compared to the first half.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

(Not Applicable)

ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures, as such terms are defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”). The Company, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of such disclosure controls and procedures for this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company’s disclosure controls and procedures were effective as of September 30, 2011 to provide reasonable assurance that material information required to be disclosed by the Company in this report was recorded, processed, summarized and communicated to the Company’s management as appropriate and within the time periods specified in SEC rules and forms.

Changes in Internal Control over Financial Reporting

There have not been any changes in the Company’s internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during its last fiscal quarter that have materially affected, or are reasonably likely to materially affect its internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

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

On June 8, 2009, the Company filed suit against Z3 Technologies, LLC (“Z3”) in Federal Court for the District of Kansas claiming breach of a production software license agreement entered into during October 2008 and the rescission of a second limited license agreement entered into during January 2009. Among various other claims, the Company has asserted that Z3 failed to deliver the material required under the contracts, the product that was delivered by Z3 is defective and/or unusable and that the January 2009 contract should be rescinded and declared void, unenforceable and of no force or effect. The Company paid license fees and made other payments to Z3 totaling $265,000 to-date under these contracts. Z3 has denied the Company’s claims and has filed counterclaims that allege the Company did not have the right to terminate the contracts and therefore Z3 has been damaged for loss of profits and related damages. The Company believes that it has insurance coverage under its director and officer liability insurance policy relative to a portion or all of the counterclaims, although no assurance can be offered in this regard. The Company has filed a legal action to establish whether it has coverage from such counterclaims under its director and officer liability insurance policy. Discovery and depositions by both parties have commenced and no trial date has been set.

On October 23, 2009, the Circuit Court of Jackson County, Missouri awarded the Company an interlocutory judgment against a former contract manufacturer. The Company had filed for and received a temporary restraining order in

June 2009 that forbids the supplier from engaging in certain actions involving the Company. The interlocutory judgment was entered in favor of the Company against the supplier that in effect cancelled all purchase orders and confirmed that the Company has no further obligations, whether monetary or otherwise, to the supplier. The Company received a notice of the filing of bankruptcy under Chapter 7 effective October 26, 2009 by this supplier. On May 28, 2010, the court granted a default judgment awarding the Company damages and legal fees totaling $11,166,686. The Company will pursue collection from the bankruptcy estate and applicable insurance policies. Management believes that the ultimate collection of any award of damages over and above the $72,000 in unpaid invoices is uncertain at this time because of the current financial status of the supplier in the pending bankruptcy proceedings and the uncertainty of insurance coverage. The Company has filed a garnishment claim against all insurance proceeds from policies issued and in force covering the contract manufacturer when these actions occurred.

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 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

(a) On May 31, 2011, the Company borrowed $1,500,000 from an individual who is an accredited investor. The Company issued the lender an 8% Subordinated Note (the "Note") that bears interest at the rate of 8% per annum and is payable interest only on a monthly basis. The loan is due and payable in full on May 30, 2012 and may be prepaid without penalty at any time. The Note is unsecured and subordinated to all existing and future senior indebtedness, as such term is defined in the Note.

In connection with the Note, the Company granted the lender a warrant (the "Warrant") exercisable to purchase 300,000 shares of its common stock at a price of $1.50 per share until November 30, 2013. The Note and the Warrant were issued in a private placement in reliance on the exemption from registration set forth in Section 4(2) of the Securities Act of 1933, as amended. The Company used the proceeds from the Note to pay the outstanding borrowings under its line of credit with its former bank.

The Company paid Source Capital Group, Inc., a member of the Financial Industry Regulatory Authority, a fee of $75,000 and issued it a warrant exercisable to purchase 75,000 shares of its common stock on the same terms and conditions as the Warrant for its services relating to the transaction.

(c) Issuer Purchases of Equity Securities.

Period	(a) Total Number of Shares Purchased [1]	(b) Average Price Paid per Share [1]	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs [1]	(d)Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs [1]
January 1 to 31, 2009	—	—	—	$ 8,375,647
February 1 to 28, 2009	—	—	—	$ 8,375,647
March 1 to 31, 2009	38,250	$1.65	38,250	$ 8,312,535
April 1 to 30, 2009	—	—	—	$ 8,312,535
May 1 to 31, 2009	—	—	—	$ 8,312,535
June 1 to 30, 2009	—	—	—	$ 8,312,535
July 1 to 31, 2009	—	—	—	$ 8,312,535
August 1 to 31, 2009	—	—	—	$ 8,312,535
September 1 to 30, 2009	—	—	—	$ 8,312,535
October 1 to 31, 2009	—	—	—	$ 8,312,535
November 1 to 30, 2009	—	—	—	$ 8,312,535
December 1 to 31, 2009	—	—	—	$ 8,312,535
January1 to 31, 2010	—	—	—	$ 8,312,535
February 1 to 28, 2010	—	—	—	$ 8,312,535
March 1 to 31, 2010	—	—	—	$ 8,312,535
April1 to 30, 2010	—	—	—	$ 8,312,535
May 1 to 31, 2010	—	—	—	$ 8,312,535
June 1 to 30, 2010	—	—	—	$ 8,312,535
July 1 to 31, 2010	—	—	—	$ 8,312,535

August 1 to 31, 2010	259,535	1.81	259,535	$ 7,842,774
September 1 to 30, 2010	—	—	—	$ 7,842,774
October 1 to 31, 2010	—	—	—	$ 7,842,774
November 1 to 30, 2010	—	—	—	$ 7,842,774
December 1 to 31, 2010	—	—	—	$ 7,842,774
January1 to 31, 2011	—	—	—	$ 7,842,774
February 1 to 28, 2011	—	—	—	$ 7,842,774
March 1 to 31, 2011	—	—	—	$ 7,842,774
April 1 to 30, 2011	—	—	—	$ 7,842,774
May 1 to 31, 2011	—	—	—	$ 7,842,774
June 1 to 30, 2011	—	—	—	$ 7,842,774
July 1 to 30, 2011	—	—	—	$ 7,842,774
August 1 to 30, 2011	—	—	—	$ 7,842,774
September 1 to 30, 2011	—	—	—	$ 7,842,774 [2]

[1] During June 2008, the Board of Directors approved a program that authorized the repurchase of up to $10 million of the Company’s common stock in the open market, or in privately negotiated transactions, through July 1, 2010. The Board of Directors approved an extension of this program to July 1, 2012. The Company has repurchased 508,145 shares at a total cost of $2,157,226 (average cost of $4.25 per share) under this program as of September 30, 2011.

[2] The Stock Repurchase Program authorized the repurchase of up to $10 million of common stock. A total of 508,145 shares have been repurchased under this program as of September 30, 2011, at a total cost of $2,157,226 ($4.25 per share average). As a result, $7,842,774 represents the maximum remaining dollar amount of common shares that may be purchased under the Program as of September 30, 2011. The Board of Directors has approved an extension of the Program to July 1, 2012.

[3] We purchased vested and unvested employee stock options to acquire 950,000 shares of our common stock in April 2009. The purchase was part of a Separation Agreement reached with our former Executive Vice President of Engineering who resigned to pursue other opportunities. This repurchase was not considered to be part of our Stock Repurchase Program and therefore is not included in the above table.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

(Not Applicable)

ITEM 4. REMOVED AND RESERVED.

ITEM 5. OTHER INFORMATION.

(Not Applicable)

ITEM 6. EXHIBITS.

(a) Exhibits.

Exhibit	Description
31.1	Certificate of Stanton E. Ross pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
31.2	Certificate of Thomas J. Heckman pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
32.1	Certificate of Stanton E. Ross pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.
32.2	Certificate of Thomas J. Heckman pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.

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.

DIGITAL ALLY, INC.,
a Nevada corporation

Date: October 27, 2011 By: /s/ Stanton E. Ross
Stanton E. Ross,
President and Chief Executive Officer

By: /s/ Thomas J. Heckman
Thomas J. Heckman,
Chief Financial Officer, Secretary, Treasurer and Principal Accounting Officer

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