Vaughan Foods, Inc.
Form 10-Q
May 16, 2011

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

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

For the quarterly period ended March 31, 2011
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
(Registrant's telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes R No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o 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 R
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No R
Number of shares outstanding of the registrant's common stock, as of March 15, 2011:

Class	Shares Outstanding
Common Stock, $0.001 par value per share	9,380,577

VAUGHAN FOODS, INC.
Form 10-Q
For the Quarterly Period Ended March 31, 2011
INDEX

PART 1 — FINANCIAL INFORMATION

ITEM 1 — FINANCIAL STATEMENTS.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Vaughan Foods, Inc. and Subsidiary

We have reviewed the accompanying consolidated balance sheet of Vaughan Foods, Inc. and subsidiary (the "Company") as of March 31, 2011, and the related consolidated statements of operations and cash flows for the three months ended March 31, 2011 and 2010, and the related statement of stockholders' equity for the three months ended March 31, 2011. 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, 2010, and the related statements of operations, stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated March 30, 2011, 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, 2010, and the accompanying statement of stockholders' equity for the year ended December 31, 2010, are fairly stated, in all material respects, in relation to the financial statements from which they have been derived.

Oklahoma City, Oklahoma
May 16, 2011
/s/ Cole & Reed, P.C.
Cole & Reed, P.C.

Vaughan Foods, Inc.
Consolidated Balance Sheets
March 31, 2011 and December 31, 2010

	March 31, 2011	December 31, 2010
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$220,534	$—
Cash receipts subject to account control agreement	889,467	533,541
Accounts receivable, net of allowance for credit losses of $78,180 at March 31, 2011 and December 31, 2010	7,278,857	6,088,245
Inventories	3,661,849	3,104,976
Prepaid expenses and other assets	621,441	246,001
Deferred tax assets	383,897	369,604
Total current assets	13,056,045	10,342,367
Restricted assets:		
Cash	584,592	937,336
Investments	729,255	557,566
Total restricted assets	1,313,847	1,494,902
Property and equipment, net	14,383,050	14,576,322
Other assets:		
Loan origination fees, net of amortization	264,790	286,767
Intangible assets	38,529	46,241
Deferred tax assets, noncurrent	2,735,079	2,604,045
Total other assets	3,038,398	2,937,053
Total assets	$31,791,340	$29,350,644
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$9,857,830	$6,980,713
Disbursements in transit	—	729,300
Line of credit	3,264,764	2,688,302
Note payable to related party	30,355	29,724
Accrued liabilities	2,003,176	1,945,094
Current portion of long-term debt	1,132,680	1,155,310
Total current liabilities	16,288,805	13,528,443
Long term liabilities:		
Long-term debt, net of current portion	6,567,670	6,694,917
Note payable to related party, net of current portion	810,392	811,023
Deferred gain on sale of assets	6,768	7,747
Total long-term liabilities	7,384,830	7,513,687
Stockholders' equity:		
Common stock, $0.001 par value; authorized 50,000,000 shares; 9,380,577 shares issued and outstanding at March 31, 2011 and December 31, 2010	9,381	9,381
Preferred stock, $0.001 par value; authorized 5,000,000 shares; 0 shares issued and outstanding at March 31, 2011 and December 31, 2010	—	—
Paid in Capital	14,547,662	14,525,179
Retained Earnings (deficit)	(6,439,338)	(6,226,046)
Total stockholders' equity	8,117,705	8,308,514

Total liabilities and stockholders’ equity	$31,791,340	$29,350,644

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

Vaughan Foods, Inc.
Unaudited Consolidated Statements of Operations
For the Three Months Ended March 31, 2011 and 2010

	Three Months Ended March 31, 2011 (unaudited)	2010 (unaudited)
Net sales	$23,578,993	$21,695,865
Cost of sales	21,401,493	18,933,711
Gross profit	2,177,500	2,762,154
Selling, general and administrative expenses	2,313,684	2,270,428
Operating income (loss)	(136,184)	491,726
Interest expense	(223,414)	(269,182)
Gain (loss) on sale of asset	979	8,965
Other income and expense, net	(222,435)	(260,217)
Net income (loss) before income taxes	(358,619)	231,509
Income tax expense (benefit)	(145,327)	114,918
Net income (loss)	$(213,292)	$116,591
Weighted average shares outstanding Basic and diluted	9,380,577	6,526,077
Net income (loss) per share basic and diluted	$(0.02)	$0.02

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

Vaughan Foods, Inc.
Consolidated Statements of Stockholders' Equity
For the Year Ended December 31, 2010 and the Three Months Ended March 31, 2011

	Common Stock				
	Shares issued	Amount	Paid in Capital	Retained Earnings (Deficit)	Total Stockholders' Equity
Balance at January 1, 2010	4,623,077	$4,623	$12,734,115	$(5,864,161)	$6,874,577
Stock-based compensation expense	—	—	89,934	—	89,934
Issuance of common stock and warrants in connection with private placement transaction	4,757,500	4,758	1,701,130	—	1,705,888
Net (loss)	—	—	—	(361,885)	(361,885)
Balance at December 31, 2010	9,380,577	$9,381	$14,525,179	$(6,226,046)	$8,308,514
Stock-based compensation expense (unaudited)	—	—	22,483	—	22,483
Net (loss) (unaudited)	—	—	—	(213,292)	(213,292)
Balance at March 31, 2011 (unaudited)	9,380,577	$9,381	$14,547,662	$(6,439,338)	$8,117,705

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

4

Vaughan Foods, Inc.
Unaudited Consolidated Statements of Cash Flows
For the Three Months Ended March 31, 2011 and 2010

	Three Months Ended March 31,	
	2011	2010
	(unaudited)	(unaudited)
Cash flows from operating activities:		
Net income (loss)	$(213,292)	$116,591
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	577,113	726,595
Provision for credit losses	—	51,317
(Gain) on sale of assets	(979)	(8,965)
Stock option expense	22,483	22,483
Deferred income taxes	(145,327)	114,918
Changes in operating assets and liabilities:		
Accounts receivable	(1,190,612)	(782,803)
Inventories	(556,873)	85,028
Prepaid expenses and other assets	(375,440)	(6,190)
Accounts payable	2,877,117	(1,538,200)
Disbursements in transit	(729,300)	121,811
Accrued liabilities	58,082	551,969
Net cash provided by (used in) operating activities	322,972	(545,446)
Cash flows from investing activities:		
Purchases of property and equipment	(354,152)	(515,801)
Distribution of insurance proceeds from restricted assets	352,744	—
Investments in restricted assets	(171,689)	(182,391)
Net cash (used by) investing activities	(173,097)	(698,192)
Cash flows from financing activities:		
Proceeds from stock issue	—	1,705,888
Net borrowings (repayments) on line of credit	576,462	(337,602)
Net proceeds from funds subject to account control agreement	(355,926)	—
Cash receipts subject to account control agreement	—	90,335
Repayment of notes payable to related party	—	(3,203)
Repayment of long-term debt and capital leases	(149,877)	(211,780)
Net cash provided by (used in) financing activities	70,659	1,243,638
Net increase (decrease) in cash and cash equivalents	220,534	—
Cash and cash equivalents at beginning of period	—	—
Cash and cash equivalents at end of period	$220,534	$—
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest paid, net of capitalized interest	$229,125	$181,092
Software development costs financed through accrued expenses	96,000	—
Issuance of warrants to placement agent in connection with private placement transaction	—	219,661

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

5

Vaughan Foods, Inc.
Notes to Unaudited Consolidated Financial Statements
March 31, 2011 and 2010

(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 processing 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 ("SEC"). 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 Company's Annual Report filed on Form 10-K with the SEC on March 30, 2011.

This summary of significant accounting policies is presented to assist in understanding the Company's consolidated financial statements. The consolidated financial statements and notes are representations of the Company's 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) 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.

(c) 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. Cash subject to account control agreement represents unrestricted cash that results from collections of trade accounts receivable. Such amounts are generally applied the next business day to outstanding balances and accrued interest on the revolving credit agreement, and subject to availability and other terms of the agreement, can be re-borrowed immediately after being applied to the line of credit.

(d) Disbursements in Transit

Disbursements in transit as presented in the consolidated balance sheet and consolidated statement of cash flows, represent drafts for payment to the Company's vendors in transit and in the process of being collected.

(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 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 generally 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. The allowance for credit losses is based on various factors including among other things, (a) our assessment of the collectability of specific customer accounts, (b) our macro assessment of political and economic risk, (c) the overall aging of accounts receivable portfolio, and (d) the effects each of these and other factors have on the consolidated portfolio. 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, certain prepaid expenses related to 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 collectability is reasonably assured. The Company's customers consist of foodservice distributors and retail sector customers. Generally, the risk of loss of ownership of products in the industry in which the Company operates, transfers from the supplier to the purchaser at the point of delivery at the customer's designated place of business. The Company considers the transfer of risk of loss to the customer as the point in which the Company has earned revenue. Revenues 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 in the form of cash payments, reductions applied to customers' accounts receivable balances and direct payment of sales and marketing related expenses are 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 sales, marketing and 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 March 31, 2011, the Company has Class A and Class B warrants outstanding resulting from its initial public offering. The Class A and Class B warrants entitle the holder to buy one common share at $9.75 and $13.00, respectively. The Company may redeem some or all of the warrants at a price of $0.25 per warrant, on 30 days notice to the holders. The Company may redeem the Class B warrants only if its gross revenue, for any period of twelve months preceding a 30 day notice to the holders, is equal to or greater than $100 million. The Class A and Class B warrants are traded on the OTC Bulletin Board under the symbols FOODW and FOODZ, respectively. Both classes of warrants expire on June 27, 2012. The exercise price of both classes of warrants exceeds the Company's 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.

On November 26, 2008, March 12, 2009 and November 11, 2010 the Company granted 605,000, 14,120 and 110,000, respectively, stock options to certain employees, members of the board of directors and certain consultants to the Company, vesting over four years. The exercise price of the options is equal to the Company's stock price on the date of issuance. The exercise price of the options exceeds the Company's stock price, therefore the Company has not included these options as shares in diluted earnings per share because the effects of inclusion would be anti-dilutive.

On March 6, 2009, the Company issued a seven-year warrant to purchase 252,454 shares of common stock to its lender in connection with refinancing its revolving line of credit, as further described in Note 7. The exercise price of the warrant $0.59 per share, which is greater than the Company's average stock price, therefore the Company has not included these options associated with the warrant in diluted earnings per share because the effects of inclusion would be anti-dilutive.

On February 24, 2010, the Company issued five year warrants to purchase 1,903,000 shares of common stock to 71 accredited investors in connection with a private placement transaction. The exercise price of the warrants is $0.70 per share, which is greater than the Company's average stock price, therefore the Company has not included these options associated with the warrants in diluted earnings per share because the effects of inclusion would be anti-dilutive.

On February 23, 2010, the Company issued five year warrants to purchase 475,750 shares of common stock to the placement agent in connection with a private placement transaction. The exercise price of the warrants is $0.625 per share, which is greater than the Company's average stock price, therefore the Company has not included these options associated with the warrants 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.

8

(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 Company's 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

The Company's investments primarily consist of money market mutual funds. These investments are classified as available for sale and are reported at fair value, which was determined using quoted market prices in active markets for identical assets. 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 month periods ended March 31, 2011 and 2010. 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.