

## **INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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	<b>Page(s)</b>
<b>Report of Independent Registered Public Accounting Firm .....</b>	F-2
<b>Consolidated Financial Statements:</b>	
Consolidated Balance Sheets – December 31, 2009 and 2008.....	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2009 and 2008.....	F-4
Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2009 and 2008.....	F-5
Consolidated Statements of Cash Flows for the Years Ended December 31, 2009 and 2008 .....	F-6
<b>Notes to the Consolidated Financial Statements.....</b>	F-7- F-20

## Report of Independent Registered Public Accounting Firm

To the Board of Directors  
Digital Ally, Inc.

We have audited the accompanying consolidated balance sheets of Digital Ally, Inc. and subsidiary as of December 31, 2009 and 2008, and the related consolidated statements of income and stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Digital Ally, Inc. and subsidiary as of December 31, 2009 and 2008, and results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

We were not engaged to examine management's assessment of the effectiveness of Digital Ally, Inc.'s internal control over financial reporting as of December 31, 2009, included in the accompanying Management's Report on Internal Control over Financial Reporting and, accordingly, we do not express an opinion thereon.

*McGladrey & Pullen, LLP*

March 22, 2010  
Kansas City, Missouri

**DIGITAL ALLY, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 31, 2009 AND 2008**

	<b>2009</b>	<b>2008</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents .....	\$ 183,150	\$ 1,205,947
Accounts receivable-trade, less allowance for doubtful accounts of \$110,000 - 2009 and \$90,000 – 2008.....	8,398,353	6,242,306
Accounts receivable-other .....	476,049	414,176
Inventories .....	7,370,505	8,359,961
Prepaid income taxes.....	—	85,943
Prepaid expenses .....	224,923	217,916
Deferred taxes .....	1,695,000	1,345,000
Total current assets .....	18,347,980	17,871,249
Furniture, fixtures and equipment .....	3,010,977	2,471,205
Less accumulated depreciation and amortization.....	1,592,874	738,554
	1,418,103	1,732,651
Deferred taxes .....	1,160,000	975,000
Intangible assets, net .....	336,182	365,643
Other assets.....	135,674	149,066
Total assets .....	\$ 21,397,939	\$ 21,093,609
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable .....	\$ 2,000,541	\$ 2,791,565
Accrued expenses.....	1,781,969	1,053,624
Income taxes payable .....	9,171	—
Customer deposits .....	39,924	84,039
Total current liabilities.....	3,831,605	3,929,228
Commitments and contingencies .....		
Stockholders' equity:		
Common stock, \$0.001 par value; 75,000,000 shares authorized; Shares issued: 16,169,739 – 2009 and 15,926,077 – 2008.....	16,170	15,926
Additional paid in capital .....	20,007,430	18,428,292
Treasury stock, at cost (shares: 248,610 – 2009 and 210,360 - 2008) .....	(1,687,465)	(1,624,353)
Retained earnings (deficit).....	(769,801)	344,516
Total stockholders' equity .....	17,566,334	17,164,381
Total liabilities and stockholders' equity.....	\$ 21,397,939	\$ 21,093,609

See Notes to Consolidated Financial Statements.

**DIGITAL ALLY, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**YEARS ENDED**  
**DECEMBER 31, 2009 AND 2008**

	<u>2009</u>	<u>2008</u>
Product revenue.....	\$25,318,294	\$32,324,678
Other revenue.....	1,047,959	300,799
	<hr/>	<hr/>
Total revenue .....	26,366,253	32,625,477
Cost of revenue .....	12,933,209	12,980,683
	<hr/>	<hr/>
Gross profit.....	13,433,044	19,644,794
	<hr/>	<hr/>
Selling, general and administrative expenses:		
Research and development expense .....	3,603,696	3,171,721
Selling, advertising and promotional expense.....	3,411,693	3,341,985
Stock-based compensation expense .....	1,399,879	1,599,264
Charges related to purchase and cancellation of employee stock options .....	358,104	—
Vendor settlements and credits .....	(278,173)	—
General and administrative expense.....	6,727,512	6,431,789
	<hr/>	<hr/>
Total selling, general and administrative expenses.....	15,222,711	14,544,759
	<hr/>	<hr/>
Operating income (loss) .....	(1,789,667)	5,100,035
	<hr/>	<hr/>
Interest income.....	35,350	78,595
	<hr/>	<hr/>
Income (loss) before income tax benefit (provision) .....	(1,754,317)	5,178,630
Income tax benefit (provision) .....	640,000	(1,825,000)
	<hr/>	<hr/>
Net income (loss) .....	\$(1,114,317)	\$ 3,353,630
	<hr/>	<hr/>
Net income (loss) per share information:		
Basic.....	\$(0.07)	\$0.22
Diluted.....	\$(0.07)	\$0.19
Weighted average shares outstanding:		
Basic.....	15,797,991	15,319,257
Diluted.....	15,797,991	17,509,091

See Notes to Consolidated Financial Statements.

**DIGITAL ALLY, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**YEARS ENDED DECEMBER 31, 2009 AND 2008**

	Common Stock		Additional Paid In Capital	Treasury stock	Retained earnings (deficit)	Total
	Shares	Amount				
Balance, January 1, 2008.....	14,092,260	\$14,092	\$12,110,890	\$ —	\$(3,009,514)	\$ 9,115,868
Stock-based compensation.....	—	—	1,599,264	—	—	1,599,264
Excess in tax benefits related to stock-based compensation.....	—	—	2,345,000	—	—	2,345,000
Stock options exercised at:						
\$1.00 per share.....	800,834	801	800,033	—	—	800,834
\$1.20 per share.....	383,500	383	459,817	—	—	460,200
\$1.60 per share.....	165,794	166	265,105	—	—	228,271
\$2.15 per share.....	230,079	230	494,440	—	—	494,670
\$2.30 per share.....	50,000	50	114,950	—	—	115,000
\$2.50 per share.....	25,000	25	62,475	—	—	62,500
\$2.65 per share.....	40,000	40	105,960	—	—	106,000
\$2.75 per share.....	199,750	200	549,113	—	—	549,313
\$4.05 per share.....	15,000	15	60,735	—	—	60,750
Common stock surrendered as consideration for cashless exercise of stock options.....	(76,140)	(76)	(539,490)	—	—	(539,566)
Purchase of 38,250 common shares for treasury.....	—	—	—	(1,624,353)	—	(1,624,353)
Net income .....	—	—	—	—	3,353,630	3,353,630
Balance, January 1, 2009.....	15,926,077	15,926	18,428,292	(1,624,353)	344,516	17,164,381
Stock-based compensation.....	—	—	1,757,983	—	—	1,757,983
Excess (deficiency) in tax benefits related to stock-based compensation.....	—	—	(120,000)	—	—	(120,000)
Restricted common stock grant.....	25,000	25	(25)	—	—	—
Stock options exercised at:						
\$1.00 per share.....	100,000	100	99,900	—	—	100,000
\$1.60 per share.....	142,901	143	228,499	—	—	228,642
\$1.95 per share.....	125,000	125	243,625	—	—	243,750
\$2.15 per share.....	5,000	5	10,745	—	—	10,750
Common stock surrendered as consideration for cashless exercise of stock options.....	(154,239)	(154)	(321,589)	—	—	(321,743)
Purchase of 38,250 common shares for treasury.....	—	—	—	(63,112)	—	(63,112)
Purchase and cancellation of employee stock options .....	—	—	(320,000)	—	—	(320,000)
Net (loss).....	—	—	—	—	(1,114,317)	(1,114,317)
Balance, December 31, 2009 .....	16,169,739	\$16,170	\$20,007,430	\$(1,687,465)	\$ (769,801)	\$17,566,334

See Notes to Consolidated Financial Statements.

**DIGITAL ALLY, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 31, 2009 AND 2008**

	<u>2009</u>	<u>2008</u>
Cash Flows From Operating Activities:		
Net income (loss) .....	\$ (1,114,317)	\$ 3,353,630
Adjustments to reconcile net income (loss) to net cash flows used in operating activities:		
Depreciation and amortization .....	914,856	455,255
Stock based compensation .....	1,757,983	1,599,264
Reserve for inventory obsolescence .....	31,304	332,793
Reserve for bad debt allowance .....	34,066	61,776
Deferred tax (benefit) provision .....	(535,000)	(545,000)
Change in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable - trade .....	(2,190,113)	(5,781,071)
Accounts receivable - other .....	(61,873)	(202,489)
Inventories .....	958,152	(5,728,656)
Prepaid income taxes .....	85,943	(85,943)
Prepaid expenses .....	(7,007)	14,985
Other assets .....	13,392	(84,059)
Increase (decrease) in:		
Accounts payable .....	(791,024)	1,782,734
Accrued expenses .....	728,345	545,929
Income taxes payable .....	9,171	(26,000)
Customer deposits .....	(44,115)	(159,132)
Unearned income .....	—	(3,864)
Net cash used in operating activities .....	<u>(210,237)</u>	<u>(4,469,848)</u>
Cash Flows from Investing Activities:		
Purchases of furniture, fixtures and equipment .....	(539,772)	(1,290,887)
Additions to intangible assets .....	(31,075)	(383,976)
Net cash (used in) investing activities .....	<u>(570,847)</u>	<u>(1,674,863)</u>
Cash Flows from Financing Activities:		
Proceeds from exercise of stock options and warrants .....	261,399	2,374,972
Excess (deficiency) in tax benefits related to stock-based compensation .....	(120,000)	2,345,000
Purchase of common shares for treasury .....	(63,112)	(1,624,353)
Purchase of employee stock options .....	(320,000)	—
Net cash provided by (used in) financing activities .....	<u>(241,713)</u>	<u>3,095,619</u>
Decrease in cash and cash equivalents .....	(1,022,797)	(3,049,092)
Cash and cash equivalents, beginning of period .....	1,205,947	4,255,039
Cash and cash equivalents, end of period .....	<u>\$ 183,150</u>	<u>\$ 1,205,947</u>
Supplemental disclosures of cash flow information:		
Cash payments for interest .....	<u>\$ —</u>	<u>\$ —</u>
Cash payments for income taxes .....	<u>\$ 21,811</u>	<u>\$ 136,943</u>
Supplemental disclosures of non-cash investing and financing activities:		
Restricted common stock grant .....	<u>\$ 58,750</u>	<u>\$ —</u>
Common stock surrendered as consideration for exercise of stock options .....	<u>\$ 321,743</u>	<u>\$ 539,566</u>

See Notes to Consolidated Financial Statements.

**DIGITAL ALLY, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**Nature of Business:**

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

The Company was originally incorporated in Nevada on December 13, 2000 as Vegas Petra, Inc. and had no operations until 2004. On November 30, 2004, the Company entered into a Plan of Merger with Digital Ally, Inc., at which time the merged entity was renamed Digital Ally, Inc. Since inception through early 2006, the Company was considered a development stage company, with its activities focused on organizational activities, including design and development of product lines, implementing a business plan, establishing sales channels, and development of business strategies. In late March 2006, the Company shipped its first completed product, and became an operating company for financial accounting and reporting purposes.

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

**Basis of Consolidation:**

The accompanying financial statements include the consolidated accounts of the Company and its wholly-owned subsidiary, Digital Ally International, Inc. 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.

**Fair Value of Financial Instruments:**

The carrying amounts of financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and line of credit, are at approximate fair value because of the short-term nature of these items.

**Revenue Recognition:**

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

The Company sells through two separate and distinct channels:

- Sales to domestic customers are generally made direct to the end customer (typically a law enforcement agency) through commissioned third-party sales agents. Revenue is recorded when the product is shipped to the end customer.
- Sales to international customers are generally made through independent distributors who purchase the product from the Company at a wholesale price and sell to the end user (typically law enforcement agencies) at a retail price. The international distributor retains the margin as their compensation. The international distributor maintains product inventory, customer receivables and all related risks and rewards of ownership. Revenue is recorded when the product is shipped to the international distributor.

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

Other revenue is comprised of revenues from repair services, leasing services and the sale of scrap and excess raw material and component parts. Revenue is recognized upon shipment of the product and acceptance of the service or materials to the end customer.

Sales returns and allowances aggregated \$1,765,203 and \$143,715 for the years ended December 31, 2009 and 2008, respectively.

**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. Included in the Company’s cash and cash equivalents as of December 31, 2009 are short-term investments in repurchase agreements with its bank of approximately \$605,800, which is collateralized 105% by the pledge of government agency securities.

**Accounts Receivable:**

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

A trade receivable is considered to be past due if any portion of the receivable balance is outstanding for more than thirty (30) days beyond terms. No interest is charged on overdue trade receivables.

The allowance for doubtful accounts receivable was comprised of the following for the years ended December 31, 2009 and 2008:

	<u>December 31,</u> <u>2009</u>	<u>December 31,</u> <u>2008</u>
Beginning balance.....	\$ 90,000	\$28,224
Provision for bad debts.....	34,066	61,776
Charges-offs applied to allowance .....	(14,066)	-0-
Ending balance	<u>\$110,000</u>	<u>\$90,000</u>

**Inventories:**

Inventories consist of electronic parts, circuitry boards, camera parts and ancillary parts (collectively “components”), work-in-process and finished goods, and are carried at the lower of cost (First-in, First-out Method) or market value. The Company determines the estimate for the reserve for slow moving or obsolete inventories by regularly evaluating individual inventory levels, projected sales and current economic conditions.

**Furniture, fixtures and equipment:**

Furniture, fixtures and equipment is stated at cost net of accumulated depreciation. Additions and improvements are capitalized while ordinary maintenance and repair expenditures are charged to expense as incurred. Depreciation is recorded by the straight-line method over the estimated useful life of the asset, which ranges from 3 to 10 years.

**Intangible assets:**

Intangible assets include deferred patent costs and license agreements. Legal expenses incurred in preparation of patent application have been deferred and will be amortized over the useful life of granted patents. Costs incurred in preparation of applications that are not granted will be charged to expense at that time. The Company has entered into several sublicense agreements whereby it has been assigned the exclusive rights to certain licensed materials used in our products. These sublicense agreements generally require upfront payments to obtain the exclusive rights to such material. The Company capitalizes the upfront payments as intangible assets and amortizes such costs over their estimated useful life.

**Long-Lived Assets:**

Long-lived assets are reviewed for impairment annually or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. As of December 31 2009 and 2008, there was no impairment in the carrying value of long-lived assets.

**Warranties:**

The Company's products carry explicit product warranties that extend two years from the date of shipment. The Company records a provision for estimated warranty costs based upon historical warranty loss experience and periodically adjusts these provisions to reflect actual experience. Accrued warranty costs are included in accrued expenses.

**Customer deposits:**

The Company requires deposits in advance of shipment for certain customer sales orders, in particular when accepting orders from foreign customers for which the Company does not have a payment history. Customer deposits are reflected as a current liability in the accompanying balance sheet.

**Shipping and Handling Costs:**

Shipping and handling costs for outbound sales orders totaled \$103,136 and \$145,673 for the years ended December 31, 2009 and 2008, respectively. Such costs are included in selling, general and administrative expenses in the statements of operations.

**Advertising Costs:**

Advertising expense includes costs related to trade shows and conventions, promotional material and supplies, and media costs. Advertising costs are expensed in the period in which they are incurred. The Company incurred total advertising expense of approximately \$518,138 and \$576,926 for the years ended December 31, 2009 and 2008, respectively. Such costs are included in operating expenses in the statements of operations.

**Income Taxes:**

Deferred taxes are provided for by the liability method wherein deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

We have adopted the provisions of FASB ASC 740 "Income Taxes" that provides a framework for accounting for uncertainty in income taxes and provided a comprehensive model to recognize, measure, present, and disclose in our financial statements uncertain tax positions taken or expected to be taken on a tax return. We initially recognize tax positions in the financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are initially and subsequently measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the tax authority assuming full knowledge of the position and all relevant facts. Application requires numerous estimates based on available information. We consider many factors when evaluating and estimating our tax positions and tax benefits, and our recognized tax positions and tax benefits may not accurately anticipate actual outcomes. As we obtain additional information, we may need to periodically adjust our recognized tax positions and tax benefits. These periodic adjustments may have a material impact on our consolidated statements of operations.

The Company's policy is to record estimated interest and penalties related to the underpayment of income taxes as income tax expense in the Statements of Income. Interest expense aggregated \$-0- and \$652 related to the underpayment of estimated taxes during the year ended December 31, 2009 and 2008, respectively. There have been no penalties in 2009 and 2008.

**Research and Development Expenses:**

The Company expenses all research and development costs as incurred. Research and development expenses incurred for the years ended December 31, 2009 and 2008 were approximately \$3,603,696 and \$3,171,721, respectively.

**Stock-Based Compensation:**

The Company grants stock-based compensation to its employees, board of directors and certain third party contractors. Share-based compensation arrangements may include the issuance of options to purchase common stock in the future or the issuance of

restricted stock which generally are subject to vesting requirements. The Company records stock-based compensation expense for all stock-based compensation granted after January 1, 2006 based on the grant-date fair value calculated in accordance with the authoritative guidance issued by the FASB. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award.

The Company estimates the grant-date fair value of stock-based compensation using the Black-Scholes valuation model. Assumptions used to estimate compensation expense are determined as follows:

- Expected term is determined using the contractual term and vesting period of the award;
- Expected volatility of award grants made in the Company’s plan is measured using the weighted average of historical daily changes in the market price of the Company’s common stock over the period equal to the expected term of the award;
- Expected dividend rate is determined based on expected dividends to be declared;
- Risk-free interest rate is equivalent to the implied yield on zero-coupon U.S. Treasury bonds with a maturity equal to the expected term of the awards; and
- Forfeitures are based on the history of cancellations of awards granted and management’s analysis of potential forfeitures.

**Income per Share:**

In June 2008, the FASB issued authoritative guidance entitled “*Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*” (ASC 260-10-65-1). Under this guidance, unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of income (loss) per share pursuant to the two-class method for all periods presented. The two-class method is an income (loss) allocation formula that treats a participating security as having rights to undistributed income (loss) that would otherwise have been available to common shareholders. The Company’s service-based restricted stock awards contain non-forfeitable rights to dividends and are considered participating securities. The Company adopted this standard effective January 1, 2009; therefore, service-based restricted stock awards were included in the calculation of income (loss) per share using the two-class method for the years ended December 31, 2009 and 2008. Unvested service-based restricted shares totaled 25,000 and -0- at December 31, 2009 and 2008, respectively. Basic income (loss) per share is calculated by first allocating income (loss) between common shareholders and participating securities. Income (loss) attributable to common shareholders are divided by the weighted average number of common shares outstanding during the period. Diluted income (loss) per share is calculated by giving effect to dilutive potential common shares outstanding during the period. The dilutive effect of stock options is determined based on the treasury stock method. The dilutive effect of service-based restricted stock awards is based on the more dilutive of the treasury stock method or the two-class method assuming a reallocation of undistributed income (loss) to common shareholders after considering the dilutive effect of potential common shares other than the participating unvested restricted awards.

**Segments of Business:**

Management has determined that its operations are comprised of one reportable segment: the sale of portable digital video and audio recording devices. For the years ended December 31, 2009 and 2008, sales by geographic area were as follows:

	<b>Year Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
Sales by geographic area:		
United States of America.....	\$ 22,394,326	\$ 24,037,142
Foreign .....	3,971,297	8,588,335
	<u>\$ 26,366,253</u>	<u>\$ 32,625,477</u>

Sales to customers outside of the United States are denominated in US dollars. All Company assets are physically located within the United States.

**Reclassifications:**

Certain reclassifications have been made to the statement of operations for the year ended December 31, 2008 to conform them to their respective 2009 presentations with no effect on net income or stockholders’ equity.

## NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

Financial instruments that potentially subject the Company to concentrations of credit risk consist of accounts receivable. Sales are typically made on credit and the Company generally does not require collateral. The Company performs ongoing credit evaluations of its customers' financial condition and maintains an allowance for estimated losses. Uncollectible accounts are written off when deemed uncollectible and accounts receivable are presented net of an allowance for doubtful accounts. The allowance for doubtful accounts totaled \$110,000 and \$90,000 as of December 31, 2009 and December 31, 2008, respectively.

The Company sells primarily through a network of unaffiliated international distributors for foreign sales and independent sales agents for domestic sales. Three distributor/agents individually exceeded 10% and in the aggregate represented \$11,099,130, or 42% of total revenues for the year ended December 31, 2009. Three distributor/agents individually exceeded 10% and in the aggregate represented \$12,135,141, or 37% of total revenues for the year ended December 31, 2008.

One customer's receivable balance exceeded 10% of total accounts receivable as of December 31, 2009. This customer had an aggregate balance of \$3,355,800, or 40% of our total accounts receivable balance as of December 31, 2009 and such receivable balance was collateralized by a bank irrevocable letter of credit. Two individual customers' receivable balances each exceeded 10% of total accounts receivable as of December 31, 2008. These customers represented an aggregated balance of \$2,889,645, or 46% of total accounts receivable as of December 31, 2008.

The Company purchases finished circuit boards and other proprietary component parts from suppliers located in the United States and on a limited basis from Asia. Although the Company obtains certain of these components from single source suppliers, management has located or is in process of locating alternative suppliers to reduce the risk in most cases to supplier problems that could result in significant production delays. The Company has not historically experienced any significant supply disruptions from any of its principal vendors, and does not anticipate future supply disruptions. The Company acquires most of its components on a purchase order basis and does not have long-term contracts with its suppliers.

## NOTE 3. INVENTORIES

Inventories consisted of the following at December 31, 2009 and December 31, 2008:

	<b>December 31, 2009</b>	<b>December 31, 2008</b>
Raw material and component parts.....	\$3,915,440	\$4,783,730
Work-in-process .....	487,266	1,282,140
Finished goods .....	3,528,225	2,823,212
Subtotal.....	7,930,931	8,889,082
Reserve for excess and obsolete inventory .....	(560,426)	(529,121)
Total.....	<u>\$7,370,505</u>	<u>\$8,359,961</u>

Finished goods inventory includes units held by potential customers and sales agents for demonstration, test and evaluation purposes. The cost of such units totaled \$933,986 and \$273,017 as of December 31, 2009 and 2008, respectively.

## NOTE 4. FURNITURE, FIXTURES AND EQUIPMENT

Furniture, fixtures and equipment consisted of the following at December 31, 2009 and 2008:

	<b>Estimated Useful Life</b>	<b>2009</b>	<b>2008</b>
Office furniture, fixtures and equipment.....	3-10 years	\$1,594,568	\$1,409,787
Warehouse and production equipment.....	3-5 years	1,129,821	814,737
Tradeshow equipment .....	3-5 years	168,450	166,292
Leasehold improvements.....	2-5 years	74,460	55,575
Website development .....	3 years	11,178	11,178
Rental equipment .....	3 years	32,500	13,636
Total cost .....		3,010,977	2,471,205
Less: accumulated depreciation and amortization ...		(1,592,874)	(738,554)
Net furniture, fixtures and equipment.....		<u>\$1,418,103</u>	<u>\$1,732,651</u>

## NOTE 5. INTANGIBLE ASSETS

Intangible assets consisted of the following at December 31, 2009 and 2008:

	December 31, 2009			December 31, 2008		
	Gross value	Accumulated amortization	Net carrying value	Gross value	Accumulated amortization	Net carrying value
Amortized intangible assets:						
Licenses.....	\$255,000	\$78,869	\$176,131	\$256,000	\$18,333	\$237,667
Unamortized intangible assets:						
Patents and trademarks pending.....	160,051	—	160,051	127,976	—	127,976
Total .....	\$415,051	\$78,869	\$336,182	\$383,976	\$18,333	\$365,643

Patents and trademarks pending will be amortized beginning at the time they are issued by the appropriate authorities. If issuance of the final patent or trademark is denied, then the amount deferred will be immediately charged to expense.

Amortization expense for the years ended December 31, 2009 and 2008 was \$60,536 and \$18,333, respectively. Estimated amortization for intangible assets with definite lives for the next five years ending December 31 and thereafter is as follows:

### Year ending December 31:

2009 .....	\$ 85,000
2010 .....	66,667
2011 .....	24,464
2012 .....	—
2013 and thereafter.....	—
	\$176,131

## NOTE 6. PLEDGED ASSETS AND BANK LINE OF CREDIT

On February 3, 2010, the Company renewed its existing credit facility with a bank that provided available borrowings on a revolving basis to \$2,500,000. The line of credit is secured by eligible trade receivables, inventory and equipment and bears variable interest at the bank's prime rate (3.25% at December 31, 2009) minus 0.50%, with a floor of 5.50%. The line of credit agreement contains a covenant that requires the Company to maintain tangible net worth (as defined in the agreement and determined at quarter end) of \$15.0 million as of December 31, 2009 and at each calendar quarter end thereafter. The line of credit matures on April 13, 2010. As of December 31, 2009 and December 31, 2008, there were no amounts outstanding and there were no borrowings under the credit facility during the years ended December 31, 2010 and 2009.

Tangible net worth as defined in the credit agreement was in excess of \$17.0 million as of December 31, 2009, compared to the required minimum of \$15.0 million. The credit facility defines tangible net worth as the net book value of the Company's total assets, excluding total liabilities and intangible assets. Intangible assets is defined to include general intangibles, software (purchased or developed in-house); accounts receivable and advances due from officers, directors, employees stockholders and affiliates; leasehold improvements net of depreciation; licenses; goodwill; prepaid expenses; escrow deposits; covenants not to compete; the excess of cost over book value of acquired assets; franchise fees; organizational costs; finance reserves held for recourse obligations capitalized research and development costs; and the capitalized costs of patents, trademarks, service marks, and copyrights net of amortization.

## NOTE 7. ACCRUED EXPENSES

Accrued expenses consisted of the following at December 31, 2009 and 2008:

	December 31, 2009	December 31, 2008
Accrued warranty expense .....	\$277,137	\$271,307
Accrued sales commissions.....	933,402	197,777
Accrued payroll and related fringes .....	343,046	395,635
Employee separation agreement .....	182,661	—
Other .....	45,723	188,905
	\$1,781,969	\$1,053,624

Accrued warranty expense was comprised of the following for the years ended December 31, 2009 and 2008:

	<u>December 31,</u> <u>2009</u>	<u>December 31,</u> <u>2008</u>
Beginning balance.....	\$271,307	\$213,428
Provision for warranty expense.....	296,681	209,293
Charges applied to warranty reserve .....	(290,851)	(151,414)
Ending balance	<u>\$277,137</u>	<u>\$271,307</u>

#### NOTE 8. INCOME TAXES

The components of income tax (provision) benefit are as follows:

	<u>2009</u>	<u>2008</u>
Current taxes:		
Federal .....	\$126,500	\$(2,180,000)
State .....	(21,500)	(190,000)
Total current taxes .....	<u>105,000</u>	<u>(2,370,000)</u>
Deferred tax (provision) benefit .....	535,000	545,000
Income tax (provision) benefit .....	<u>\$640,000</u>	<u>\$(1,825,000)</u>

The Company received total proceeds of \$261,399 and \$2,914,538 during the years ended December 31, 2009 and 2008, respectively, from the exercise of stock purchase options and warrants. The Company realized an aggregate tax deduction approximating \$288,350 and \$6,992,000 relative to the exercise of such stock options during the years ended December 31, 2009 and 2008, respectively. During April 2009, the Company repurchased and cancelled outstanding vested and unvested options from a former employee to acquire a total of 950,000 shares of common stock for approximately \$320,000. The repurchase/cancellation of these stock options resulted in a net deficiency compared to the net deferred tax benefit previously recorded. The related deficiency in tax benefits aggregated \$120,000 for the year ended December 31, 2009 and the excess tax benefits aggregated \$2,345,000 for the year ended December 31, 2008, which has been allocated directly to additional paid in capital.

A reconciliation of the income tax (provision) benefit at the statutory rate of 34% for the years ended December 31, 2009 and 2008 to the Company's effective tax rate is as follows:

	<u>2009</u>	<u>2008</u>
U.S. Statutory tax rate.....	34.0%	(34.0)%
State taxes, net of Federal benefit.....	4.0%	(4.0)%
Research and development tax credits.....	10.3%	3.2%
Incentive stock option compensation .....	(9.7)%	(1.7)%
Other, net .....	(2.1)%	1.3%
Income tax (provision) benefit .....	<u>36.5%</u>	<u>(35.2)%</u>

Significant components of the Company's deferred tax assets (liabilities) as of December 31, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Deferred tax assets:		
Stock-based compensation .....	\$ 1,422,000	\$ 1,262,000
Start-up costs .....	165,000	165,000
Inventory reserves .....	211,000	196,000
Uniform capitalization of inventory costs .....	18,000	31,000
Allowance for doubtful accounts receivable .....	42,000	33,000
Other reserves .....	105,000	—
Accrued expenses .....	138,000	178,000
Net operating loss carryforward .....	356,000	362,000
Research and development tax credit carryforward .....	595,000	413,000
Alternative minimum tax credit carryforward .....	92,000	90,000
State jobs credit carryforward .....	65,000	42,000
Other .....	5,000	—
	<hr/>	<hr/>
Total deferred tax assets .....	3,214,000	2,772,000
Valuation allowance .....	(165,000)	(165,000)
	<hr/>	<hr/>
Net deferred tax assets .....	3,049,000	2,607,000
Deferred tax liabilities:		
Equipment depreciation .....	(194,000)	(287,000)
	<hr/>	<hr/>
Net deferred tax assets (liability) .....	<u>\$ 2,855,000</u>	<u>\$ 2,320,000</u>
Net deferred tax asset (liability) reported as:		
Current .....	\$ 1,695,000	\$ 1,345,000
Non-current .....	\$ 1,160,000	\$ 975,000

The valuation allowance on deferred tax assets totaled \$165,000 as of December 31, 2009 and 2008 and represents start-up costs that are not amortizable under current income tax rules and are only deductible upon dissolution of the Company. Management believes it is unlikely that such start-up costs will be deductible in the foreseeable future and therefore has provided a 100% reserve on the related deferred tax asset.

At December 31, 2009, the Company had available approximately \$945,000 of net operating loss carryforwards available to offset future taxable income generated. Such tax net operating loss carryforwards expire between 2024 and 2028. In addition, the Company had research and development tax credit carryforwards totaling \$595,000 available as of December 31, 2009, which expire between 2023 and 2029. Management will continue to evaluate the likelihood of realizing the benefits of the net deferred tax assets (including the net operating tax loss and research and development credit carryforwards), and will adjust the valuation allowance accordingly.

The Internal Revenue Code contains provisions under Section 382 which limit a company's ability to utilize net operating loss carry-forwards in the event that it has experienced a more than 50% change in ownership over a three-year period. Current estimates prepared by the Company indicate that due to ownership changes which have occurred, approximately \$765,000 of its net operating loss and \$175,000 of its research and development tax credit carryforwards are currently subject to an annual limitation of approximately \$1,151,000, but may be further limited by additional ownership changes which may occur in the future. As stated above, the net operating loss and research and development credit carryforwards expire between 2024 and 2028, allowing the Company to potentially utilize all of the limited net operating loss carry-forwards during the carryforward period.

As discussed in Note 1, "Summary of Significant Accounting Policies," tax positions are evaluated in a two-step process. We first determine whether it is more likely than not that a tax position will be sustained upon examination. If a tax position meets the more-likely-than-not recognition threshold, it is then measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. Management has identified no tax positions taken that would meet or exceed these thresholds and therefore there are no gross interest, penalties and unrecognized tax expense/benefits that are not expected to ultimately result in payment or receipt of cash in the consolidated financial statements.

The Company's federal and state income tax returns are closed for examination purposes by relevant statute for 2005 and all prior tax years.

**NOTE 9. COMMITMENTS AND CONTINGENCIES**

**Lease commitments.** The Company has several non-cancelable operating lease agreements for office space and warehouse space. The agreements expire at various dates through October 2012. The Company also has entered into month-to-month leases. Rent expense for the years ended December 31, 2009 and 2008 was \$390,196 and \$375,321, respectively, related to these leases. The future minimum amounts due under the leases are as follows:

<b>Year ending December 31:</b>	
2010 .....	\$ 265,565
2011 .....	169,086
2012 .....	126,815
2013 .....	—
2014 and thereafter .....	—
	\$ 561,466

**License agreements.** The Company has several license agreements whereby it has been assigned the rights to certain licensed materials used in its products. Certain of these agreements require the Company to pay ongoing royalties based on the number of products shipped containing the licensed material on a quarterly basis. Royalty expense related to these agreements aggregated \$16,903 and \$38,646 for the years ended December 31, 2009 and 2008, respectively.

Following is a summary of the Company’s licenses as of December 31, 2009:

<b>License Type</b>	<b>Effective Date</b>	<b>Expiration Date</b>	<b>Terms</b>
Production software license agreement	April, 2005	April, 2010	Automatically renews for one year periods unless terminated by either party.
Software sublicense agreement	October, 2007	October, 2010	Automatically renews for one year periods unless terminated by either party.
Technology license agreement	July, 2007	July, 2010	Automatically renews for one year periods unless terminated by either party.
Limited license agreement	August, 2008	Perpetual	May be terminated by either party.

During April 2009, the Company terminated a production license agreement, entered into in October 2008 and terminated its production software license agreement, entered into during October 2008 because of failure of the counter party to deliver the required materials and refusal to honor warranty provisions. Both of these terminations are now in dispute and the Company has filed a lawsuit to enforce its rights and protect its interests pursuant to these agreements. See “Litigation” below.

**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 any 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 April 9, 2008, Thomas DeHuff filed suit against the Company and Charles A. Ross in the Chancery Court of Lincoln County, Mississippi. Charles A. Ross, Jr. (“Ross”) is the son of Charles A. Ross and was a former officer and director of the Company. The complaint alleges that on or about April 8, 2005, the plaintiff entered into a verbal agreement with Ross, whom the plaintiff maintains was acting for and on behalf of the Company, under which he purportedly was to receive 150,000 shares of the Company’s common stock to resolve certain claims to compensation the plaintiff maintains was due from the Company. The lawsuit also claims that the plaintiff advanced funds to Ross, believing that he was purchasing the Company’s common stock, which was never issued. Plaintiff is seeking unspecified damages, punitive damages and attorney fees in addition to requiring the Company to issue the common shares. The Company has successfully removed the case from the Chancery Court of Lincoln County, Mississippi to the United States District Court located in Jackson Mississippi and the trial date is set for May 2010. The Company believes that the lawsuit is without merit and will continue to vigorously defend itself.

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 has paid license fees and made other payments to Z3 totaling \$265,000 to-date relative to 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 contract and therefore Z3 has been damaged for loss of profits and related damages. Discovery and depositions by both parties have commenced.

On October 23, 2009, the Circuit Court of Jackson County, Missouri awarded the Company an interlocutory judgment against a previous contract manufacturer for the Company. 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 recorded a benefit of approximately \$72,000 during the year ended December 31, 2009 representing the amount of unpaid invoices to the supplier which it is no longer obligated to pay. The Company has submitted damage claims in excess of \$11 million against the supplier relative to this lawsuit. The Company received a Notice of the filing of bankruptcy under Chapter 7 effective October 26, 2009 by this supplier. This filing has stayed any further action by the Company in court regarding the award of its claimed damages. 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 and the bankruptcy proceedings.

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.

**Vendor Settlements and Credits.** The Company resolved a dispute with a vendor during August 2009 that resulted in an aggregate benefit to the Company of \$278,173. The Company disputed the value of services and products delivered and invoiced to the Company. The dispute was resolved through mediation prior to the filing of a lawsuit and resulted in the Company receiving a cash settlement of \$200,000, plus the cancellation of \$78,173 of invoices payable to this vendor. The Company recognized an aggregate benefit of \$278,173 during the year ended December 31, 2009, which was reflected as an offset to selling, general and administrative expenses.

**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 \$154,099 and \$65,208 for the years ended December 31, 2009 and 2008, 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 authorizes 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 repurchases, if and when made, will be subject to market conditions, applicable rules of the Securities and Exchange Commission and other factors. The repurchase program will be funded using a portion of cash and cash equivalents, along with cash flow from operations. Purchases may be commenced, suspended or discontinued at any time. The Company repurchased 38,250 shares for an aggregate purchase price of \$63,112 (average cost of \$1.65 per share) during the year ended December 31, 2009. In total, the Company has repurchased 248,610 shares at a total cost of \$1,687,465 (average cost of \$6.79 per share) under this program as of December 31, 2009.

**Standby Letters of Credit.** The Company is contingently liable for standby letters of credit issued by its bank to certain customers as security for the performance by the Company under contracts to deliver products. Outstanding letters of credit totaled \$201,348 as of December 31, 2009, which expire during March 2012. To date, no beneficiary has drawn upon the standby-by letters of credit.

#### **NOTE 10. STOCK-BASED COMPENSATION**

The Company recorded pretax compensation expense related to the grant of stock options and restricted stock issued of \$1,399,879 and \$1,599,264 for the years ended December 31, 2009 and 2008, respectively.

As of December 31, 2009, the Company has adopted four separate stock-based option plans: (i) the 2005 Stock Option and Restricted Stock Plan (the "2005 Plan"), (ii) the 2006 Stock Option and Restricted Stock Plan (the "2006 Plan"), (iii) the 2007 Stock Option and Restricted Stock Plan (the "2007 Plan"), and (iv) the 2008 Stock Option and Restricted Stock Plan (the "2008 Plan"). These Plans permit the grant of share options to its employees, non-employee directors and others for up to an aggregate total of 6,500,000 shares of common stock. The Company believes that such awards better align the interests of its employees with those of its shareholders. Option awards have been granted with an exercise price equal to the market price of the Company's stock at the date of grant with such option awards generally vesting based on the completion of continuous service and having 10-year contractual

terms. These option awards provide for accelerated vesting if there is a change in control (as defined in the Plans). In July 2008, the Company registered all 6,500,000 shares of common stock that are issuable under its 2005 Plan, 2006 Plan, 2007 Plan and 2008 Plan. A total of 600,312 options remain available for grant under the various Plans as of December 31, 2009.

In addition to the Stock Option and Restricted Stock Plans described above, the Company has issued an aggregate of 430,000 stock options to non-employees for services rendered that are subject to the same general terms.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model. The assumptions used for the determining the grant-date fair value of options during each period and are reflected in the following table:

	<b>Years ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
Expected term of the options in years .....	2-5 years	2-6 years
Expected volatility of Company stock .....	76% - 86%	50% - 55%
Expected dividends.....	None	None
Risk-free interest rate .....	0.84% - 2.66%	2.37%-3.06%
Expected forfeiture rate .....	5.00%	5.00%

A summary of stock options outstanding follows:

<b>Options</b>	<b>Year Ended December 31, 2009</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding at January 1, 2009 .....	5,369,627	\$2.62
Granted .....	695,000	2.06
Exercised.....	(218,662)	1.70
Exercised and surrendered/cancelled (cashless exercise)	(154,239)	1.37
Forfeited.....	(1,023,000)	2.22
Outstanding at December 31, 2009.....	<u>4,668,726</u>	<u>\$2.71</u>
Exercisable at December 31, 2009.....	<u>3,334,892</u>	<u>\$2.00</u>
Weighted-average fair value for options granted during the period at fair value.....	<u>695,000</u>	<u>\$1.15</u>

The Company's 2005 Plan, 2006 Plan, 2007 Plan and 2008 Plan allow for the cashless exercise of stock options. This provision allows the option holder to surrender/cancel options with an intrinsic value equivalent to the purchase/exercise price of other options exercised. During the year ended December 31, 2009, a total of 154,239 options with an intrinsic value of \$110,273 were exercised and the underlying common stock was concurrently surrendered and cancelled as consideration for the cashless exercise price of 83,262 shares issued upon the exercise of stock options.

During April 2009, the Company repurchased and cancelled outstanding stock options from a former employee to acquire a total 950,000 shares (included in forfeited options in the above table) for total consideration of approximately \$320,000. These stock options included both vested and unvested options and resulted in the immediate recognition of \$358,104 in compensation expense related to unvested stock options during the year ended December 31, 2009. The repurchase price of \$320,000 was charged directly to additional paid-in capital. In addition, the resulting deficiency in income tax deductions approximated \$120,000, which was also charged directly to additional paid-in capital during year ended December 31, 2009.

At December 31, 2009, the aggregate intrinsic value of options outstanding was approximately \$1,633,937, the aggregate intrinsic value of options exercisable was approximately \$1,492,688, and the aggregate intrinsic value of options exercised during the year ended December 31, 2009 was \$288,350.

As of December 31, 2009, the unamortized portion of stock compensation expense on all existing stock options was \$1,742,027, which will be recognized over the next forty-eight months.

The following table summarizes the range of exercise prices and weighted average remaining contractual life for outstanding and exercisable options under the Company's option plans as of December 31, 2009:

Exercise price range	Outstanding options		Exercisable options	
	Number of options	Weighted average remaining contractual life	Number of options	Weighted average remaining contractual life
\$1.00 to \$1.99.....	2,272,805	6.8 years	1,850,471	6.1 years
\$2.00 to \$2.99.....	1,136,421	2.3 years	1,053,921	1.8 years
\$3.00 to \$3.99.....	210,000	8.1 years	56,000	3.9 years
\$4.00 to \$4.99.....	254,500	7.8 years	254,500	7.8 years
\$5.00 to \$5.99.....	—	—	—	—
\$6.00 to \$6.99.....	755,000	8.0 years	80,000	8.0 years
\$7.00 to \$7.99.....	—	—	—	—
\$8.00 to \$8.99.....	30,000	6.7 years	30,000	6.7 years
\$9.00 to \$9.99.....	10,000	3.6 years	10,000	3.6 years
	<u>4,668,726</u>	<u>6.6 years</u>	<u>3,334,892</u>	<u>4.9 years</u>

*Restricted stock grants.* The Board of Directors has granted restricted stock awards under the Plans. Restricted stock awards are valued on the date of grant and have no purchase price. Restricted stock awards typically vest over four years in increments on the first (10%), second (20%), third (30%) and fourth (40%) anniversaries of the grant date. Under the Plans, unvested shares of restricted stock awards may be forfeited upon the termination of service to or employment with the Company, depending upon the circumstances of termination. Except for restrictions placed on the transferability of restricted stock, holders of unvested restricted stock have full stockholder's rights, including voting rights and the right to receive cash dividends.

A summary of all restricted stock activity under the equity compensation plans for the nine months ended December 31, 2009 is as follows:

	Restricted stock	Weighted average grant date fair value
Nonvested balance, January 1, 2009.....	—	\$ —
Granted .....	25,000	2.35
Vested.....	—	—
Forfeited .....	—	—
Nonvested balance, December 31, 2009 .....	<u>25,000</u>	<u>\$ 2.35</u>

During 2009, the Company granted 25,000 shares of restricted stock to a non-employee director pursuant to a restricted stock agreement. The grant consisted of 25,000 shares that vest on a graduated scale over four years in increments on the first (10%),

second (20%), third (30%) and fourth (40%) anniversaries of the grant date. The Company estimated the fair market value of this restricted stock grant at \$58,750 based on the closing market price on the date of grant (\$2.35 per share). As of December 31, 2009, there was \$44,671 of total unrecognized compensation costs related to the non-vested restricted stock grant, which will be amortized over the next 42 months in accordance with the graduated vesting scale.

#### NOTE 11. NET INCOME (LOSS) PER SHARE

The calculation of the weighted average number of shares outstanding and income (loss) per share outstanding and income per share for the year ended December 31, 2009 and 2008 are as follows:

	Years Ended December 31,	
	2009	2008
Numerator for basic and diluted income per share – Net income (loss).....	<u>\$(1,114,317)</u>	<u>\$3,353,630</u>
Denominator for basic income (loss) per share – weighted average shares outstanding.....	15,797,991	15,319,257
Dilutive effect of shares issuable under stock options and warrants outstanding.....	—	2,189,834
Denominator for diluted income (loss) per share – adjusted weighted average shares outstanding.....	<u>15,797,991</u>	<u>17,509,091</u>
Net income (loss) per share:		
Basic.....	<u>\$(0.07)</u>	<u>\$0.22</u>
Diluted.....	<u>\$(0.07)</u>	<u>\$0.19</u>

Basic income (loss) per share is based upon the weighted average number of common shares outstanding during the year. For the year ended December 31, 2009, all outstanding stock options to purchase common stock were antidilutive and, therefore, not included in the computation of diluted income (loss) per share. For the year ended December 31, 2008 weighted-average outstanding stock options and warrants totaling 921,667 and 59,359, respectively, of common stock were antidilutive and, therefore, not included in the computation of diluted income (loss) per share.

#### NOTE 12. RELATED PARTY TRANSACTIONS

The Company sells primarily through a network of unaffiliated distributors/sales agents. An entity that previously served as an independent sales agent was owned by the spouse of one of the Company’s executive officers. The Company paid commissions during 2008 aggregating \$36,602 on sales generated by this sales agent prior to January 1, 2008. Subsequent to December 31, 2007, this entity was dissolved and no longer serves as an independent sales agent for the Company.

#### NOTE 13. RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2007 new guidance was issued for the recognition and measurement of assets, liabilities and equity in business combinations. This guidance is found in ASC Topic 805, *Business Combinations* (“ASC 805”), and was effective for us as of January 1, 2009. Due to these new guidelines, we now expense, as incurred, acquisition-related costs for potential and completed acquisitions. This guidance also requires the recognition of changes in an acquirer’s income tax valuation allowance on deferred taxes and acquired tax contingencies associated with acquisitions that closed prior to the effective date of the guidance to apply the new provisions. The Company has completed no acquisitions during 2008 and 2009 therefore this new guidance had no impact on our financial statements.

In December 2007 new guidance was issued that changed the way in which noncontrolling interests in subsidiaries are measured and classified on the balance sheet. These provisions are contained in ASC Topic 810, *Consolidations* (“ASC 810”) and were effective for us as of January 1, 2009. The adoption of these new guidelines had no impact on our consolidated financial position or results of operations.

In February 2008, new guidance was issued that delayed the effective date of certain fair value guidance for nonfinancial assets and nonfinancial liabilities contained in ASC Topic 820, *Fair Value Measurements and Disclosures* (“ASC 820”), except for

items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of this guidance, which was effective as of January 1, 2009, did not have a material impact on our financial position, results of operations, or cash flows.

In March 2008 new guidance was issued that changed the disclosure requirements for derivative instruments and hedging activities. This guidance can be found in ASC Topic 815, *Derivatives and Hedging* (“ASC 815”) and was effective for us as of January 1, 2009. The adoption of these new guidelines had no impact on our consolidated financial position or results of operations.

In April 2008 new guidance was issued on determining the useful life of a recognized intangible asset. These provisions, the detail of which can be found in ASC Topic 350, *Intangibles — Goodwill and Other* (“ASC 350”) and ASC Topic 275, *Risks and Uncertainties* (“ASC 275”), were effective for us as of January 1, 2009, and had no impact on our consolidated financial position or results of operations as we did not renew or extend the useful lives of any of our intangible assets.

In June 2008 new guidance was issued that clarified that share-based payment awards that entitle their holders to receive non-forfeitable dividends or dividend equivalents before vesting should be considered participating securities, and requires them to be included in the computation of earnings per share pursuant to the two-class method. This guidance is contained in ASC Topic 260, *Earnings per Share* (“ASC 260”) and was effective for us as of January 1, 2009, with the requirement that all prior period income per share data presented to be adjusted retroactively. We have determined that nonvested share awards that were granted in the second quarter of 2009 are participating securities as defined by this guidance because they have equivalent common stock dividend rights. Accordingly, we have included these shares in our basic and diluted share calculations as appropriate. There is no prior period impact of this guidance as there were no participating securities outstanding prior to 2009.

In June 2008 the Financial Accounting Standards Board (“FASB”) ratified the consensus reached by the Emerging Issues Task Force (“EITF”) on three issues discussed at its June 12, 2008 meeting pertaining to how an entity should evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock, including evaluating the instrument’s contingent exercise and settlement provisions; how the currency in which the strike price of an equity-linked financial instrument (or embedded feature) is denominated affects the determination of whether the instrument is indexed to an entity’s own stock; and how the issuer should account for market-based employee stock option valuation. This guidance can be found in ASC 815, and did not have an impact on our consolidated financial position.

In April 2009 new guidance was issued that addressed application issues raised by preparers, auditors, and members of the legal profession on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. This guidance can be found in ASC 805 and was effective for us for any business combinations completed on or after January 1, 2009. The adoption of this guidance had no impact on us.

In April 2009 new guidance was issued that required disclosure about the fair value of financial instruments in interim as well as in annual financial statements. These standards were effective for periods ending after June 15, 2009 and can be found in ASC Topic 825, *Financial Instruments* (“ASC 825”). The adoption of this guidance had no impact on us.

In May 2009 new guidance was issued that established general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This guidance requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. This guidance was effective for reporting periods ending after June 15, 2009 and can be found in ASC Topic 855, *Subsequent Events* (“ASC 855”). The disclosures required by this guidance are included in Note 12.

In June 2009 new guidance was issued that identified the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States, commonly referred to as the Accounting Standards Codification. This guidance was effective for periods ending after September 15, 2009, and the appropriate references to accounting guidance have been incorporated into this Form 10-K.

#### **NOTE 14. SUBSEQUENT EVENTS**

During the period from January 1, 2010 through March 22, 2010, the Company issued a total of 330,000 shares pursuant to the exercise of outstanding stock purchase options.

On January 4, 2010, the Company issued 250,869 restricted shares of common stock to directors and officers. Directors received 67,475 of these restricted shares that will vest on May 4, 2010 and officers received 183,394 which vest on January 4, 2011 assuming that they are employed by the Company at that date.

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