Vaughan Foods, Inc.
Form 10-Q
August 12, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to

Commission file number 001-33446

VAUGHAN FOODS, INC.

(Exact name of registrant as specified in its charter)

Oklahoma	**73-1342046**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
216 N.E. 12th Street, Moore, OK	**73160**
(Address of principal executive offices)	(Zip Code)

(405) 794-2530
(Registrants telephone number, including area code)

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

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

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

Number of shares outstanding of the registrant's common stock, as of August 12, 2008:

Class	Shares Outstanding
Common Stock, $0.001 par value per share	4,623,077

VAUGHAN FOODS, INC.
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For the Quarterly Period Ended June 30, 2008
INDEX

	Page
PART I FINANCIAL INFORMATION	3
Item 1. Financial Statements	3
Consolidated Balance Sheets as of June 30, 2008 (unaudited), and December 31, 2007	4
Unaudited Consolidated Statements of Operations for the Three Months and Six Months Ended June 30, 2008 and 2007	5
Consolidated Statements of Stockholders Equity (Deficiency) for the Year Ended December 31, 2007 and Six Months Ended June 30, 2008 (unaudited)	6
Unaudited Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2008 and 2007	7
Notes to Unaudited Consolidated Financial Statements	8
Item 2. Managements Discussion and Analysis of Financial Condition and Results of Operations	22
Item 3. Quantitative and Qualitative Disclosures about Market Risk	25
Item 4. Controls and Procedures	26
PART II OTHER INFORMATION	26
Item 1. Legal Proceedings	26
Item 1A. Risk Factors	26
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	26
Item 3. Defaults Upon Senior Securities	27
Item 4. Submission of Matters to Security Holders	27
Item 5. Other Information	27
Item 6. Exhibits	28
SIGNATURES	29

INDEX TO EXHIBITS 30

Certification Pursuant to 18 U.S.C. Section 1350

PART 1 — FINANCIAL INFORMATION

ITEM 1 — FINANCIAL STATEMENTS.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders
Vaughan Foods, Inc. and Subsidiaries

We have reviewed the accompanying consolidated balance sheet of Vaughan Foods, Inc. and subsidiaries (the "Company") as of June 30, 2008, and the related consolidated statements of operations for the three-month and six-month periods ended June 30, 2008 and 2007, and the consolidated statements of cash flows for the six-month periods ended June 30, 2008 and 2007, and the consolidated statements of changes in stockholders' equity for the six-month period ended June 30, 2008. These consolidated financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board, the balance sheet of the Company as of December 31, 2007, and the related statements of operations and cash flows (not presented herein), and stockholders' equity, for the year then ended; and in our report dated March 12, 2008, we expressed an unqualified opinion on those financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2007, and the accompanying statement of stockholders' equity for the year ended December 31, 2007, are fairly stated, in all material respects, in relation to the financial statements from which they have been derived.

Oklahoma City, Oklahoma
August 11, 2008

VAUGHAN FOODS, INC.
Consolidated Balance Sheets
June 30, 2008 & December 31, 2007

	June 30, 2008 (unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 698,254	$ 2,698,474
Accounts receivable, net of allowance for credit losses of $138,477 at June 30, 2008 and $173,561 at December 31, 2007	6,834,167	5,980,293
Inventories	3,849,761	2,846,054
Prepaid expenses and other assets	209,162	119,049
Deferred tax assets	52,621	40,264
Total current assets	11,643,965	11,684,134
Restricted assets:		
Cash	286	283
Investments	754,196	708,298
Total restricted assets	754,482	708,581
Property and equipment, net	16,787,602	16,569,195
Other assets:		
Loan origination fees, net of amortization	364,171	377,045
Intangible assets	231,860	714,921
Deferred tax assets, noncurrent	831,198	393,193
Total other assets	1,427,229	1,485,159
Total assets	$ 30,613,278	$ 30,447,069
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 8,111,851	$ 4,940,968
Short-term borrowings	-	1,000,000
Note payable to former owners of Allisons Gourmet Kitchens, LP	802,500	1,000,000
Accrued liabilities	1,887,479	1,889,346
Current portion of long-term debt	1,011,793	865,062
Current portion of capital lease obligation	196,345	189,364
Amounts payable to former owners of Wild About Food	16,291	221,370
Total current liabilities	12,026,259	10,106,110

Long term liabilities:		
Long-term debt, net of current portion	8,688,061	9,146,110
Capital lease obligation, net of current portion	198,224	297,062
Deferred gain on sale of assets	97,398	-
Amounts payable to former owners of Wild About Food, net of current portion	-	250,000
Total long-term liabilities	8,983,683	9,693,172
Stockholders' equity:		
Common stock, $0.001 par value; authorized 50,000,000 shares; 4,623,077 shares issued and outstanding at June 30, 2008 and December 31, 2007	4,623	4,623
Preferred stock, $0.001 par value; authorized 5,000,000 shares; 0 shares issued and outstanding at June 30, 2008 and December 31, 2007	-	-
Paid in Capital	12,563,803	12,563,803
Member Capital	-	80,167
Retained Earnings (deficit)	(2,965,090)	(2,000,806)
Total stockholders' equity	9,603,336	10,647,787
Total liabilities and stockholders' equity	$ 30,613,278	$ 30,447,069

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

VAUGHAN FOODS, INC.
Unaudited Consolidated Statements of Operations
For the Three and Six Months Ended June 30, 2008 and 2007

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net sales	$ 24,423,914	$ 13,945,725	$ 45,253,189	$ 26,478,941
Cost of sales	22,618,327	12,858,724	41,408,175	24,005,232
Gross profit	1,805,587	1,087,001	3,845,014	2,473,709
Selling, general and administrative expenses	2,489,928	969,755	4,903,803	1,803,200
Operating income (loss)	(684,341)	117,246	(1,058,789)	670,509
Rent income	-	124,624	-	219,805
Interest expense	(224,580)	(777,932)	(403,389)	(1,396,967)
Gain (loss) on sale of asset	17,930	(21,486)	17,930	(21,486)
Interest income	8,814	13,543	29,602	24,518
Other income and expense, net	(197,836)	(661,251)	(355,857)	(1,174,130)
Net income (loss) before income taxes	(882,177)	(544,005)	(1,414,646)	(503,621)
Income tax expense (benefit)	(335,863)	(97,633)	(450,362)	54,115
Net income (loss)	$ (546,314)	$ (446,372)	$ (964,284)	$ (557,736)
Weighted average shares outstanding - basic and diluted	4,623,077	2,300,000	4,623,077	2,300,000
Net income (loss) per share - basic and diluted	$ (0.12)	$ (0.19)	$ (0.21)	$ (0.24)

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

VAUGHAN FOODS, INC.
Unaudited Consolidated Statements of Stockholders' Equity
For the Year Ended December 31, 2007 and the Six Months Ended June 30, 2008

	Common Stock					Total
	Shares issued	Amount	Paid in Capital	Member Capital (Deficit)	Retained Earnings (Deficit)	Stockholders' Equity (Deficiency)
Balance at January 1, 2007	2,300,000	2,300	$ 413,693	$ (22,921)	$ (991,642)	$ (598,570)
Issuance of common stock in connection with intitial public offering	2,150,000	2,150	11,025,283	-	-	11,027,433
Issuance of common stock in connection with bridge funding liability	173,077	173	1,124,827	-	-	1,125,000
Net income (loss)	-	-	-	103,088	(1,009,164)	(906,076)
Balance at December 31, 2007	4,623,077	4,623	12,563,803	80,167	(2,000,806)	10,647,787
Exclusion of previously consolidated variable interest entity (See Note 19) (unaudited)	-	-	-	(80,167)	-	(80,167)
Net (loss) (unaudited)	-	-	-	-	(964,284)	(964,284)
Balance at June 30, 2008 (unaudited)	4,623,077	$ 4,623	$ 12,563,803	$ -	$ (2,965,090)	$ 9,603,336

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

VAUGHAN FOODS, INC.
Unaudited Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2008 and 2007

	Six Months Ended June 30, 2008 (unaudited)	2007 (unaudited)
Cash flows from operating activities:		
Net (loss)	$ (964,284)	$ (557,736)
Adjustments to reconcile net (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	882,181	1,235,912
Provision for credit losses	(32,519)	(2,605)
(Gain) loss on sale of asset	(17,930)	21,486
Deferred income taxes	(450,362)	54,115
Changes in operating assets and liabilities:		
Accounts receivable	(821,355)	(746,933)
Accounts receivable - related party	-	(210,085)
Inventories	(1,003,707)	(96,049)
Prepaid expenses and other assets	(90,113)	(58,775)
Accounts payable	3,170,883	776,225
Accounts payable, related party	-	(32,703)
Accrued liabilities	(1,867)	630,346
Net cash provided by operating activities	670,927	1,013,198
Cash flows from investing activities:		
Purchases of property and equipment	(1,586,919)	(685,326)
Investments in Restricted assets	(45,901)	(216,785)
Proceeds from sale of assets	692,600	18,514
Cash acquired in acquisition	-	222,411
Deconsolidation of variable interest entity	(80,167)	-
Net cash (used by) investing activities	(1,020,387)	(661,186)
Cash flows from financing activities:		
Cash paid for deferred public offering expense	-	(495,473)
Payments of loan origination fees	(5,086)	-
Repayment of long-term debt and capital leases	(403,174)	(253,391)
Repayments of notes payable to former owners of Allison's Gourmet Kitchens, LP	(197,500)	-
Cash paid to former owners of Wild About Food	(45,000)	-
Repayments of short-term borrowings	(1,000,000)	-
Net cash (used by) financing activities	(1,650,760)	(748,864)
Net (decrease) in cash and cash equivalents	(2,000,220)	(396,852)
Cash and cash equivalents at beginning of period	2,698,474	868,377

Cash and cash equivalents at end of period	$	698,254	$	471,525
Supplemental disclosures of cash flow information:				
Cash paid during the period for:				
Interest paid, net of capitalized interest	$	424,699	$	307,758
Supplemental disclosures of noncash financing and investing activities:				
Decrease in amounts payable to former owners of Wild About Food				
due to net loss incurred by Wild	$	410,078	$	-
Fair value of assets acquired and liabilities assumed in acquisition:				
Accounts receivable	$	-	$	2,054,514
Inventories		-		1,724,940
Prepaids		-		25,044
Property and equipment		-		3,354,543
Intangible assets		-		872,569
Total assets acquired		-		8,031,610
Accounts payable and accrued expenses		-		3,770,987
Long-term debt and capital leases		-		1,983,034
Total liabilities assumed	$	-	$	5,754,021

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

Vaughan Foods, Inc.
Notes to Unaudited Consolidated Financial Statements
June 30, 2008 and 2007

(1) Nature of Operations

Vaughan Foods, Inc. (the Company) is an Oklahoma-based specialty food processor serving customers in a multi-state region. The Company and its subsidiaries operate from manufacturing facilities in Moore, Oklahoma and Fort Worth, Texas.

(2) Summary of Significant Accounting Policies

(a) Basis of Reporting

The accompanying consolidated financial statements and notes thereto have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain disclosures normally prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Companys Annual Report filed on Form 10-K/A.

This summary of significant accounting policies is presented to assist in understanding the Companys consolidated financial statements. The consolidated financial statements and notes are representations of the Companys management which is responsible for the integrity and objectivity of the consolidated financial statements. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the consolidated financial statements.

(b) Principles of Consolidation

The December 31, 2007 consolidated balance sheet, consolidated statement of operations and statement of cashflows for the three month and six month periods ended June 30, 2007, include the accounts of the Company and of Cimarron Holdings, LLC (Cimarron). Cimarron is owned by our current chief operating officer and a former member of management. Cimarron previously owned an airplane that was used by Company management. The Company was making the debt service payments on the liability associated with the airplane, as well as all costs of maintenance and operations. Because the Company was the primary beneficiary of Cimarron, it was considered a variable interest entity subject to FIN 46R, and was previously consolidated by the Company in its consolidated financial statements. All significant intercompany transactions and balances were eliminated in consolidation. Due to the sale of the airplane on December 3, 2007, the Company no longer has a beneficial interest in Cimarron, and therefore has not consolidated the June 30, 2008 unaudited consolidated balance sheet or the unaudited consolidated statements of operations and unaudited statement of cashflows for the three and six month periods ended June 30, 2008.

On June 30, 2007, the Company acquired 100 percent of Allisons Gourmet Kitchens, LP (Allisons) and its wholly-owned subsidiary, Wild About Food - Oklahoma, a Texas Limited Liability Company (Wild). The accompanying consolidated balance sheets as of December 31, 2007 and June 30, 2008 include the accounts of Allisons and Wild. The accompanying consolidated statement of operations, statement of stockholders equity and statement of cash flows for the three month and six month periods ended June 30, 2008 include the accounts of Allisons and Wild. All intercompany balances have been eliminated in consolidation.

(c) **Unaudited Interim Financial Information**

The financial information herein is unaudited; however, such information reflects solely normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. Operating results of the interim period are not necessarily indicative of the amounts that will be reported for the entire year.

(d) **Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, the Company considers investments with maturities of three months or less at date of purchase to be cash equivalents.

(e) Accounts Receivable and Credit Policies

Trade accounts receivable are customer obligations due under normal trade terms generally requiring payment within 15 to 21 days from the invoice date. Receivables are recorded based on the amounts invoiced to customers. Interest and delinquency fees are not included in income or trade accounts receivable until realized in cash. Discounts allowed for early payment, if any, are charged against income when the payment is received. Payments of accounts receivable are allocated to the specific invoices identified on the customer's remittance advice or, if unspecified, are applied to the earliest unpaid invoices.

The carrying amount of accounts receivable is reduced by an allowance for credit losses that reflects management's estimate of the amounts that will not be collected. Management provides for probable uncollectible amounts through a charge to earnings and a credit to the allowance for credit losses based on historical collection trends and an assessment of the creditworthiness of current customers. The adequacy of the valuation allowance is evaluated periodically through an individual assessment of potential losses on customer accounts giving particular emphasis to accounts with invoices unpaid more than 60 days past the due date. Balances still outstanding after management has used reasonable collection efforts are charged off to the valuation allowance. Recoveries on accounts previously charged off are credited to the valuation allowance.

A lien exists on certain receivables related to fresh produce under the Perishable Agricultural Commodities Act of 1930, which partially subordinates the lien placed by the line of credit.

(f) Inventories

Inventories consist principally of food products and are stated at the lower of average cost (which approximates first-in, first-out) or market. Costs included in inventories consist of materials, packaging supplies, and labor. General and administrative costs are not charged to inventories.

(g) Property and Equipment

Property and equipment are recorded at cost. Equipment classified as capital leases are recorded at the present value of the future minimum lease payments, and amortized on a straight-line basis over the shorter of the lease term or the estimated useful life of the asset. Expenditures for major additions and improvements are capitalized, while minor replacements, maintenance and repairs are charged to expense as incurred. When property and equipment are retired or otherwise disposed of, the cost of the asset and related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in other income and expense.

Depreciation, including assets classified as capital leases, are provided using the straight-line method over the following estimated useful lives:

Plant and improvements	15 - 40 years
Machinery and equipment	2 - 15 years
Transportation equipment	3 - 10 years
Office equipment	2 - 7 years

(h) Concentrations of Credit Risk

The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

(i) Revenue Recognition

The Company recognizes revenue, net of related sales discounts and allowances, when persuasive evidence of an arrangement exists (such as a customer purchase order), delivery has occurred, the price to the customer has been fixed or is determinable, and collectibility is reasonably assured. Revenues also include those amounts related to shipping and handling. Shipping and handling expenses are also included in cost of sales. Consideration from the Company to a customer is presumed to be a reduction to the selling price of the Company’s products and accordingly, is characterized as a reduction of sales when recognized in the Company’s consolidated statements of operations. As a result, certain promotional expenses are recorded as a reduction of net sales, at the time in which the sale is recognized.

(j) Accounting for Rebates

The Company establishes liabilities for rebates to customers based on specific programs, expected usage and historical experience.

(k) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(l) Earnings (Loss) Per Share

Basic earnings (loss) per share (EPS) excludes dilution and is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of shares of common stock outstanding during the period. Diluted EPS is computed in a manner similar to that of basic EPS except that the weighted-average number of common shares outstanding is increased to include the number of incremental common shares (computed using the treasury stock method) that would have been outstanding if all potentially dilutive common shares (such as stock options) were issued during the period. Diluted EPS is not presented if the effect of the incremental shares is anti-dilutive.

As of June 30, 2008, the Company has Class A and Class B warrants outstanding resulting from its initial public offering as described in Note 12. The exercise price of both classes of warrants exceeds the Companys stock price, therefore the Company has not included these warrants as shares in diluted earnings per share because the effects of inclusion would be anti-dilutive.

(m) 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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. An estimate for the value of intangible assets related to customer relationships was calculated by discounting projected earnings to the date of acquisition and recognized to the extent of the contingent liability of the excess purchase price.

(n) Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities are measured at cost which approximates fair value because of the short-term nature of these instruments. The carrying amount of the Companys borrowings under the line of credit and long-term debt approximates fair value because the interest rate on the instruments fluctuate with market interest rates or represents borrowing rates available with similar terms.

(o) Investments

All of the Companys investments are classified as available for sale and are stated at fair value. Any related unrealized gains and losses are excluded from earnings and reported net of income tax as a separate component of stockholders equity until realized. There were no unrealized gains or losses for the three and six months ended June 30, 2008 and 2007. Realized gains and losses on sales of securities are based on the specific identification method. Declines in the fair value of investment securities below their carrying value that are other than temporary are recognized in earnings. As of June 30, 2008 and December 31, 2007, the Companys investments consisted primarily of guaranteed investment contracts at a fixed interest rate of 2.25 percent.

(p) **Recently Issued Accounting Pronouncements**

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which provides companies an option to report selected financial assets and liabilities at fair value. SFAS No. 159 requires companies to provide information helping financial statement users to understand the effect of a companys choice to use fair value in determining its earnings, as well as to display the fair value of the assets and liabilities a company has chosen to use fair value for on the face of its balance sheet. Additionally, SFAS No. 159 establishes presentation and disclosure requirements designed to simplify comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The statement is effective as of the beginning of an entitys first fiscal year beginning after November 15, 2007. The Company has determined the effects of the adoption of this statement does not have a material effect on its consolidated financial statements, because the Company has elected not to report any liabilities or assets at any value other than that achieved by historical cost, and that if the Company were to make such an election, the difference in values reported on the Company’s consolidated financial statements would not provide more relevant and understandable information for the users of the Company’s consolidated financial statements. The Company will continue to evaluate the application of SFAS No. 159.

In December 2007, the FASB issued SFAS No. 141R, “Business Combinations”, which replaces SFAS No. 141, “Business Combinations”, which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. The statement also establishes disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS No. 141R is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 141R will have an effect on accounting for business combinations once adopted, but the effect is not known and will vary depending on the nature of the acquisition.

In December 2007, the FASB issued SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51”, which establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the non-controlling interest, changes in a parent’s ownership interest and the valuation of retained non-controlling equity investments when a subsidiary is deconsolidated. The statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 160 will not have an effect on the Company’s consolidated financial statements due to the Company’s existing subsidiaries being owned 100%. The effect of application of SFAS No. 160 on future acquisitions is not known and will vary depending on the nature of the acquisition.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities”, which amends and expands the disclosure requirements of SFAS No. 133. SFAS No. 161 requires enhanced disclosures about an entity’s derivative and hedging activities. The statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company has determined that the adoption of SFAS No. 161 will not have a material effect on the consolidated financial statements due to the absence of derivatives and hedging instruments in the Company’s consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles” which identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The statement is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles”. The Company does not anticipate the adoption of SFAS No. 162 will have a material effect on the consolidated financial statements.

(3) Inventories

A summary of inventories follows:

	June 30, 2008 (unaudited)	December 31, 2007

Raw materials and supplies	$ 3,349,968	$ 2,096,887
Finished goods	499,793	627,060
Deferred production costs	-	122,107
Total inventory	$ 3,849,761	$ 2,846,054

(4) Restricted Assets

The Company is required to hold cash in reserve in separate trust accounts applicable to its $5.0 million Cleveland County Industrial Authority Industrial Development Revenue Bonds, issued December 2004. The project construction account represents proceeds of the bond offering to be drawn for approved capital expenditures. The debt reserve account represents funds to be used for debt service in the event of default. The interest and principal accounts represent deposits to be used for debt service. These assets are as follows:

	June 30, 2008 (unaudited)	December 31, 2007
Project construction account	$ 286	$ 283
Debt reserve account	501,474	512,134
Interest fund account	77,366	129,195
Principal fund account	175,356	66,969
Total restricted assets	$ 754,482	$ 708,581

(5) Property and Equipment

Property and equipment, at cost, consists of the following:

	June 30, 2008 (unaudited)	December 31, 2007
Land	$ 238,162	$ 238,162
Plant and improvements	11,480,482	11,325,438
Machinery and equipment	8,340,035	8,170,088
Transportation equipment	1,172,031	2,066,506
Office equipment	201,991	187,145
Construction in progress	1,441,507	211,338
	22,874,208	22,198,677
Less accumulated depreciation	(6,086,606)	(5,629,482)
Property and equipment, net	$ 16,787,602	$ 16,569,195

During the three and six months ended June 30, 2008 and 2007, depreciation expense, including depreciation on assets classified as capital leases, was $410,710, $270,416, $791,326 and $516,782, respectively.

In January of 2008, the Company entered into an agreement to sell certain transportation equipment for $692,600 and lease back the same equipment under operating leases, for terms of three and five years varying on the remaining useful lives of the equipment. The gain on the sale of equipment has been deferred and is being amortized over the lease terms. Future minimum annual lease payments related to these operating leases have been included in Note 14.

(6) Line of Credit

On December 31, 2007, the Company completed a $5.0 million secured bank line of credit, due on March 31, 2010, providing for interest at prime rate minus five-eights percent (0.625%), adjusted on date of change. The rate is also adjustable quarterly with respect to the Company's financial ratio of funded debt to EBITDA, as defined (earnings before interest, tax, depreciation and amortization). A change in the financial ratio will cause a variation in the adjustment to the prime in the range between 1.000% and 0.375% . The line of credit is secured by accounts receivable, inventory and general intangibles, and subject to a debt service coverage ratio covenant of 1.25x to 1.0, as defined, for which the Company is not in compliance as of June 30, 2008. The Company has obtained a waiver of non-compliance with the agreement from its lender and the availability under the facility is now tied to certain benchmarks of performance, such that the Company's availability will be limited to $1.0 million through December 31, 2008, and will be increased thereafter upon the Company's compliance with additional benchmarks. The Company is limited by covenants of the line of credit regarding the sale or assignment of encumbered assets or any asset when done so outside the ordinary course of business. There were no short-term borrowings under this line of credit at June 30, 2008 and December 31, 2007. This line of credit replaces all previous lines of credit as previously held by the Company and its subsidiaries.

(7) Short-term Borrowings

The Company agreed to enter into a 10 percent non-secured promissory note on September 21, 2006 for a maximum of $1.0 million. The maturity date was the earlier of April 30, 2007, or the consummation of any initial public offering consummated before the maturity date. This note is payable to the lead underwriter for the Companys initial public offering (see Note 12). Following the completion of the initial public offering, the Company entered into an agreement to extend the note to the earlier of June 30, 2008 or the closing of an equity financing in which the Company receives at least $4.0 million in gross proceeds. On January 24, 2008, prior to maturity, the borrowings and accrued interest were repaid. Borrowings under this note were $1.0 million at December 31, 2007.

(8) Long-Term Debt and Capital Lease Obligations

Long-term debt consists of the following:

	June 30, 2008 (unaudited)	December 31, 2007
6.75 - 7.10 % Cleveland County Industrial Revenue Bonds secured by real property final payment due December 1, 2024	$ 4,365,000	$ 4,365,000
5.75 - 9.00 % Real estate loans secured by real property final payments due July 22, 2009 and August 1, 2028	3,425,817	3,455,589
4.75 - 6.50 % Vehicle loans secured by various transportation equipment final payments due from 2008 thru 2010	52,432	132,617
8.75 % Equipment loan secured by manufacturing equipment final payment due March 3, 2011	1,628,034	1,814,547
9.56 % Equipment loans secured by refrigeration equipment final payment due May 1, 2021	88,129	101,004
9.56 % Real estate loan secured by real property final payment due May 1, 2021	140,442	142,415
Total long-term debt	9,699,854	10,011,172
Less current portion	1,011,793	865,062
Net long-term debt	$ 8,688,061	$ 9,146,110

The Industrial Development Revenue Bonds issued by Cleveland County Industrial Authority contain certain financial covenants as follows:

Debt Service Coverage Ratio: The Company is required to maintain a debt service coverage ratio of 1.50x to 1.00. The ratio will be reported to the Trustee and notice given to Beneficial Owners quarterly for each of the previous four quarters. If the Debt Service coverage ratio reported for each of the previous four quarters is less than 1.50x to 1.00 the Company is required to retain a consultant. The actual coverage ratio as of June 30, 2008 is 0.45x to 1.00.

Current Ratio: The Company is required to maintain a current ratio 1.10 to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. The actual current ratio as of June 30, 2008 is 0.97x to 1.00.

Debt to Equity Ratio: The Company is required to maintain a debt to equity ratio of not more than 4.00x to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. The actual debt to equity ratio as of June 30, 2008 is 0.93x to 1.00.

Accounts Payable: The Company agrees that not more than 20 percent of its accounts payable shall be in excess of 90 days past due. The actual percentage as of June 30, 2008 is 1.60 percent.

Accounts Receivable: The Company agrees that not more than 20 percent of accounts receivable will be in excess of 90 days past due. The actual percentage as of June 30, 2008 is 0.78 percent.

Noncompliance with the financial covenants will not be considered an event of default under the terms of the agreement. Noncompliance with the above ratios has resulted in an increase in the interest rate on each of the Bonds of 1% until the Company is in compliance with the required ratios.

Capital lease obligations consist of the following:

	June 30, 2008 (unaudited)	**December 31, 2007**
8.95 - 9.19 % Equipment leases	$ 392,292	$ 482,302
8.62 % Equipment lease	2,277	4,124
	394,569	486,426
Less current portion	196,345	189,364
Net long-term debt	$ 198,224	$ 297,062

Annual Debt Service Requirements

The annual principal payment requirements to maturity, for long-term debt and capital lease obligations at June 30, 2008 are as follows:

Year Ending June 30,	**Long-Term Debt**	**Capital Lease Obligations**	**Total**
2009	$ 1,011,793	$ 196,345	$ 1,208,138
2010	875,970	186,445	1,062,415
2011	1,400,181	11,779	1,411,960
2012	506,027	-	506,027
2013	543,978	-	543,978
Thereafter	5,361,905	-	5,361,905
Principal outstanding at June 30, 2008	$ 9,699,854	$ 394,569	$ 10,094,423

During the the three and six months ended June 30, 2008 and 2007, total interest costs were $224,580, $777,932, $403,388, and $1,396,967 respectively. The amount of interest costs capitalized to construction projects during the three and six months ended June 30, 2007 was $106,988.

(9) Accrued Liabilities

A summary of accrued liabilities follows:

	June 30, 2008 (unaudited)	December 31, 2007
Rebates and commissions	$ 984,695	$ 939,242
Interest expense	43,464	228,199
Compensation	498,885	309,261
Workers' compensation	192,159	194,192
Payroll taxes	-	56,452
Promotions and incentives	95,395	131,218
Property taxes	81,503	23,474
Other	(8,622)	7,308
Total accrued liabilities	$ 1,887,479	$ 1,889,346

(10) Amounts Payable to Former Owners of Wild

The Company has current liabilities in the amount of $16,291 related to contingent payments to former owners of Wild.

(11) Intangible Assets

Allison□s holds an intangible asset, a customer list related to its acquisition by the Company in the amount of $154,210. The Company began amortizing the asset to expense over a period of five years beginning July 1, 2007, resulting in accumulated amortization expense of $30,848 and a net carrying amount at June 30, 2008 of $123,362. Allison□s holds an intangible asset, a customer relationship with a certain customer of Wild. The value of the customer relationship is $108,498 net of amortization of $221,207 at June 30, 2008. The Company amortizes the asset to expense over a period of five years. The amount of annual amortization expense related to the June 30, 2008 value of the customer relationship is $82,207. The earnings (losses) of Wild will cause an increase (decrease) in the value, which will add (reduce) total amortization expense.

(12) Initial Public Offering

On July 3, 2007, the Company completed an initial public offering of its shares. The offering consisted of 2.15 million units, with each unit consisting of one share of common stock, one Class A warrant and one Class B warrant. The units were priced at $6.50 each in the offering.

Class A warrants entitle the holder to buy one common share at $9.75 a share. The Class B warrants entitle holders to buy one share at $13.00 a share.

The Class A and Class B warrants are exercisable at any time after they become separately tradable. The Company may redeem some or all of the warrants commencing six months after the initial public offering, after they become separately tradable, at a price of $0.25 per warrant, on 30 days□ notice to the holders. At close of business on July 27, 2007, the units separated into common stock and warrants and the stock and each warrant commenced trading, individually, after that date, on the Nasdaq Capital Market under the symbols: FOOD for the common stock, FOODW for the Class A warrants and FOODZ for the Class B warrants. The Units ceased to trade on that date.

The Company may redeem the Class B warrants only if its gross revenue, for any period of twelve months preceding the notice is equal to or greater than $100 million.

The Class A and Class B warrants expire on June 27, 2012.

A portion of the proceeds from the initial public offering were used to (a) acquire the partnership interests in Allison□s for $1.5 million in cash and a deferred payment of $1.0 million (see Note 20), (b) repay a short-term borrowing of $2.0 million which was used to complete the extension of our existing facility, and (c) repay our bank line of credit of $2.7 million. The remainder of the proceeds are being used to supplement our working capital for general corporate purposes and to construct or acquire one or more new facilities.

(13) Income Taxes

Income tax expense (benefit) for the three and six months ended June 30, 2008 and 2007, consist of the following:

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
	(unaudited)		(unaudited)	
Current:				
Federal	$ -	$ -	$ -	$ -
State	-	-	-	-
	-	-	-	-
Deferred:				
Federal	(300,496)	(87,352)	(402,940)	48,417
State	(35,366)	(10,281)	(47,423)	5,698
	(335,862)	(97,633)	(450,363)	54,115
Total income tax expense (benefit)	$ (335,862)	$ (97,633)	$ (450,363)	$ 54,115

Deferred tax assets (liabilities) are as follows:

	June 30, 2008	December 31, 2007
	(unaudited)	
Net operating loss carryforward	$ 1,200,985	$ 802,874
Oklahoma job and investment credits	87,567	87,567
Depreciation	(494,365)	(497,248)
Deferred gain on sale of assets	37,011	-
Other	52,621	40,264
Net deferred tax asset	$ 883,819	$ 433,457
Current portion	$ 52,621	$ 40,264
Non-current portion	831,198	393,193
	$ 883,819	$ 433,457

In assessing the realizability of the net deferred tax assets, management considers whether it is more likely than not that some or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon either the generation of future taxable income during the periods in which those temporary differences become deductible or the carryback of losses to recover income taxes previously paid during the carryback period.

The Company is not currently subject to any specific audit by any federal, state or local taxing authority. There are no unrecognized tax benefits or tax positions previously taken which could give rise to uncertainty, and therefore there are no calculations or classifications of interest, penalties or effects on income tax rates related to such uncertainties. The Company has taken the position that the acquisition of Allison's is a non-taxable transaction.

As of June 30, 2008, the Company has a net operating loss carryforward of $3.2 million which, if unused, will commence expiring in 2018 and state new jobs/investment credit carryforwards totaling $88,000 of which, if unused, will commence expiring in 2009.

Actual income tax expenses differ from "expected" income tax, computed by applying the U.S. Federal corporate tax rate of 34 percent to earnings from operations before income taxes, as follows:

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Computed "expected" income taxes	$ (301,429)	$ (184,962)	$ (480,980)	$ (171,231)
State income taxes, net of federal income tax	(34,434)	(31,682)	(47,406)	(28,236)
Permanent difference due to amortization of equity transactions	-	95,625	-	191,250
Effect of consolidation of variable interest entity	-	(958)	-	(1,981)
Difference in taxable gain and book gain on sale of assets			78,024	
Utilization of net operating loss carryforwards against current income	-	24,344	-	64,313
	$ (335,863)	$ (97,633)	$ (450,362)	$ 54,115

(14) Operating Leases

The Company has noncancelable long-term operating leases for certain distribution equipment with various expiration dates, one lease for refrigerated warehouse space and one lease for office equipment. The equipment leases require the Company to pay a base rate plus specific mileage amounts. Future minimum annual lease payments for these long-term leases for the next five years ending June 30,

	(unaudited)
2009	$ 598,021
2010	406,504
2011	283,065
2012	157,271
2013	67,560
	$ 1,512,421

(15) Employee Benefit Plans

In 2002, the Company adopted a Flexible 401(k) plan covering all full-time employees with a minimum of one year of service. The Company makes contributions under the plan at an amount equal to 25 percent of the employees elective deferral rate, up to a maximum of 4 percent of the employees compensation. The Companys contributions to the plan during the three and six months ended June 30, 2008 and 2007 were $1,548, $2,560, $2,575, and $4,441, respectively.

In August 2006, the Company adopted a stock option plan providing for potential awards of up to 1,000,000 options to purchase shares. No options have been issued under the plan.

(16) Major Customers

The Company has supply arrangements with a certain distributor, representing 12 percent of its gross revenues. The distributor is composed of numerous distinct purchasing units. No individual purchasing unit represents greater than 3 percent of gross revenues.

(17) Related Party Transactions

On June 30, 2007, Allisons merged into the Company. Prior to the merger, the Company provided a discounted price for products sold to Allisons for use as ingredients in Allisons products. All other transactions between the companies are at fair value.

During the three and six months ended June 30, 2007 the Companys sales, including freight services, to Allisons and purchases from Allisons were as follows (unaudited):

	Three months ended June 30, 2007 (unaudited)	Six months ended June 30, 2007 (unaudited)
Sales of product to Allison's	$ 299,774	$ 491,739
Freight revenue from Allison's	119,191	207,634
Purchases from Allison's	136,624	285,403

Prior to the merger, the Company leased a portion of its facilities to Allisons on an annual lease agreement. The Company and Allisons shared utilities, sales and administration staff, and other facility expenses. Allisons reimbursed the Company for its portion of the shared expenses through periodic reimbursement. A summary of the shared expenses for the three and six months ended June 30, 2007 are as follows:

	Three months ended June 30, 2007 (unaudited)	Six months ended June 30, 2007 (unaudited)
Rents	$ 124,624	$ 219,805
Utilities	34,127	79,220
Salaries	40,369	86,812

Amounts payable and receivable between the companies as of June 30, 2008 and December 31, 2007 are eliminated in consolidation on the consolidated balance sheet.

(18) Commitments and Contingencies

The Company and its subsidiaries are subject to legal proceedings and claims which arise in the ordinary course of business. Although occasional adverse decisions or settlements may occur, the Company is not aware of any proceeding at June 30, 2008, which would have a material adverse effect on its consolidated financial position, results of operations or liquidity.

(19) Cimarron Holdings, L.L.C.

The Companys current chief operating officer and a former member of management each have a 50 percent ownership in Cimarron Holdings, LLC. (Cimarron). Cimarron previously owned an airplane that was used by Company management. The Company had not guaranteed the obligations of Cimarron, but was making the debt service payments for Cimarron, as well as all of the costs of maintenance and operations of the airplane. The airplane was sold on December 3, 2007. Due to the sale of the airplane on December 3, 2007, the Company no longer has a beneficial interest in Cimarron, and therefore has not consolidated the June 30, 2008 unaudited consolidated balance sheet or the unaudited consolidated statements of operations and unaudited statement of cashflows for the three and six month periods ended June 30, 2008.

The Companys consolidated financial statements through December 31, 2007 include the financial statements of Cimarron. The consolidation of Cimarron increased the Companys consolidated total assets and liabilities at December 31, 2007 as follows:

		December 31, 2007
Total assets	$	85,167
Total liabilities	$	5,000

(20) Acquisition of Allisons

On June 30, 2007, the Company acquired (i) for nominal consideration, 60 percent of the limited partnership interests in Allisons from Mark Vaughan, our President and Chief Operating Officer, and Vernon J. Butch Brandt, our former Vice PresidentOperations, (ii) the general partnership interest in Allisons from Braxton Management, Inc., in return for our agreement to indemnify it from all liability as the former general partner of Allisons, and (iii) for a total price of $2,500,000, the remaining 40 percent of the limited partnership interests in Allisons from Herbert Grimes, our Chairman and Chief Executive Officer and Stan Gustas, our former Chief Financial Officer.

We consummated these acquisitions pursuant to agreements dated April 20, 2007, as contemplated by the Prospectus for our initial public offering. Allisons was acquired to increase our productive capacity for refrigerated prepared salads, increase our utilization of refrigerated delivery capacity and broaden our product line.

The purchase price of the 40 percent minority interest in Allisons was $2.5 million. Of the total purchase price minority interests, $1.5 million was paid from the net proceeds of our initial public offering, which closed on July 3, 2007.

Mr. Grimes, through Braxton Management, Inc., owned 87.5 percent of such minority limited partnership interests and received $1,312,500 of such net proceeds. Mr. Gustas owned the remaining 12.5 percent of such minority limited partnership interests and received $187,500 of such net proceeds. The $1.0 million balance of the purchase price for the 40 percent minority interests, which bears interest at 10 percent per annum, was paid, $72,500 to Mr. Grimes and $125,000 to the estate of Mr. Gustas, on June 30, 2008. The remaining balance of $802,500 due to Mr. Grimes will be paid at five specific dates between August 12, 2008 and June 30, 2009 with respect to a note executed on June 30, 2008, bearing interest at 10 percent per annum.

The terms of the acquisition of the limited partnership interests in Allisons were approved by our board of directors at the time we entered into the acquisition agreements. At that time, we lacked sufficient independent directors for majority approval by independent directors. The terms of the acquisition of the limited partnership interests in Allisons were at least as favorable to us as could have been obtained through arms length negotiations with unaffiliated third parties.

The acquisition of Allisons was accounted for as a purchase and, accordingly, all assets and liabilities have been stated at their fair values at the date of the acquisition and are included in the accompanying consolidated balance sheet as of June 30, 2008 and December 31, 2007.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. Allisons is in the process of further evaluating the fair values of its assets and liabilities and, accordingly, the following allocation may be subject to further adjustment:

Current assets	$ 4,418,036
Property and equipment	3,354,543
Intangible assets	872,569
Total assets acquired	8,645,148
Current liabilities	(3,307,786)
Accounts payable - related party	(354,328)
Long term liabilities	(1,856,254)
Amounts payable to former owners of Wild	(626,780)
Total liabilities assumed	(6,145,148)
Net assets acquired	$ 2,500,000

Of the $872,569 of intangible assets, substantially all of the amount represents customer relationships, which are being amortized over a five-year period.

The results of operations prior to acquisition for Allisons have not been included in the primary financial statements for the three and six months periods ended June 30, 2007, since the transaction was consummated as of the close of business on June 30, 2007.

The following Unaudited Proforma Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2007 give effect to the acquisition of Allisons as if it had occurred on or before January 1, 2006:

Vaughan Foods, Inc. and Allison's Gourmet Kitchens, LP
Unaudited Proforma Condensed Consolidated Statements of Operations
Three Months Ended June 30, 2007

	Vaughan Historical	Allisons Historical	Acquisition Adjustments		ProForma Post Acquisition
	(unaudited)	(unaudited)	(unaudited)		(unaudited)
Net sales	$ 13,945,725	$ 7,523,309	($ 555,589)	A1	$ 20,913,445
Cost of sales	12,858,724				