

Edgar Filing: AMERICAN AMMUNITION INC/FL - Form 10QSB

AMERICAN AMMUNITION INC/FL  
Form 10QSB  
August 18, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

Form 10-QSB

(Mark one)

Quarterly Report Under Section 13 or 15(d) of The Securities Exchange Act of 1934

For the quarterly period ended June 30, 2006

Transition Report Under Section 13 or 15(d) of The Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-32379

American Ammunition, Inc.

-----  
(Exact name of small business issuer as specified in its charter)

Nevada

91-2021594

-----  
(State of incorporation)

-----  
(IRS Employer ID Number)

3545 NW 71st Street, Miami, FL 33147

-----  
(Address of principal executive offices)

(305) 835-7400

-----  
(Issuer's telephone number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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  NO

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): YES  NO

State the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date: August 16, 2006: 5,600,309

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Transitional Small Business Disclosure Format (check one): YES  NO

American Ammunition, Inc.

Form 10-QSB for the Quarter ended June 30, 2006

## Table of Contents

	Page
Part I - Financial Information	
Item 1 Financial Statements	3
Item 2 Management's Discussion and Analysis or Plan of Operation	21
Item 3 Controls and Procedures	24
Part II - Other Information	
Item 1 Legal Proceedings	25
Item 2 Recent Sales of Unregistered Securities and Use of Proceeds	25
Item 3 Defaults Upon Senior Securities	27
Item 4 Submission of Matters to a Vote of Security Holders	27
Item 5 Other Information	27
Item 6 Exhibits	27
Signatures	27

Part I

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## Item 1 - Financial Statements

American Ammunition, Inc. and Subsidiaries  
 Consolidated Balance Sheets  
 June 30, 2006 and 2005  
 (Unaudited)

	June 30, 2006
	-----
<b>ASSETS</b>	
Current Assets	
Cash on hand and in bank	\$ 250,413
Accounts receivable - trade, net of allowance for doubtful accounts of \$10,000 and \$-0-, respectively	241,954
Inventory	426,676
Prepaid expenses	55,324
	-----
Total Current Assets	974,367
	-----
Property and Equipment - at cost	-
	-----
Other Assets	294,424
	-----
<b>TOTAL ASSETS</b>	<b>\$ 1,268,791</b>
	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>	
Current Liabilities	
Notes payable to shareholders	\$ 1,075,000
Working capital advance	150,000
Customer deposits	188,020
Accounts payable - trade	829,847
Accrued salaries and wages	337,648
Accrued interest payable	30,162
Accrued dividends payable	65,084
	-----
Total Current Liabilities	2,675,761
	-----
Commitments and Contingencies	
Convertible Debenture	226,365
	-----
Stockholders' Equity (Deficit)	
Preferred stock - \$0.001 par value 20,000,000 shares authorized. 2,022,902 and 2,009,582 shares and outstanding, respectively	2,022
Common stock - \$0.001 par value. 300,000,000 shares authorized. 5,122,931 and 3,795,365 shares issued and outstanding	5,123
Additional paid-in capital	25,814,532
Accumulated deficit	(27,280,012)
	-----
Total Stockholders' Equity (Deficit)	(1,458,335)
	-----
Stock subscription receivable	(175,000)
	-----
Total Stockholders' Equity (Deficit)	(1,633,335)
	-----
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 1,268,791</b>
	=====

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The financial information presented herein has been prepared by management without audit by independent certified public accountants.

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

3

American Ammunition, Inc. and Subsidiaries  
Consolidated Statements of Operations and Comprehensive Income (Loss)  
Six and Three months ended June 30, 2006 and 2005  
(Unaudited)

	Six months ended June 30, 2006 -----	Six months ended June 30, 2005 -----	Three months ended June 30, 2006 -----	
Revenues	\$ 1,305,296	\$ 1,855,010	\$ 622,435	\$
Cost of Sales				
Materials, Direct Labor and other direct costs	1,737,969	2,502,842	643,138	
Depreciation	31,024	382,311	-	
Total Cost of Sales	1,768,993	2,885,153	643,138	
Gross Profit	(463,697)	(1,030,143)	(20,703)	
Operating Expenses				
Research and development expenses	-	1,611	-	
Selling and marketing expenses	74,075	111,752	18,258	
Other operating expenses	663,017	631,521	338,109	
Interest expense	76,621	10,131	39,376	
Depreciation and amortization	27,569	30,203	13,784	
Compensation expense related to common stock issuances at less than "fair value"	139,373	200,502	139,373	
Total Operating Expenses	980,655	985,920	548,900	
Loss from Operations	(1,444,352)	(2,016,063)	(569,603)	
Other Income (Expense)				
Interest and other income	189,492	6,232	147,935	
Income (Loss) before Income Taxes	(1,254,860)	(2,009,831)	(421,668)	
Provision for Income Taxes	-	-	-	
Net Income (Loss)	(1,254,860)	(2,009,831)	(421,668)	
Other Comprehensive Income	-	-	-	

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Comprehensive Income (Loss)	\$ (1,254,860)	\$ (2,009,831)	\$ (421,668)	\$
	=====	=====	=====	=====
Loss per weighted-average share of common stock outstanding, computed on net loss - basic and fully diluted	\$ (0.28)	\$ (0.58)	\$ (0.09)	\$
	=====	=====	=====	=====
Weighted-average number of common shares outstanding	4,537,640	3,472,930	4,797,286	
	=====	=====	=====	

The financial information presented herein has been prepared by management without audit by independent certified public accountants.

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

4

American Ammunition, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Six months ended June 30, 2006 and 2005  
(Unaudited)

	Six months ended June 30, 2006	J
	-----	-----
Cash flows from operating activities		
Net loss for the year	\$ (1,254,860)	\$
Adjustments to reconcile net loss to net cash provided by operating activities		
Depreciation and amortization	85,563	
Bad debt expense	14,153	
Operating expenses paid with common stock	20,186	
Compensation expense related to common stock issuances at less than "fair value"	139,373	
(Increase) Decrease in		
Accounts receivable	315,320	
Inventory	133,414	
Prepaid expenses, deposits and other	1,465	
Increase (Decrease) in		
Accounts payable - trade	(41,770)	
Other accrued expenses	91,719	
Accrued interest payable	40,494	
Customer deposits	(44,670)	
	-----	-----
Net cash used in operating activities	(499,613)	
	-----	-----
Cash flows from investing activities		
Purchase of property and equipment	(31,024)	
	-----	-----
Net cash used in investing activities	(31,024)	
	-----	-----
Cash flows from financing activities		

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Cash advanced on loans from shareholders	100,000	
Cash paid to obtain capital	-	
Cash received on sale of preferred stock	250,000	
Cash received on sale of common stock	-	
	-----	
Net cash provided by financing activities	350,000	
	-----	
Increase (Decrease) in Cash	(180,637)	
Cash at beginning of year	431,050	
	-----	
Cash at end of period	\$ 250,413	\$
	=====	
Supplemental disclosure of interest and income taxes paid		
Interest paid for the period	\$ 9,157	\$
	=====	
Income taxes paid for the period	\$ -	\$
	=====	
Supplemental disclosure of non-cash investing and financing activities		
Conversion of debt and/or accrued interest payable into common stock	\$ 36,720	\$
	=====	
Common stock issued in payment for costs of raising capital	\$ -	\$
	=====	
Common stock issued in payment of accrued dividends on Preferred Stock - Series A and Series B	\$ -	\$
	=====	

The financial information presented herein has been prepared by management without audit by independent certified public accountants.

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

5

American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

Note A - Organization and Description of Business

American Ammunition, Inc. (AAI or Company) was incorporated on February 1, 2000 in accordance with the Laws of the State of California. The Company functions as a holding company providing management oversight services to it's wholly-owned operating subsidiaries; F&F Equipment, Inc. and Industrial Plating Enterprise Co.

F&F Equipment, Inc. (F&F) was incorporated on October 4, 1983 in accordance with the Laws of the State of Florida. F&F is engaged in the design, manufacture and international sales of small arms ammunition. F&F has conducted its business operations under the assumed name of "American Ammunition" since its inception.

Industrial Plating Enterprise Co. (IPE), which was incorporated and commenced production on June 14, 2002. IPE is a fully licensed and approved state of the art electrochemical metallization facility for processing the Company's line of small arms projectiles as well as other products and services while employing environmentally sound water conservation and proven waste treatment techniques.

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The facility meets or exceeds all current environmental requirements and enjoys the "conditionally exempt small quantity generator" status for State and Federal regulations. All activities of IPE since its inception have been dedicated to the needs and demands of F&F.

On January 9, 2006, by written consent in lieu of meeting, a majority of the Company's stockholders approved a recommendation by the Company's Board of Directors to effect a one share for twenty shares reverse stock split of our common stock, par value \$.001 per share, with fractional shares rounded up to the nearest whole share. The reverse split became effective on that date. As a result of the reverse split, the total number of issued and outstanding shares of the Company's common stock decreased from 92,576,839 to 4,629,381 shares, after giving effect to rounding for fractional shares. The effect of this action is reflected in the Company's financial statements as of the first day of the first period presented.

### Note B - Preparation of Financial Statements

The Company and its subsidiaries follow the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America and have adopted a year-end of December 31 for all entities.

The preparation of 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 amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Management further acknowledges that it is solely responsible for adopting sound accounting practices, establishing and maintaining a system of internal accounting control and preventing and detecting fraud. The Company's system of internal accounting control is designed to assure, among other items, that 1) recorded transactions are valid; 2) valid transactions are recorded; and 3) transactions are recorded in the proper period in a timely manner to produce financial statements which present fairly the financial condition, results of operations and cash flows of the Company for the respective periods being presented

During interim periods, the Company follows the accounting policies set forth in its annual audited financial statements filed with the U. S. Securities and Exchange Commission on its Annual Report on Form 10-KSB for the year ended December 31, 2005. The information presented within these interim financial statements may not include all disclosures required by generally accepted accounting principles and the users of financial information provided for interim periods should refer to the annual financial information and footnotes when reviewing the interim financial results presented herein.

American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

### Note B - Preparation of Financial Statements - Continued

In the opinion of management, the accompanying interim financial statements,

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prepared in accordance with the U. S. Securities and Exchange Commission's instructions for Form 10-QSB, are unaudited and contain all material adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial condition, results of operations and cash flows of the Company for the respective interim periods presented. The current period results of operations are not necessarily indicative of results which ultimately will be reported for the full fiscal year ending December 31, 2006.

For segment reporting purposes, the Company operated in only one industry segment during the periods represented in the accompanying financial statements and makes all operating decisions and allocates resources based on the best benefit to the Company as a whole.

The accompanying consolidated financial statements contain the accounts of American Ammunition, Inc. and its wholly-owned subsidiaries, F&F Equipment, Inc. and Industrial Plating Enterprise Co. All significant intercompany transactions have been eliminated. The consolidated entities are collectively referred to as "Company".

### Note C - Summary of Significant Accounting Policies

#### 1. Cash and cash equivalents

For Statement of Cash Flows purposes, the Company considers all cash on hand and in banks, certificates of deposit and other highly-liquid investments with maturities of three months or less, when purchased, to be cash and cash equivalents.

Cash overdraft positions may occur from time to time due to the timing of making bank deposits and releasing checks, in accordance with the Company's cash management policies.

#### (2) Accounts receivable and Revenue Recognition

In the normal course of business, the Company extends unsecured credit to virtually all of its customers which are located throughout the United States. Because of the credit risk involved, management has provided an allowance for doubtful accounts which reflects its opinion of amounts which will eventually become uncollectible. In the event of complete non-performance, the maximum exposure to the Company is the recorded amount of trade accounts receivable shown on the balance sheet at the date of non-performance.

The Company ships all product on an FOB-Plant, "as-is" basis. Accordingly, revenue is recognized by the Company at the point at which an order is shipped at a fixed price, collection is reasonably assured and the Company has no remaining performance obligations related to the sale. The Company sells all products with "no right of return" by the purchaser for any factor other than defects in the product's production.

In limited situations, the Company may elect to accept product returns from customers on a case-by-case basis to offset unpaid accounts receivable. These situations are a "last case" scenario and are initiated by senior management through negotiations with the respective customer.

#### 3. Inventory

Inventory consists of raw materials, work-in-process and finished goods related to the production and sale of small arms ammunition. Inventory is valued at the lower of cost or market using the first-in, first-out method.



American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note C - Summary of Significant Accounting Policies - Continued

4. Property, plant and equipment

Property and equipment are recorded at historical cost. These costs are depreciated over the estimated useful lives of the individual assets using the straight-line method, generally three to ten years.

Gains and losses from disposition of property and equipment are recognized as incurred and are included in operations.

In accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company follows the policy of evaluating all property and equipment as of the end of each reporting quarter. At December 31, 2005, pursuant to the requirements of this accounting standard, management recorded an impairment against the future recoverability of these assets of approximately \$2,777,829.

5. Income Taxes

The Company uses the asset and liability method of accounting for income taxes. At June 30, 2006 and 2005, the deferred tax asset and deferred tax liability accounts, as recorded when material to the financial statements, are entirely the result of temporary differences. Temporary differences represent differences in the recognition of assets and liabilities for tax and financial reporting purposes, primarily accumulated depreciation and amortization, allowance for doubtful accounts and vacation accruals.

As of June 30, 2006 and 2005, respectively, the deferred tax asset related to the Company's net operating loss carryforward is fully reserved. In the event that these carryforwards were not fully utilized, these carryforwards began to expire in 2005.

6. Earnings (loss) per share

Basic earnings (loss) per share is computed by dividing the net income (loss) available to common shareholders by the weighted-average number of common shares outstanding during the respective period presented in our accompanying financial statements.

Fully diluted earnings (loss) per share is computed similar to basic income (loss) per share except that the denominator is increased to include the number of common stock equivalents (primarily outstanding options and warrants).

Common stock equivalents represent the dilutive effect of the assumed exercise of the outstanding stock options and warrants, using the treasury stock method, at either the beginning of the respective period presented or

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the date of issuance, whichever is later, and only if the common stock equivalents are considered dilutive based upon the Company's net income (loss) position at the calculation date.

As of June 30, 2006 and 2005, and subsequent thereto, the Company had no options outstanding. The outstanding warrants and convertible preferred stock and mandatorily convertible debentures are anti-dilutive due to the Company's net operating loss position.

### 7. Advertising costs

The Company does not conduct any direct response advertising activities. For non-direct response advertising, the Company charges the costs of these efforts to operations at the first time the related advertising is published.

8

### American Ammunition, Inc. and Subsidiaries

#### Notes to Consolidated Financial Statements - Continued

#### Note D - Fair Value of Financial Instruments

The carrying amount of cash, accounts receivable, accounts payable and notes payable, as applicable, approximates fair value due to the short term nature of these items and/or the current interest rates payable in relation to current market conditions.

Interest rate risk is the risk that the Company's earnings are subject to fluctuations in interest rates on either investments or on debt and is fully dependent upon the volatility of these rates. The Company does not use derivative instruments to moderate its exposure to interest rate risk, if any.

Financial risk is the risk that the Company's earnings are subject to fluctuations in interest rates or foreign exchange rates and are fully dependent upon the volatility of these rates. The company does not use derivative instruments to moderate its exposure to financial risk, if any.

#### Note E - Inventory

As of June 30, 2006 and 2005, inventory, as valued using the lower-of-cost or market, consisted of the following components:

	June 30, 2006	June 30, 2005
Raw materials	\$ 398,511	\$ 339,605
Work in process	19,313	125,533
Finished goods	8,852	83,478
Totals	\$ 426,676	\$ 548,616

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### Note F - Property and Equipment

Property and equipment consist of the following components:

	June 30, 2006	June 30, 2005	Estimated useful life
-----			
Manufacturing equipment	\$ 7,939,335	\$ 8,083,624	3-10 years
Office furniture and fixtures	69,889	55,577	3- 7 years
Leasehold improvements	190,277	190,277	8-20 years
-----			
	8,199,501	8,329,478	
Accumulated depreciation	(5,575,782)	(5,186,640)	
Impairment of recoverability of carrying value	(2,623,719)	-	
-----			
Net property and equipment	\$ -	\$ 3,142,838	
=====			

Total depreciation expense charged to operations for the six month periods ended June 30, 2006 and 2005, respectively, was approximately \$31,024 and \$409,880.

In accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company follows the policy of evaluating all property and equipment as of the end of each reporting quarter. At December 31, 2005, pursuant to the requirements of this accounting standard, management recorded an impairment for the future recoverability of these assets of approximately \$2,777,829.

9

American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

### Note G - Convertible Debenture

The Company entered into a Securities Purchase Agreement with La Jolla Cove Investors, Inc. ("La Jolla") on October 4, 2002 for the sale of (i) \$250,000 in convertible debentures and (ii) warrants to buy 30,000,000 shares of our common stock. On March 13, 2003 and May 6, 2003, La Jolla advanced an aggregate of \$350,000 to our company which such funding was allocated towards the principal balance of our convertible debentures.

As of June 30, 2006, the outstanding balance on the convertible debenture is approximately \$226,365 and we have approximately 2,263,650 warrants outstanding. A recap of the debenture activity is as follows:

	Debenture	Warrant
	(in dollars)	(in shares)
-----		
Initial amount	\$ 600,000	6,000,000
2003 redemptions	(208,635)	(2,086,350)
2004 redemptions	(125,000)	(1,250,000)

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2005 redemptions	(40,000)	(400,000)
	-----	-----
Balances outstanding at June 30, 2006	\$ 226,365	2,263,650
	=====	=====

The debentures bear interest at 8%, mature on June 31 [sic], 2007, and are convertible into the Company's common stock, at the selling stockholder's option. The convertible debentures are convertible into the number of the Company's shares of common stock equal to the principal amount of the debentures being converted multiplied by 11, less the product of the conversion price multiplied by 10 times the dollar amount of the debenture. The conversion price for the convertible debentures is the lesser of (I) \$1.00 or (ii) seventy six percent of the average of the five lowest volume weighted average prices during the twenty (20) trading days prior to the conversion. Accordingly, there is in fact no limit on the number of shares into which the debenture may be converted. However, in the event that our market price is less than \$0.30 per share, the Company will have the option to prepay the debenture at 125% rather than have the debenture converted. In addition, the selling stockholder is obligated to exercise the warrant concurrently with the submission of a conversion notice by the selling stockholder. As of June 30, 2006, the warrant is exercisable into 2,263,650 shares of common stock at an exercise price of \$1.00 per share.

In December 2004, we entered into an addendum to the convertible debenture and warrant whereby the Company agreed to the following:

- \* the discount multiplier was reduced from eighty percent to seventy six percent;
- \* within five business days after this registration statement being declared effective, La Jolla is required to submit a debenture conversion in the amount of \$10,000 and every ten business days thereafter La Jolla shall submit three additional debenture conversion in the amount of \$10,000 each;
- \* within five business days after this registration statement being declared effective, La Jolla shall wire \$400,000 to us as a prepayment towards the exercise of its warrant; and
- \* immediately following the sale of all shares held by La Jolla in connection with the debenture conversions in the aggregate amount of \$40,000, La Jolla shall wire \$275,000 to us as a prepayment towards the exercise of its warrant and shall submit a debenture conversion in the amount of \$6,250 on the first business day of each month until the debenture is no longer outstanding.

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In May 2005, we entered into an additional addendum to the convertible debenture and warrant whereby the Company agreed to the following:

- \* The Company shall deposit 4,000,000 unregistered shares in the name of LaJolla with the Company's Escrow Agent and, upon confirmation of receipt, LaJolla will wire the Company \$150,000 as an advance on the \$400,000 amount that LaJolla was obligated to fund pursuant to the December 2004 Addendum. In the event that the Company's Registration Statement was not declared effective within nine (9) months of the date of this Addendum, the 4,000,000 shares in escrow will be released to LaJolla and sold by LaJolla pursuant to Rule 144. If LaJolla sells these shares for net sales proceeds of more than \$150,000 (without interest accruing on this amount), the excess over \$150,000 will be refunded to the Company.
- \* The maturity date of the convertible debenture and warrant was extended to June 31, [sic], 2007. \* All other terms and conditions remain in full force and effect.

LaJolla has contractually agreed to restrict its ability to convert or exercise its warrants and receive shares of our common stock such that the number of shares of common stock held by them and their affiliates after such conversion or exercise does exceed 4.9% of the then issued and outstanding shares of common stock.

Due to the contractually agreed mandatory conversion of this Debenture, the Company has reflected this transaction in its balance sheet as a "mezzanine" level debt obligation on its balance sheet, between "Total Liabilities" and "Stockholders' Equity". Upon the respective mandatory conversion, the Company will relieve the respective portion of the Debenture and the any related accrued, but unpaid interest, and credit this amount to the respective "common stock" and "additional paid-in capital" accounts in the stockholder's equity section for the par value and excess amount over the par value of the respective shares issued.

As the warrant is non-detachable from the Debenture and requires simultaneous exercise upon conversion of the Debenture, no value was assigned to the issued warrant. Upon exercise of the warrant, the Company will record the issuance of the underlying shares as a new issuance of common stock on the date of each respective exercise.

On various dates through December 31, 2003, the Debenture Holder elected to convert an aggregate \$208,635, through 24 separate transactions, in outstanding Debenture principal into restricted, unregistered common stock. This election caused the Company to issue 4,561,753 shares of restricted, unregistered common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 2,086,350 shares of the Company's restricted, unregistered common stock for gross proceeds of \$2,086,350.

On various dates between January 1, 2004 and December 31, 2004, the Debenture Holder elected to convert an aggregate \$125,000, through 6 separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 4,150,000 shares of common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 1,250,000 shares of the Company's common stock for gross proceeds of \$1,250,000. As of December 31, 2004, an aggregate of 1,000,000 shares of the Company's common stock have been issued by the Company and are being held in escrow by the Company's counsel pending receipt of the final \$175,000 from the Debenture Holder. As of June 30, 2006, this amount remains unpaid.

On various dates between June 28, 2005 and August 10, 2005, the Debenture Holder

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elected to convert an aggregate \$40,000, through 4 separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 5,872,048 shares of common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 400,000 shares of the Company's common stock for gross proceeds of \$400,000.

11

### American Ammunition, Inc. and Subsidiaries

#### Notes to Consolidated Financial Statements - Continued

##### Note H - Preferred Stock Transactions

Preferred stock consists of the following as of June 30, 2006 and 2005, respectively:

	June 30, 2006		June 30, 2005	
	# shares	value	# shares	value
Series A Cumulative Convertible Preferred Stock	12,000	\$ 60,000	12,000	\$ 60,000
Series B Cumulative Convertible Preferred Stock	55,020	275,100	91,700	458,500
Series C Convertible Preferred Stock	1,905,882	324,000	1,905,882	324,000
Series E 8% Convertible Preferred Stock	50,000	250,000	-	-
	2,022,902	\$909,100	2,009,582	\$842,500
	2,022,902	\$909,100	2,009,582	\$842,500

##### Series A Convertible Preferred Stock

In September, October and November 2001, the Company sold an aggregate 222,600 shares of \$5.00 Series A Convertible Preferred Stock (Series A Preferred Stock) for total proceeds of approximately \$1,113,000 through a Private Placement Memorandum. The Series A Convertible Preferred Stock provides for cumulative dividends at a rate of 8.0% per year, payable quarterly, in cash or shares of the Company's common stock at the Company's election. Each share of Series A Preferred Stock is convertible into 11 shares of the Company's common stock initially at any time after 6 months of the date of issue and prior to the notice of redemption at the option of the holder, subject to adjustments for customary anti-dilution events. In December 2001, at the request of the holders of the Series A Preferred Stock, the Company and the individual holders modified the holding period for conversion to allow for conversion in December 2001.

In September 2001, the Company's principal stockholder converted approximately \$4,007,327 of unsecured debt and approximately \$3,546,273 of cumulative and unpaid accrued interest into 1,510,710 shares of Series A Preferred Stock.

In September 2001, a creditor of the Company agreed to convert approximately

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\$10,000 of trade accounts payable into 2,000 shares of Series A Preferred Stock.

In December 2001, concurrent with a modification in the holding period prior to conversion, certain holders of the Series A Preferred Stock orally notified the Company of their intent to exercise the conversion features on 1,749,720 issued and outstanding shares of Series A Preferred Stock into 19,246,920 shares of common stock prior to December 31, 2001. Due to the timing of the requisite documentation, the clerical activities related to this conversion were not completed until February 2002.

In conjunction with the Series A Preferred Stock, certain shares were sold after the Company's common stock was approved for trading by the National Association of Securities Dealers on the OTC Bulletin Board in October 2001. The shares of Series A Preferred Stock sold subsequent to this date had an equivalent per share value of common stock below the ending quoted market price of the Company's common stock on their respective issue dates. This difference created a Beneficial Conversion Feature Discount of approximately \$1,207,993. This discount was then amortized over the unexpired time period between the date of issue of the eligible shares and the eligible conversion date, as amended. All of the shares sold subsequent to the initial trading date were converted in December 2001 and, accordingly, the approximate \$1,207,993 in Beneficial Conversion Feature Discount was fully amortized to operations.

In December 2002, a holder of 5,000 shares of Series A Preferred Stock exercised his conversion rights and converted these shares of Series A Preferred Stock into 55,000 shares of restricted, unregistered common stock.

In January 2003, three separate holders of 9,000 shares of Series A Preferred Stock exercised their conversion rights and converted these shares of Series A Preferred stock into 99,000 shares of restricted, unregistered common stock.

12

American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note H - Preferred Stock Transactions - Continued

Series B Convertible Preferred Stock

In May 2003, the Company sold an aggregate 91,700 shares of \$5.00 Series B Convertible Preferred Stock (Series B Preferred Stock) for total proceeds of approximately \$458,500 through a separate Private Placement Memorandum. The Series B Convertible Preferred Stock provides for cumulative dividends at a rate of 8.0% per year, payable quarterly, in cash or shares of the Company's common stock at the Company's election. Each share of Series B Preferred Stock is convertible into 11 shares of the Company's common stock initially at any time after 6 months of the date of issue and prior to the notice of redemption at the option of the holder, subject to adjustments for customary anti-dilution events.

In September and December 2004, respectively, the Holders of the Series B Preferred Stock exercised their conversion rights and exchanged an aggregate 18,340 shares of Series B Preferred Stock for 66,810 post-reverse split shares of restricted, unregistered common stock.

On March 31 and June 30, 2006, respectively, the holders of the Series B Preferred Stock exercised their conversion rights and exchanged an aggregate

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18,340 shares (9,170 shares per conversion) of Series B Preferred Stock for 415,706 shares of restricted, unregistered common stock.

### Series C Convertible Preferred Stock

In November 2004, the Company sold 1,905,882 shares of Series C Convertible Preferred Stock to an existing shareholder and officer of the Company in a private transaction pursuant to Section (4)2 of the Securities Act of 1933 for gross proceeds of approximately \$324,000. No underwriter was used in conjunction with this transaction.

The Series C Convertible Preferred Stock provides for dividends at a rate of 4.0% per annum, to be declared and paid monthly in either cash or stock at the discretion of the Company.

Each share of Series C Preferred Stock is convertible at a rate of \$0.18 per share into 1,800,000 shares of the Company's common stock at any time at the option of the holder, subject to adjustments for customary anti-dilution events.

### Series E 8% Convertible Preferred Stock

On March 1, 2006, the Company issued a Private Placement Memorandum offering up to 200,000 shares of 8% Convertible Preferred Stock at an offering price of \$5.00 per share on a "best efforts" basis through an unrelated placement agent.

The Series E 8% Convertible Preferred Stock provides for cumulative dividends at the rate of 8% per year, payable quarterly, 50% in cash and 50% in shares or 100% in cash at the Company's election. In the event the Company elects to pay such dividends in shares of the Company's Common Stock, the number of shares to be issued shall be based on the average of the closing prices of the Company's Common Stock, as reported on the NASDAQ Over the Counter Bulletin Board (or such other market on which the Company's Common Stock is then traded) for the 10 consecutive trading days preceding the record date for each such dividend, with such record date being the 14th day preceding the end of each calendar quarter.

13

American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note H - Preferred Stock Transactions - Continued

Series E 8% Convertible Preferred Stock - continued

Each share of Series E Convertible Preferred Stock shall be convertible into shares of the Company's Common Stock at any time after March 1, 2007. The number of shares to be issued on a conversion shall be based on 80% of the average closing price of the Common Stock of the Company; as reported on the NASDAQ OTC Bulletin Board (or such other market on which such stock is traded) for ten (!0) consecutive trading days preceding the date the Company received notice of such conversion. Subject to certain restrictions, the Series E 8% Convertible Preferred Stock shall automatically convert into shares of the Company's Common Stock upon any of the following events: (I) the sale by the Company of all or



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substantially all of its assets; (ii) the consummation of a merger or a consolidation in which the Company is not the survivor; or (iii) the sale or exchange of all or substantially all of the outstanding shares of the Company's common stock (including by way of merger, consolidation, or other similar action).

In the event of the liquidation, dissolution or winding up of the Company, the holders of Series E Convertible Preferred Stock shall have a liquidation preference over holders of common stock and shares junior to the Series E 8% Convertible Preferred Stock equal to \$5.50 per share. Additionally, the Company shall not impose or allow any additional liens on its existing fixed assets in excess of \$1,000,000; provided that at such time as total gross proceeds from the offering equal or exceed \$2,000,000, the Company shall satisfy such existing liens on its existing fixed assets and shall not impose or allow any additional liens on its existing fixed assets unless subordinated to the interest of the Series E 8% Convertible Preferred Stock, with such preference on the fixed assets equal to the fixed asset value, as determined in accordance with the United States Generally Accepted Accounting Principles ("GAAP"), of 150% of the stated value of the aggregate of the outstanding shares of Series E Convertible Preferred Stock except for fixed assets of the Company that were otherwise purchased pursuant to a security interest.

The Series E 8% Convertible Preferred Stock shall be redeemable, at the option of the Company, for cash in the amount of \$5.50 per share of Series E Convertible Preferred Stock or for shares of the Company's Common Stock in accordance with the Conversion Rate, at any time after March 1, 2007, or in the event the closing sale price of the Company's Common Stock, as reported on the NASDAQ Over the Counter Bulletin Board (or such other market on which the Company's Common Stock is then traded), is greater than or equal to \$7.00 after March 1, 2007 for any consecutive five trading days. In addition, the Series E 8% Convertible Preferred Stock shall be redeemable, at the option of the holder, at any time for shares of the Company's Common Stock in accordance with the Conversion Rate. At any time after March 1, 2007, at the option of the holder, the Series E 8% Convertible Preferred Stock shall be redeemable for cash in the amount of \$5.10 per share of Series E Convertible Preferred Stock or for shares of the Company's Common Stock in accordance with the Conversion Rate. After such date, if redemption is for cash, shares will be redeemed at the rate of 1/10 of such aggregate shares per quarterly period for any 10 consecutive quarters commencing after March 1, 2007. Any redemption by either the Company or the holder shall be subject to 15 days written notice.

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note H - Preferred Stock Transactions - Continued

Series E 8% Convertible Preferred Stock - continued

The Company warrants and agrees that if, at any time within the period commencing on the date of the final closing of the Offering and expiring on the 5<sup>th</sup> anniversary of the date thereof, the Company should file a registration statement with the SEC under the Securities Act (other than in connection with a merger or other business combination transaction or pursuant to Form S-8), it will give written notice at least 30 calendar days prior to the filing of each such registration statement to the holders of the Series E 8% Convertible Preferred Stock and the holders of the shares of the Common Stock issued upon the conversion or redemption of the shares of Series E Convertible Preferred Stock, or their permitted assigns (Holders) of its intention to do so. If the Holders notify the Company within 30 calendar days after receipt of any such notice of its or their desire to include any such shares of Common Stock issued or issuable upon the conversion or redemption of the Series E 8% Convertible Preferred Stock in such proposed registration statement, the Company shall use its "best efforts" to have any such shares of Common Stock issued or issuable upon the conversion or redemption of the Series E 8% Convertible Preferred Stock registered under such registration statement. Notwithstanding the foregoing, the Company shall have the right at any time after it shall have given written notice (irrespective of whether a written request for inclusion of any such securities shall have been made) to elect not to file any such proposed registration statement, or to withdraw the same after the filing but prior to the effective date thereof. If the managing underwriter of an offering to which the above "piggyback registration rights" apply, in good faith and for valid business reasons, objects to such rights, such objection shall preclude such inclusion. All expenses incurred by the Company in registration of the shares of Common Stock issued or issuable upon the conversion or redemption of the Series E 8% Convertible Preferred Stock, including without limitation all registration and filing fees, listing fees, printing expenses, fees and disbursements of all independent accounts, or counsel for the Company and the expense of any special audits incident to or required by any such registration and the expenses of complying with the securities or blue sky laws of any jurisdiction shall be paid by the Company.

The Company has agreed to pay the Placement Agent a cash commission equal to 10% of the aggregate Purchase Price of the shares of Series E Convertible Preferred Stock sold by the Placement Agent in the Offering (Placement Agent Fee). The Company shall also pay the Placement Agent reasonable expenses associated with the Offering, which expenses shall not exceed \$50,000 (Expense Allowance). In addition, the Company shall issue to the Placement Agent 500 warrants for each \$50,000 of Series E Convertible Preferred Stock sold by the Placement Agent in the Offering (Placement Agent Warrants), each warrant entitling the holder to purchase 1 share of the Company's Common Stock at an exercise price of \$0.90 per share exercisable at any time for a period of 3 years from date of issuance.

Upon completion of the Maximum Offering, the Company will receive net proceeds of approximately \$900,000.00. The Company intends to use the net proceeds for potential acquisitions, working capital, general corporate purposes and repayment of outstanding debt.

The Company and the Placement Agent shall have discretion to increase the Maximum Offering to \$2,000,000.00, without notice to investors..

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As of June 30, 2006, the Company has sold 50,000 shares in a single transaction under this Private Placement Memorandum and has received the gross sales proceeds of \$250,000 and has accrued a payable to the Placement Agent for the 10% (or \$25,000) fee due on this transaction.

15

### American Ammunition, Inc. and Subsidiaries

#### Notes to Consolidated Financial Statements - Continued

##### Note I - Common Stock Transactions

On January 9, 2006, by written consent in lieu of meeting, a majority of the Company's stockholders approved a recommendation by the Company's Board of Directors to effect a one share for twenty shares (1 for 20) reverse stock split of our common stock, par value \$.001 per share, with fractional shares rounded up to the nearest whole share. The reverse split became effective on that date. As a result of the reverse split, the total number of issued and outstanding shares of the Company's common stock decreased from 92,576,839 to 4,629,381 shares, after giving effect to rounding for fractional shares. The effect of this action is reflected in the Company's financial statements as of the first day of the first period presented.

In conjunction with the above discussed reverse stock split, all share references in the following paragraphs reflect the January 9, 2006 reverse split action.

##### Calendar 2005 Transactions

On various dates between June 28, 2005 and August 10, 2005, the Debenture Holder elected to convert an aggregate \$40,000, through 4 separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 293,602 shares of common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 400,000 shares of the Company's common stock for gross proceeds of \$400,000.

In September and December 2004, respectively, the Holders of the Series B Preferred Stock exercised their conversion rights and exchanged an aggregate 18,340 shares of Series B Preferred Stock for 66,810 shares of restricted, unregistered common stock.

In July 2005, the Company issued approximately 8,333 shares of unregistered, restricted common stock to Paul Goebel, the Company's Director of Domestic Sales, as an employee bonus. These shares were valued at approximately \$17,166, which approximated the market value of the shares on the transaction date. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In February, August, September and December 2005, the Company issued an aggregate 23,615 shares of restricted, unregistered common stock in payment of approximately \$44,124 in accrued dividends payable on the Company's outstanding Series B Preferred Stock for the quarters ended December 31, 2004, March 31,

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2005, June 30, 2005, September 30, 2005 and December 31, 2005, respectively. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In August, November and December 2005, respectfully, the Company issued an aggregate 37,500 shares of restricted, unregistered common stock to an existing shareholder as payment of various fees and costs associated with the funding of approximately \$875,000 short-term working capital loans to the Company. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

### Calendar 2006 Transactions

In February 2006, the Company issued approximately 41,666 shares of unregistered, restricted common stock to Paul Goebel, the Company's Director of Domestic Sales, as an employee bonus. These shares were valued at approximately \$17,500, which approximated the market value of the shares on the transaction date. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

16

### American Ammunition, Inc. and Subsidiaries

#### Notes to Consolidated Financial Statements - Continued

#### Note I - Common Stock Transactions

##### Calendar 2006 Transactions - continued

In February 2006, the Company issued approximately 226,065 shares of restricted, unregistered common stock, valued at approximately \$18,325, to an existing shareholder as for payment of accrued interest associated with approximately \$875,000 short-term working capital loans to the Company and reimbursement of direct public relation expenses. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction. As the per share value of this transaction was substantially less than the "fair value" of the Company's common stock, per the closing price of the Company's common stock on the transaction date, the Company recognized "compensation expense related to the issuance of common stock at less than "fair value" in the amount of approximately \$70,080 on this transaction.

In May 2006, the Company issued approximately 266,511 shares of restricted, unregistered common stock, valued at approximately \$21,054, to an existing shareholder as for payment of accrued interest associated with approximately \$975,000 short-term working capital loans to the Company and reimbursement of direct public relation expenses. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction. As the per share value of this transaction was substantially less than the "fair value" of the Company's common stock, per the closing price of the Company's common stock on the transaction date, the Company recognized "compensation expense related to the issuance of common stock at less than "fair value" in the amount of approximately \$69,293 on this transaction.

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### Note J - Rental Commitments

The Company leases its corporate office and manufacturing facility from its controlling stockholder under a long-term operating lease agreement. The lease requires a monthly payment of approximately \$5,735, including applicable sales taxes. The Company is responsible for all utilities and maintenance expenses. The lease expires on December 1, 2009 and contains a clause that upon expiration, the Company and the controlling shareholder shall renegotiate the annual rental amount.

The Company's subsidiary, IPE, leases its manufacturing facility from an unrelated third-party under a long-term operating lease agreement. This lease is for a period of five (5) years and requires graduated monthly payments, changing on the lease anniversary date, ranging from approximately \$1,751 to \$1,914, plus the applicable sales taxes. The Company is responsible for all utilities and maintenance expenses. The lease expires on February 28, 2007 and may be renewed for an additional five (5) year term at a rental rate of approximately \$1,971, plus applicable sales taxes for the first renewal year and 3.0% increase on each succeeding anniversary date. Total rent expense under this lease was approximately \$20,752 and \$16,622, respectively, for each of the years ended December 31, 2004 and 2003.

In May 2004, the Company entered into a long-term lease agreement for a warehouse facility adjacent to the Company's primary office and manufacturing facility. This lease is for a period of two (2) years and requires payments of approximately \$6,206 per month for the first 12 months and approximately \$6,393 for the second 12 months, plus applicable sales taxes. The Company is responsible for all utilities and maintenance expenses. This lease expires on May 31, 2006. Further, the Company is responsible for any incremental real estate taxes and property insurance in excess of the amounts incurred by the landlord for the calendar year immediately preceding the execution of the lease.

17

### American Ammunition, Inc. and Subsidiaries

#### Notes to Consolidated Financial Statements - Continued

### Note J - Rental Commitments - Continued

Future minimum rental payments on the above leases are as follows:

Year ended December 31,	Amount
2006	\$ 117,244
2007	72,643
2008	68,815
2009	68,815
	-----
Totals	\$ 327,517
	=====

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For the respective years ended December 31, 2005 and 2004, the Company paid an aggregate of \$158,947 and \$131,804 in rent under these three lease agreements.

### Note M - Income Taxes

The components of income tax (benefit) expense for the six month periods ended June 30, 2006 and 2005, respectively, are as follows:

	Six months ended June 30, 2006	Six months ended June 30, 2005
	-----	-----
Federal:		
Current	\$ -	\$ -
Deferred	-	-
	-----	-----
	-	-
	-----	-----
State:		
Current	-	-
Deferred	-	-
	-----	-----
	-	-
	-----	-----
Total	\$ -	\$ -
	=====	=====

As of December 31, 2005, the Company has a net operating loss carryforward of approximately \$12,000,000 to offset future taxable income. Subject to current regulations, components of this carryforward began to expire in 2005. The amount and availability of the net operating loss carryforwards may be subject to limitations set forth by the Internal Revenue Code. Factors such as the number of shares ultimately issued within a three year look-back period; whether there is a deemed more than 50 percent change in control; the applicable long-term tax exempt bond rate; continuity of historical business; and subsequent income of the Company all enter into the annual computation of allowable annual utilization of the carryforwards.

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note M - Income Taxes - continued

The Company's income tax expense (benefit) for the six month periods ended June 30, 2006 and 2005, respectively, differed from the statutory federal rate of 34 percent as follows:

	Six months ended June 30, 2006	Six months ended June 30, 2005
Statutory rate applied to loss before income taxes	\$ (426,700)	\$ (683,000)
Increase (decrease) in income taxes resulting from:		
State income taxes	-	-
Other, including reserve for deferred tax asset	426,700	683,000
Income tax expense	\$ -	\$ -

Temporary differences, consisting primarily of the net operating loss carryforward and statutory differences in the depreciable lives for property and equipment, between the financial statement carrying amounts and tax bases of assets and liabilities give rise to deferred tax assets and liabilities as of December 31, 2005 and 2004, respectively:

	Year ended December 31, 2005	Year ended December 31, 2004
Deferred tax assets - long-term		
Net operating loss carryforwards	\$ 4,080,000	\$ 2,669,000
Deferred tax liabilities - long-term		
Statutory depreciation differences	(525,000)	(690,000)
	3,555,000	1,979,000
Less valuation allowance	(3,555,000)	(1,979,000)
Net Deferred Tax Asset	\$ -	\$ -

During the years ended December 31, 2005 and 2004, respectively, the valuation allowance increased (decreased) by approximately \$1,576,000 and \$(671,000).

Note N - Selected Financial Data (Unaudited)

The following is a summary of the quarterly results of operations for the years ended December 31, 2005 and 2004, respectively.

Quarter ended    Quarter ended    Quarter ended    Quarter ended    Y

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	March 31,	June 30,	September 30,	December 31,	D
Calendar 2006					
Revenues - net	\$ 682,861	\$ 622,435			
Gross profit	\$ (442,994)	\$ (20,703)			
Net earnings after provision for income taxes	\$ (833,192)	\$ (421,668)			
Basic and fully diluted earnings per share	\$ (0.20)	\$ (0.09)			
Weighted average number of shares issued and outstanding	4,270,491	4,797,286			

19

American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note N - Selected Financial Data (Unaudited) - Continued

	Quarter ended March 31,	Quarter ended June 30,	Quarter ended September 30,	Quarter ended December 31,	Y	D
Calendar 2005						
Revenues - net	\$ 1,170,317	\$ 684,693	\$ 378,326	\$ 1,010,297	\$	\$
Gross profit	\$ (366,263)	\$ (676,300)	\$ (757,023)	\$ 451,009	\$	\$
Net earnings after provision for income taxes	\$ (786,044)	\$ (1,155,474)	\$ (1,118,089)	\$ (2,882,062)	\$	\$
Basic and fully diluted earnings per share	\$ (0.21)	\$ (0.32)	\$ (0.29)	\$ (0.70)	\$	\$
Weighted average number of shares issued and outstanding	3,742,585	3,557,402	3,812,069	4,126,366		
Calendar 2004						
Revenues - net	\$ 281,507	\$ 568,785	\$ 861,988	\$ 1,535,088	\$	\$
Gross profit	\$ (423,626)	\$ (676,300)	\$ 377,181	\$ (650,553)	\$	\$
Net earnings after provision for income taxes	\$ (1,188,358)	\$ (1,155,307)	\$ 9,552	\$ (983,960)	\$	\$
Basic and fully diluted earnings per share	\$ (0.35)	\$ (0.32)	\$ 0.00	\$ (0.26)	\$	\$
Weighted average number of shares issued and outstanding	3,388,458	3,557,402	3,683,671	3,730,807		



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20

Item 2 - Management's Discussion and Analysis or Plan of Operation

Caution Regarding Forward-Looking Information

Certain statements contained in this Registration Statement including, without limitation, statements containing the words "believes", "anticipates", "expects" and words of similar import, constitute forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements.

Such factors include, among others, the following: international, national and local general economic and market conditions; demographic changes; the ability of the Company to sustain, manage or forecast its growth; the ability of the Company to successfully make and integrate acquisitions; raw material costs and availability; new product development and introduction; existing government regulations and changes in, or the failure to comply with, government regulations; adverse publicity; competition; the loss of significant customers or suppliers; fluctuations and difficulty in forecasting operating results; changes in business strategy or development plans; business disruptions; the ability to attract and retain qualified personnel; the ability to protect technology; and other factors referenced in this and previous filings.

Given these uncertainties, readers of this Quarterly Report on Form 10-QSB and investors in our equity securities are cautioned not to place undue reliance on such forward-looking statements. The Company disclaims any obligation to update any such factors or to publicly announce the result of any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

General

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American Ammunition, Inc. is a holding company with two operating subsidiaries: F&F Equipment, Inc. and Industrial Plating Enterprise Co.

F&F Equipment, Inc. (F&F) was incorporated on October 4, 1983 under the laws of the State of Florida. F&F was formed to engage principally in the "import, export, retail & wholesale of firearms equipment, ammunition & other devices and for the purpose of transacting any and/or all lawful business." F&F conducts its business operations under the assumed name of "American Ammunition."

In June 2002, American Ammunition, Inc. formed a wholly owned subsidiary, Industrial Plating Enterprise Co. (IPE), which started production on June 14, 2002. IPE is a fully licensed and approved electrochemical metallization facility with significant capacity for processing our line of projectiles as well as other products and services while employing environmentally sound water conservation and proven waste treatment techniques.

### Results of Operations

Six months ended June 30, 2006 compared with the six months ended June 30, 2005.

During the six months ended June 30, 2006, we experienced aggregate net revenues of approximately \$1,305,000 (\$622,000 in the current quarter), as compared to approximately \$1,855,000 during the first six months of Calendar 2005. The decline in sales was attributable to our curtailing of production during January 2006 to improve the operating efficiency of our manufacturing equipment and better automate select machines so we can rely upon lower labor requirements in future periods.

In 2004, the Company initiated a direct solicitation program for its "dealer direct" sales program. This endeavor has received a very positive initial response from the qualified retail resellers of the Company's product. We are realizing that the existence of previously announced contracts with various U. S. Governmental agencies and orders from foreign governments are becoming more erratic in their order placements. Accordingly, management is realizing that a consistent demand from the U. S. retail segment will be our best source of consistent sales. Further, we have identified certain production issues which has inhibited the full realization of existing product demands and management believes that the necessary steps are being taken to remedy any production deficiencies.

We experienced costs of goods sold of approximately \$1,769,000 for the six months ended June 30, 2006 as compared to approximately \$2,885,000 for the first six months of Calendar 2005. Through June 30, 2006, and

subsequent thereto, we continue to experience negative trends with relation to our calculated standard production costs for material and labor due to excess labor capacity due to anticipated governmental orders which did not materialize as management was led to believe from the various U. S. Governmental agencies contracting officers. Management remains of the opinion that the production labor force is stable and able to maintain a constant standard of quality in future periods. We experience variable costs in the area of material consumption and direct labor. In the second quarter of 2006, management took drastic steps to reduce excess labor capacity through the elimination of the 2nd shift, which was never able to reach full utilization. This action is not expected to have any adverse impact on our ability to meet our existing and future product demands.

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For the six month periods ended June 30, 2006 and 2005, we generated a negative gross profit of approximately \$(464,000), or (35.52%), and approximately \$(1,030,000), or (55.53%).

We experienced nominal research and development expenses of approximately \$-0- and \$1,600, respectively, during the respective six month periods ended June 30, 2006 and 2005.

During the six months of Calendar 2006 and 2005, we expended approximately \$74,000 and \$112,000, respectively, in advertising and marketing expenses, principally in developing and promoting our retail dealer direct program. We anticipate to continue our marketing efforts in this area in future periods; however, the volume and frequency of our expenditures may fluctuate as management allocates available capital to these efforts.

Other general and administrative expenses increased nominally from approximately \$595,000 for the six months ended June 30, 2006 as compared to approximately \$663,000 for the six months ended June 30, 2005. Management is of the opinion that these costs are relatively stable and should not experience significant increases except for inflationary pressures caused principally by increases in energy costs which are affecting all businesses in all sectors of the U. S. economy.

We recognized a net loss of approximately \$(1,256,000) and \$(2,010,000) for the respective six month periods ended June 30, 2006 and 2005, respectively, or \$(0.28) and \$(0.58) per share. We call to the reader's attention that the loss per share calculation for the six months ended June 30, 2005 includes the effect of our 1 for 20 reverse stock split on January 9, 2006.

### Liquidity And Capital Resources

As of June 30, 2006, December 31, 2005 and June 30, 2005, respectively, we had working capital of approximately \$(1,701,000), \$(885,000) and \$(265,000). Our working capital position continues to fluctuate based on collections on our trade accounts receivable and investments from the mandatory exercise of our outstanding warrant related to our convertible debenture. We anticipate that we have sufficient inventory levels to support our order demand and have access to raw material suppliers that will enable us to receive raw materials for future periods. We also note that we have approximately \$1,075,000 in short-term notes payable to existing shareholders which may or may not be renegotiated, repaid in common stock of the Company or otherwise reclassified prior to their maturity on December 31, 2006. This amount is a contributing factor to our negative working capital position at June 30, 2006 and December 31, 2005.

We have used cash in operating activities of approximately \$(500,000) and \$(797,000) during the six month periods ended June 30, 2006 and 2005, respectively. Due to our history of operating losses, our resources for additional working capital are becoming more scarce. Additionally, LaJolla Cove Investors, the holder of our mandatorily convertible debenture and related warrant, is in default on their agreement to provide us with additional working capital. On March 1, 2006, the Company issued a Private Placement Memorandum offering up to 200,000 shares of 8% Convertible Preferred Stock at an offering price of \$5.00 per share on a "best efforts" basis through an unrelated placement agent. As of June 30, 2006, the Company had sold 50,000 shares for gross proceeds of \$250,000 in a single transaction pursuant to this Private Placement Memorandum. Management continues to undertake all prudent measures to assure that the Company can be self-supporting.

We anticipate that our liquidity position will continue to improve as management is of the opinion that, with the current changes to our production capacity, the Company will be in a position to better support all existing orders and accept existing and future inquiries.

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During the six months ended June 30, 2006 and 2005, respectively, we added approximately \$31,000 and \$98,000 in new equipment. Any equipment to be added in future periods is fully dependent upon the Company's cash

22

position, the availability of either new equity or debt capital and the ultimate realization of communicated future product sales demand. However, we may not be able to obtain additional funding or, that such funding, if available, will be obtained on terms favorable to or affordable by us.

### Convertible Debenture

The Company entered into a Securities Purchase Agreement with La Jolla Cove Investors, Inc. ("La Jolla") on October 4, 2002 for the sale of (i) \$250,000 in convertible debentures and (ii) warrants to buy 30,000,000 shares of our common stock. On March 13, 2003 and May 6, 2003, La Jolla advanced an aggregate of \$350,000 to our company which such funding was allocated towards the principal balance of our convertible debentures.

As of June 30, 2006, the outstanding balance on the convertible debenture is approximately \$226,365 and we have approximately 2,263,650 warrants outstanding. A recap of the debenture activity is as follows:

	Debenture (in dollars)	Warrant (in shares)
	-----	-----
Initial amount	\$ 600,000	6,000,000
2003 redemptions	(208,635)	(2,086,350)
2004 redemptions	(125,000)	(1,250,000)
2005 redemptions	(40,000)	(400,000)
	-----	-----
Balances outstanding at June 30, 2006	\$ 226,365	2,263,650
	=====	=====

The debentures bear interest at 8%, mature on June 31 [sic], 2007, and are convertible into the Company's common stock, at the selling stockholder's option. The convertible debentures are convertible into the number of the Company's shares of common stock equal to the principal amount of the debentures being converted multiplied by 11, less the product of the conversion price multiplied by 10 times the dollar amount of the debenture. The conversion price for the convertible debentures is the lesser of (i) \$1.00 or (ii) seventy six percent of the average of the five lowest volume weighted average prices during the twenty (20) trading days prior to the conversion. Accordingly, there is in fact no limit on the number of shares into which the debenture may be converted. However, in the event that our market price is less than \$0.30 per share, the Company will have the option to prepay the debenture at 125% rather than have the debenture converted. In addition, the selling stockholder is obligated to exercise the warrant concurrently with the submission of a conversion notice by the selling stockholder. As of June 30, 2006, the warrant is exercisable into 2,263,650 shares of common stock at an exercise price of \$1.00 per share.

In December 2004, we entered into an addendum to the convertible debenture and warrant whereby the Company agreed to the following:

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- \* the discount multiplier was reduced from eighty percent to seventy six percent;
- \* within five business days after this registration statement being declared effective, La Jolla is required to submit a debenture conversion in the amount of \$10,000 and every ten business days thereafter La Jolla shall submit three additional debenture conversion in the amount of \$10,000 each;
- \* within five business days after this registration statement being declared effective, La Jolla shall wire \$400,000 to us as a prepayment towards the exercise of its warrant; and
- \* immediately following the sale of all shares held by La Jolla in connection with the debenture conversions in the aggregate amount of \$40,000, La Jolla shall wire \$275,000 to us as a prepayment towards the exercise of its warrant and shall submit a debenture conversion in the amount of \$6,250 on the first business day of each month until the debenture is no longer outstanding.

In May 2005, we entered into an additional addendum to the convertible debenture and warrant whereby the Company agreed to the following:

- \* The Company shall deposit 4,000,000 unregistered shares in the name of LaJolla with the Company's Escrow Agent and, upon confirmation of receipt, LaJolla will wire the Company \$150,000 as an advance on the \$400,000 amount that LaJolla was obligated to fund pursuant to the December 2004 Addendum. In the event that the Company's Registration Statement was not declared effective within nine (9) months of the date of this Addendum, the 4,000,000 shares in escrow will be released to LaJolla and sold by LaJolla pursuant to

23

Rule 144. If LaJolla sells these shares for net sales proceeds of more than \$150,000 (without interest accruing on this amount), the excess over \$150,000 will be refunded to the Company.

- \* The maturity date of the convertible debenture and warrant was extended to June 31, [sic], 2007. \* All other terms and conditions remain in full force and effect.

LaJolla has contractually agreed to restrict its ability to convert or exercise its warrants and receive shares of our common stock such that the number of shares of common stock held by them and their affiliates after such conversion or exercise does exceed 4.9% of the then issued and outstanding shares of common stock.

Due to the contractually agreed mandatory conversion of this Debenture, the Company has reflected this transaction in its balance sheet as a "mezzanine" level debt obligation on its balance sheet, between "Total Liabilities" and "Stockholders' Equity". Upon the respective mandatory conversion, the Company will relieve the respective portion of the Debenture and the any related accrued, but unpaid interest, and credit this amount to the respective "common stock" and "additional paid-in capital" accounts in the stockholder's equity section for the par value and excess amount over the par value of the respective shares issued.

As the warrant is non-detachable from the Debenture and requires simultaneous exercise upon conversion of the Debenture, no value was assigned to the issued warrant. Upon exercise of the warrant, the Company will record the issuance of the underlying shares as a new issuance of common stock on the date of each respective exercise.

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On various dates through December 31, 2003, the Debenture Holder elected to convert an aggregate \$208,635, through 24 separate transactions, in outstanding Debenture principal into restricted, unregistered common stock. This election caused the Company to issue 4,561,753 shares of restricted, unregistered common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 2,086,350 shares of the Company's restricted, unregistered common stock for gross proceeds of \$2,086,350.

On various dates between January 1, 2004 and December 31, 2004, the Debenture Holder elected to convert an aggregate \$125,000, through 6 separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 4,150,000 shares of common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 1,250,000 shares of the Company's common stock for gross proceeds of \$1,250,000. As of December 31, 2004, an aggregate of 1,000,000 shares of the Company's common stock have been issued by the Company and are being held in escrow by the Company's counsel pending receipt of the final \$175,000 from the Debenture Holder. As of June 30, 2006, this amount remains unpaid.

On various dates between June 28, 2005 and August 10, 2005, the Debenture Holder elected to convert an aggregate \$40,000, through 4 separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 5,872,048 shares of common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 400,000 shares of the Company's common stock for gross proceeds of \$400,000.

LaJolla is in default on their contractual agreements to redeem the outstanding warrant(s) and convert the outstanding debenture as of June 30, 2006.

### Item 3 - Controls and Procedures

#### (a) Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (Exchange Act), as of June 30, 2006. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to our Company required to be included in our reports filed or submitted under the Exchange Act.

24

#### (b) Changes in Internal Controls

There were no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls over financial reporting that occurred during the second quarter of Calendar 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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### Part II - Other Information

#### Item 1 - Legal Proceedings

None

#### Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

On March 31 and June 30, 2006, respectively, the holders of the Series B Preferred Stock exercised their conversion rights and exchanged an aggregate 18,340 shares (9,170 shares per conversion) of Series B Preferred Stock for 415,706 shares of restricted, unregistered common stock.

In May 2006, the Company issued approximately 266,511 shares of restricted, unregistered common stock, valued at approximately \$21,054, to an existing shareholder as for payment of accrued interest associated with approximately \$975,000 short-term working capital loans to the Company and reimbursement of direct public relation expenses. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction. As the per share value of this transaction was substantially less than the "fair value" of the Company's common stock, per the closing price of the Company's common stock on the transaction date, the Company recognized "compensation expense related to the issuance of common stock at less than "fair value" in the amount of approximately \$69,293 on this transaction

#### Series E 8% Convertible Preferred Stock

On March 1, 2006, the Company issued a Private Placement Memorandum offering up to 200,000 shares of 8% Convertible Preferred Stock at an offering price of \$5.00 per share on a "best efforts" basis through an unrelated placement agent.

The Series E 8% Convertible Preferred Stock provides for cumulative dividends at the rate of 8% per year, payable quarterly, 50% in cash and 50% in shares or 100% in cash at the Company's election. In the event the Company elects to pay such dividends in shares of the Company's Common Stock, the number of shares to be issued shall be based on the average of the closing prices of the Company's Common Stock, as reported on the NASDAQ Over the Counter Bulletin Board (or such other market on which the Company's Common Stock is then traded) for the 10 consecutive trading days preceding the record date for each such dividend, with such record date being the 14th day preceding the end of each calendar quarter.

Each share of Series E Convertible Preferred Stock shall be convertible into shares of the Company's Common Stock at any time after March 1, 2007. The number of shares to be issued on a conversion shall be based on 80% of the average closing price of the Common Stock of the Company; as reported on the NASDAQ OTC Bulletin Board (or such other market on which such stock is traded) for ten (!0) consecutive trading days preceding the date the Company received notice of such conversion. Subject to certain restrictions, the Series E 8% Convertible Preferred Stock shall automatically convert into shares of the Company's Common Stock upon any of the following events: (I) the sale by the Company of all or substantially all of its assets; (ii) the consummation of a merger or a consolidation in which the Company is not the survivor; or (iii) the sale or exchange of all or substantially all of the outstanding shares of the Company's common stock (including by way of merger, consolidation, or other similar action).

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In the event of the liquidation, dissolution or winding up of the Company, the holders of Series E Convertible Preferred Stock shall have a liquidation preference over holders of common stock and shares junior to the Series E 8% Convertible Preferred Stock equal to \$5.50 per share. Additionally, the Company shall not impose or allow any additional liens on its existing fixed assets in excess of \$1,000,000; provided that at such

25

time as total gross proceeds from the offering equal or exceed \$2,000,000, the Company shall satisfy such existing liens on its existing fixed assets and shall not impose or allow any additional liens on its existing fixed assets unless subordinated to the interest of the Series E 8% Convertible Preferred Stock, with such preference on the fixed assets equal to the fixed asset value, as determined in accordance with the United States Generally Accepted Accounting Principles ("GAAP"), of 150% of the stated value of the aggregate of the outstanding shares of Series E Convertible Preferred Stock except for fixed assets of the Company that were otherwise purchased pursuant to a security interest.

The Series E 8% Convertible Preferred Stock shall be redeemable, at the option of the Company, for cash in the amount of \$5.50 per share of Series E Convertible Preferred Stock or for shares of the Company's Common Stock in accordance with the Conversion Rate, at any time after March 1, 2007, or in the event the closing sale price of the Company's Common Stock, as reported on the NASDAQ Over the Counter Bulletin Board (or such other market on which the Company's Common Stock is then traded), is greater than or equal to \$7.00 after March 1, 2007 for any consecutive five trading days. In addition, the Series E 8% Convertible Preferred Stock shall be redeemable, at the option of the holder, at any time for shares of the Company's Common Stock in accordance with the Conversion Rate. At any time after March 1, 2007, at the option of the holder, the Series E 8% Convertible Preferred Stock shall be redeemable for cash in the amount of \$5.10 per share of Series E Convertible Preferred Stock or for shares of the Company's Common Stock in accordance with the Conversion Rate. After such date, if redemption is for cash, shares will be redeemed at the rate of 1/10 of such aggregate shares per quarterly period for any 10 consecutive quarters commencing after March 1, 2007. Any redemption by either the Company or the holder shall be subject to 15 days written notice.

The Company warrants and agrees that if, at any time within the period commencing on the date of the final closing of the Offering and expiring on the 5th anniversary of the date thereof, the Company should file a registration statement with the SEC under the Securities Act (other than in connection with a merger or other business combination transaction or pursuant to Form S-8), it will give written notice at least 30 calendar days prior to the filing of each such registration statement to the holders of the Series E 8% Convertible Preferred Stock and the holders of the shares of the Common Stock issued upon the conversion or redemption of the shares of Series E Convertible Preferred Stock, or their permitted assigns (Holders) of its intention to do so. If the Holders notify the Company within 30 calendar days after receipt of any such notice of its or their desire to include any such shares of Common Stock issued or issuable upon the conversion or redemption of the Series E 8% Convertible Preferred Stock in such proposed registration statement, the Company shall use its "best efforts" to have any such shares of Common Stock issued or issuable upon the conversion or redemption of the Series E 8% Convertible Preferred Stock registered under such registration statement. Notwithstanding the foregoing, the Company shall have the right at any time after it shall have given written notice (irrespective of whether a written request for inclusion of any such securities shall have been made) to elect not to file any such proposed



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registration statement, or to withdraw the same after the filing but prior to the effective date thereof. If the managing underwriter of an offering to which the above "piggyback registration rights" apply, in good faith and for valid business reasons, objects to such rights, such objection shall preclude such inclusion. All expenses incurred by the Company in registration of the shares of Common Stock issued or issuable upon the conversion or redemption of The Series E 8% Convertible Preferred Stock, including without limitation all registration and filing fees, listing fees, printing expenses, fees and disbursements of all independent accounts, or counsel for the Company and the expense of any special audits incident to or required by any such registration and the expenses of complying with the securities or blue sky laws of any jurisdiction shall be paid by the Company.

The Company has agreed to pay the Placement Agent a cash commission equal to 10% of the aggregate Purchase Price of the shares of Series E Convertible Preferred Stock sold by the Placement Agent in the Offering (Placement Agent Fee). The Company shall also pay the Placement Agent reasonable expenses associated with the Offering, which expenses shall not exceed \$50,000 (Expense Allowance). In addition, the Company shall issue to the Placement Agent 500 warrants for each \$50,000 of Series E Convertible Preferred Stock sold by the Placement Agent in the Offering (Placement Agent Warrants), each warrant entitling the holder to purchase 1 share of the Company's Common Stock at an exercise price of \$0.90 per share exercisable at any time for a period of 3 years from date of issuance.

Upon completion of the Maximum Offering, the Company will receive net proceeds of approximately \$900,000.00. The Company intends to use the net proceeds for potential acquisitions, working capital, general corporate purposes and repayment of outstanding debt.

26

The Company and the Placement Agent shall have discretion to increase the Maximum Offering to \$2,000,000.00, without notice to investors..

As of June 30, 2006, the Company has sold 50,000 shares in a single transaction under this Private Placement Memorandum and has received the gross sales proceeds of \$250,000 and has accrued a payable to the Placement Agent for the 10% (or \$25,000) fee due on this transaction. The Company used the \$250,000 in proceeds to support its operations during the 2nd quarter of Calendar 2006 as shown on the accompanying statement of cash flows.

Item 3 - Defaults on Senior Securities

None

Item 4 - Submission of Matters to a Vote of Security Holders

None

Item 5 - Other Information

None

Item 6 - Exhibits

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Exhibits

- 31.1 Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002
- 32.1 Certification pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

American Ammunition, Inc.

Dated: August 16, 2006

/s/ Andres F. Fernandez

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Andres F. Fernandez  
President, Chief Executive Officer  
Chief Financial Officer and Director