

Vaughan Foods, Inc.  
Form 10-Q  
November 10, 2009

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

(Mark One)

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

**For the quarterly period ended September 30, 2009**

**OR**

**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**

(State or other jurisdiction of incorporation or organization)

**73-1342046**

(I.R.S. Employer Identification No.)

**216 N.E. 12th Street, Moore, OK**

(Address of principal executive offices)

**73160**

(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  No

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  No

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  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

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Number of shares outstanding of the registrant's common stock, as of November 5, 2009:

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

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VAUGHAN FOODS, INC.  
Form 10-Q  
For the Quarterly Period Ended September 30, 2009  
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**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 September 30, 2009, and the related consolidated statements of operations for the three-month and nine-month periods ended September 30, 2009 and 2008, and the consolidated statements of cash flows for the nine-month periods ended September 30, 2009 and 2008, and the related statement of stockholders' equity for the nine-month period ended September 30, 2009. 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, 2008, 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 18, 2009, 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, 2008, and the accompanying statement of stockholders' equity for the year ended December 31, 2008, are fairly stated, in all material respects, in relation to the financial statements from which they have been derived.

Oklahoma City, Oklahoma  
November 10, 2009

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Vaughan Foods, Inc.  
**Consolidated Balance Sheets**  
**September 30, 2009 & December 31, 2008**

	September 30, 2009 (unaudited)	December 31, 2008
<u>Assets</u>		
Current assets:		
Cash and cash equivalents	\$ -	\$ -
Cash receipts subject to account control agreement	833,492	-
Accounts receivable, net of allowance for credit losses of \$131,403 at September 30, 2009 and \$140,870 at December 31, 2008	5,281,266	5,323,125
Inventories	3,570,016	3,376,180
Prepaid expenses and other assets	133,083	76,880
Deferred tax assets	310,543	310,266
<b>Total current assets</b>	<b>10,128,400</b>	<b>9,086,451</b>
Restricted assets:		
Cash	528,287	287
Investments	901,948	561,715
<b>Total restricted assets</b>	<b>1,430,235</b>	<b>562,002</b>
Property and equipment, net	16,149,192	17,058,691
Other assets:		
Loan origination fees, net of amortization	468,361	368,192
Intangible assets	84,802	107,938
Deferred tax assets, noncurrent	2,610,860	2,300,701
<b>Total other assets</b>	<b>3,164,023</b>	<b>2,776,831</b>
<b>Total assets</b>	<b>\$ 30,871,850</b>	<b>\$ 29,483,975</b>
<u>Liabilities and Stockholders' Equity</u>		
Current liabilities:		
Accounts payable	\$ 8,220,768	\$ 7,960,982
Disbursements in transit	1,666,101	1,236,264
Line of credit	2,336,273	1,000,000
Note payable to former owners of Allison's Gourmet Kitchens, LP	875,819	802,500
Accrued liabilities	2,081,776	1,850,705
Current portion of long-term debt	1,107,048	1,093,974
Current portion of capital lease obligation	146,932	203,672
<b>Total current liabilities</b>	<b>16,434,717</b>	<b>14,148,097</b>
Long term liabilities:		
Long-term debt, net of current portion	7,498,457	7,949,941
Capital lease obligation, net of current portion	-	94,479
Deferred gain on sale of assets	52,572	79,467
<b>Total long-term liabilities</b>	<b>7,551,029</b>	<b>8,123,887</b>
Stockholders' equity:		
Common stock, \$0.001 par value; authorized 50,000,000 shares; 4,623,077 shares issued and outstanding at September 30, 2009 and December 31, 2008	4,623	4,623
Preferred stock, \$0.001 par value; authorized 5,000,000 shares; 0 shares issued and outstanding at September 30, 2009 and December 31, 2008	-	-

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Paid in Capital	12,711,857	12,571,302
Retained Earnings (deficit)	(5,830,376)	(5,363,934)
Total stockholders' equity	6,886,104	7,211,991
Total liabilities and stockholders' equity	\$ 30,871,850	\$ 29,483,975

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

**Vaughan Foods, Inc.**  
**Unaudited Consolidated Statements of Operations**  
**For the Three and Nine Months Ended September 30, 2009 and 2008**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net sales	\$ 24,107,433	\$ 23,874,602	\$ 73,892,354	\$ 69,127,791
Cost of sales	22,123,101	22,928,973	67,310,730	64,339,303
Gross profit	1,984,332	945,629	6,581,624	4,788,488
Selling, general and administrative expenses	2,067,191	2,573,301	6,551,704	7,474,950
Operating income (loss)	(82,859)	(1,627,672)	29,920	(2,686,462)
Interest expense	(306,074)	(200,447)	(821,954)	(603,835)
Gain (loss) on sale of asset	8,965	(93,521)	15,044	(75,591)
Interest income	2	5,135	112	34,737
Other income and expense, net	(297,107)	(288,833)	(806,798)	(644,689)
Net income (loss) before income taxes	(379,966)	(1,916,505)	(776,878)	(3,331,151)
Income tax expense (benefit)	(161,923)	(757,973)	(310,436)	(1,208,335)
Net income (loss)	\$ (218,043)	\$ (1,158,532)	\$ (466,442)	\$ (2,122,816)
Weighted average shares outstanding - basic and diluted	4,623,077	4,623,077	4,623,077	4,623,077
Net income (loss) per share - basic and diluted	\$ (0.05)	\$ (0.25)	\$ (0.10)	\$ (0.46)

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

**Vaughan Foods, Inc.**  
**Unaudited Consolidated Statements of Stockholders Equity**  
**For the Year Ended December 31, 2008 and the Nine Months Ended September 30, 2009**

	Common Stock		Paid in Capital	Member	Retained	Total
	Shares issued	Amount		Capital	Earnings	Stockholders
				(Deficit)	(Deficit)	Equity
Balance at January 1, 2008	4,623,077	\$ 4,623	\$ 12,563,803	\$ 80,167	\$ (2,000,806)	\$ 10,647,787
Exclusion of previously consolidated variable interest entity	-	-	-	(80,167)	-	(80,167)
Issuance of stock options in connection with Equity Incentive Plan	-	-	7,499	-	-	7,499
Net (loss)	-	-	-	-	(3,363,128)	(3,363,128)
Balance at December 31, 2008	4,623,077	4,623	12,571,302	-	(5,363,934)	7,211,991
Issuance of stock options in connection with Equity Incentive Plan (unaudited)	-	-	66,094	-	-	66,094
Issuance of stock warrants in connection with refinancing revolving line of credit (unaudited)	-	-	74,461	-	-	74,461
Net (loss) (unaudited)	-	-	-	-	(466,442)	(466,442)
Balance at September 30, 2009 (unaudited)	4,623,077	\$ 4,623	\$ 12,711,857	\$ -	\$ (5,830,376)	\$ 6,886,104

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



**Vaughan Foods, Inc.**  
**Unaudited Consolidated Statements of Cash Flows**  
**For the Nine Months Ended September 30, 2009 and 2008**

	Nine Months Ended September 30,	
	2009	2008
	(unaudited)	(unaudited)
Cash flows from operating activities:		
Net (loss)	\$ (466,442)	\$ (2,122,816)
Adjustments to reconcile net (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,477,310	1,321,597
Provision for credit losses	(9,467)	(51,556)
(Gain) on sale of asset	(15,044)	75,591
Stock based compensation expense	66,094	-
Deferred income taxes	(310,436)	(1,208,335)
Changes in operating assets and liabilities:		
Accounts receivable	51,326	(109,514)
Inventories	(193,836)	(730,154)
Prepaid expenses and other assets	(56,203)	(9,333)
Accounts payable	259,786	2,879,734
Disbursements in transit	429,837	-
Accrued liabilities	231,071	327,175
Net cash provided by operating activities	1,463,996	372,389
Cash flows from investing activities:		
Purchases of property and equipment	(365,812)	(2,451,096)
Investments in restricted assets	(868,233)	(211,009)
Proceeds from sale of assets	5,000	697,600
Deconsolidation of variable interest entity	-	(80,167)
Net cash (used in) investing activities	(1,229,045)	(2,044,672)
Cash flows from financing activities:		
Payments of loan origination fees	(221,422)	(5,086)
Proceeds from line of credit	1,336,273	900,000
Cash receipts subject to account control agreement	(833,492)	-
Repayment of long-term debt and capital leases	(589,629)	(588,485)
Repayments of notes payable to former owners of Allison's Gourmet Kitchens, LP	(6,931)	(197,500)
Proceeds of notes payable to former owners of Allison's Gourmet Kitchens, LP	80,250	-
Cash paid to former owners of Wild About Food	-	(45,000)
Repayments of short-term borrowings	-	(1,000,000)
Net cash (used in) financing activities	(234,951)	(936,071)
Net increase (decrease) in cash and cash equivalents	-	(2,608,354)
Cash and cash equivalents at beginning of period	-	2,698,474

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Cash and cash equivalents at end of period	\$	-	\$	90,120
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Supplemental disclosures of cash flow information:

Cash paid during the period for:

Interest paid	\$	575,023	\$	646,762
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Supplemental disclosures of noncash financing and investing activities:

Decrease in amounts payable to former owners of Wild About Food due to net loss incurred by Wild	\$	-	\$	426,370
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Stock options issued in connection with refinancing revolving line of credit	\$	74,461	\$	-
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The accompanying notes are an integral part of these consolidated financial statements.

Vaughan Foods, Inc.  
Notes to Unaudited Consolidated Financial Statements  
September 30, 2009 and 2008

**(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 subsidiary 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, filed with the SEC on April 15, 2009.

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) Principles of Consolidation**

On June 30, 2007, the Company acquired the net assets of Allison's Gourmet Kitchens, LP (Allison's). All of the assets and liabilities of Allison's were assumed by the Company.

**(c) Unaudited Interim Financial Information**

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

**(d) Subsequent Events**

We have evaluated subsequent events through November 10, 2009, the date of issuance of the consolidated financial statements.

**(e) 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 represent 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 new 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.

**(f) Disbursements in Transit**

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

**(g) 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 collectibility 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.

**(h) 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.

**(i) 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

**(j) 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.

**(k) Revenue Recognition**

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

**(l) Accounting for Rebates**

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

**(m) Income Taxes**

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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.

**(n) 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 September 30, 2009, the Company has Class A and Class B warrants outstanding resulting from its initial public offering. 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, the Company granted 619,120 stock options to certain employees, members of the board of directors and certain consultants to the Company, as further described in Note 14, vesting over four years. The exercise price of the options is equal to the Company's stock price on the date of issuance. The unaudited consolidated statements of operations for the three and nine month periods ending on September 30, 2009, report net losses, 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 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 unaudited consolidated statements of operations for the three and nine month periods ending on September 30, 2009, report net losses, therefore the Company has not included these options as shares in diluted earnings per share because the effects of inclusion would be anti-dilutive.

**(o) Use of Estimates**

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. An estimate for the value of intangible assets related to acquired customer relationships was determined by discounting estimated future cash flows from the acquired customer relationships to the date of acquisition using an appropriate discount rate, and recognized to the extent of the contingent liability of the excess purchase price.

**(p) 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.

**(q) Investments**

All of the Company's investments are classified as available for sale and are stated at fair value. Any related unrealized gains and losses are excluded from earnings and reported net of income tax as a separate component of stockholders' equity until realized. There were no unrealized gains or losses for the three and nine months ended September 30, 2009 and 2008. Realized gains and losses on sales of securities are based on the specific identification method. Declines in the fair value of investment securities below their carrying value that are other than temporary are recognized in earnings. As of September 30, 2009 and December 31, 2008, the Company's investments consisted primarily of guaranteed investment contracts at a fixed interest rate of 2.25 percent.

**(r) Stock-Based Compensation Expense**

The Company measures stock-based compensation costs at the grant date based on the fair value of the award and recognize as expense ratably over the requisite service period, net of estimated forfeitures. The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock option awards. The Company awards stock options to employees, executive officers, directors and certain consultants.

**(s) Recently Issued Accounting Pronouncements**

In June 2009, the FASB issued SFAS No. 168 The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 . The FASB Accounting Standards Codification ( ASC ) will be the single source of authoritative nongovernmental U.S. generally accepted accounting principles. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. All existing accounting standards are superseded as described in SFAS 168. All other accounting literature not included in the Codification is nonauthoritative. Updates to the ASC are issued in the form of Accounting Standards Updates ( ASU ). Adoption of SFAS No. 168 did not have a material effect on the Company s financial statements.

**(3) Operating Results and Liquidity**

During 2008, the Company incurred a loss of \$3.4 million, used cash of \$2.7 million and experienced a decrease in working capital of \$6.6 million.

Management has taken several actions to provide assurance that the Company will continue as a going concern, including plans to enhance and conserve liquidity and capital resources. These plans include, among other things, (a) aggressive cost and cash management, including a moratorium on hiring of non-core personnel, compensation adjustments, and non-essential capital expenditures, (b) increased operational discipline, including the completion of the implementation of an Enterprise Resource Planning system designed to strengthen internal accounting and operational controls, and provide considerably more transparency and visibility into the business, (c) timely and adequate pricing adjustments to mitigate changes in input costs, (d) undertaking steps to mitigate the effects of changes in certain input and commodity costs, (e) continued aggressive management of the balance sheet, capital structure and working capital, (f) refinancing the revolving line of credit, which was completed during the first quarter of 2009, and (g) continuing to seek longer-term sources of capital, such as consideration of raising additional equity, subordinated debt, or a combination of similar instruments to strengthen the long term capital of the company. Not all of these actions will be undertaken with equal importance, and some may not be implemented at all. Those that are implemented may not be successful in achieving management s objectives. There can be no assurance that actions taken will be sufficient to enable management to mitigate the effects of continuing fragile economic conditions, and other external market conditions which are beyond the control of management. A further worsening of the economy in the United States of America could materially adversely affect the Company s business, including its results of operations, financial condition and prospects.

During the nine months ended September 30, 2009, the Company incurred a loss of \$0.5 million. The Company has improved the financial results of its operations in comparison to the same reporting period of 2008 through pricing adjustments and lower input costs and is reporting positive cash flow from operations. The Company increased its short-term borrowings under its new revolving line of credit by \$1.3 million and continues to aggressively manage its cash and capital resources.

**(4) Inventories**

A summary of inventories follows:

	<b>September 30, 2009 (unaudited)</b>	<b>December 31, 2008</b>
Raw materials and supplies	\$ 3,019,046	\$ 2,740,137
Finished goods	501,103	472,879
Deferred production costs	49,867	163,164
Total inventory	\$ 3,570,016	\$ 3,376,180

The Company has advanced certain monies related to growing costs to growers, pursuant to contracts and accounted for those advanced monies as Deferred production costs . The prepaid amounts represent raw materials that have yet to be harvested.





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(5) **Restricted Assets**

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

	<b>September 30, 2009 (unaudited)</b>	<b>December 31, 2008</b>
Project construction account	\$ 287	\$ 287
Debt reserve account	500,000	500,000
Interest fund account	185,403	29,456
Principal fund account	216,545	32,259
Letters of credit	528,000	
Total restricted assets	\$ 1,430,235	\$ 562,002

(6) **Property and Equipment**

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

	<b>September 30, 2009 (unaudited)</b>	<b>December 31, 2008</b>
Land	\$ 238,162	\$ 238,162
Plant and improvements	11,693,585	11,693,585
Machinery and equipment	9,251,830	9,083,707
Transportation equipment	485,159	560,257
Office equipment	198,875	178,991
Software development	1,727,470	1,420,811
Construction in progress	33,762	162,616
	23,628,843	23,338,129
Less accumulated depreciation	(7,479,651)	(6,279,438)
Property and equipment, net	\$ 16,149,192	\$ 17,058,691

During the three months ended September 30, 2009 and 2008, depreciation expense, including depreciation on assets classified as capital leases, was \$423,531 and \$398,523, respectively. During the nine months ended September 30, 2009 and 2008, depreciation expense, including depreciation on assets classified as capital leases, was \$1,258,579 and \$1,189,849, respectively.

In January of 2008, the Company entered into an agreement to sell certain transportation equipment for \$692,600 and lease back the same equipment under operating leases, for terms of three and five years varying on the remaining useful lives of the equipment. The gain on the sale of equipment has been deferred and is being amortized over the lease terms. Future minimum annual lease payments related to these operating leases have been included in Note 12.

(7) **Line of Credit**

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On December 31, 2007, the Company secured a \$5.0 million secured bank line of credit, due on March 31, 2010, providing for interest, floating at the bank's prime rate minus 0.625 percent (the prior revolving line of credit). The rate was adjustable quarterly depending on the Company's financial ratio of funded debt to EBITDA, as defined (earnings before interest, tax, depreciation and amortization). A change in the financial ratio would have caused a variation in the adjustment to the prime rate in the range between 1.000% and 0.375%. The line of credit was secured by accounts receivable, inventory and general intangibles, and subject to a debt service coverage ratio covenant of 1.25x to 1.00, as defined, for which the Company was not in compliance as of June 30, 2008, and the event of non-compliance was continuing through December 31, 2008.

The Company obtained a waiver of non-compliance with the agreement from its lender. The interest rate on the prior revolving line of credit was the prime rate plus 1.0 percent. There were short-term borrowings under the prior revolving line of credit of \$1.0 million at December 31, 2008.

On March 18, 2009, the Company closed on an asset-based line of credit of up to \$3.0 million, secured by accounts receivable and inventories (the new revolving line of credit). The new revolving line of credit bears interest, floating at the Wall Street Journal Prime Rate plus 4.5 percent, and is subject to certain financial covenants, including minimum cash position and EBITDA, measured on a monthly and quarterly basis, respectively, which the Company was in compliance with or has obtained a waiver of compliance as of September 30, 2009. The maximum amount of the line of credit was increased to \$3.5 million on September 30, 2009 in connection with a modification of terms used to calculate the available borrowing amount and a modification of the covenants. The new revolving line of credit matures on May 1, 2010. In connection with the new revolving line of credit, the Company issued 252,454 warrants to purchase common stock of the Company. The new revolving line of credit replaces the prior line of credit, which was retired with proceeds from the new revolving line of credit. Cash receipts from customers are deposited into a bank account that is subject to an account control agreement, wherein the funds are held for collection generally one-to-two days before being applied to balances outstanding under the new revolving line of credit. Once the funds are applied to balances outstanding, additional borrowing capacity is created, and funds can be immediately re-borrowed, subject to the other terms of the new revolving line of credit agreement. There were short-term borrowings under the new revolving line of credit of \$2.3 million at September 30, 2009, which represents the approximate amount available under the new revolving line of credit as of that date.

**(8) Long-Term Debt and Capital Lease Obligations**

Long-term debt consists of the following:

	September 30, 2009 (unaudited)	December 31, 2008
6.75 - 7.10% Cleveland County Industrial Revenue Bonds secured by real property final payment due December 1, 2024	\$ 4,015,000	\$ 4,015,000
5.75 - 9.00% Real estate loans secured by real property final payments due December 22, 2009 and August 1, 2028	3,302,284	3,383,671
8.75% Equipment loan secured by manufacturing equipment final payment due March 3, 2011	1,085,932	1,396,674
Various equipment and real estate loans with interest rates from 4.75 - 9.56% and due dates from 2009 - 2021	202,289	248,570
<b>Total long-term debt</b>	<b>8,605,505</b>	<b>9,043,915</b>
Less current portion	1,107,048	1,093,974
<b>Net long-term debt</b>	<b>\$ 7,498,457</b>	<b>\$ 7,949,941</b>

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

**Debt Service Coverage Ratio:** The Company is required to maintain a debt service coverage ratio of 1.50x to 1.00. The ratio will be reported to the Trustee and notice given to Beneficial Owners quarterly for each of the previous four quarters. If the Debt Service coverage ratio reported for each of the previous four quarters is less than 1.50x to 1.00 the Company is required to retain a consultant. As of September 30, 2009, our earnings before interest, income tax, depreciation and amortization (EBITDA) is a negative number which causes our debt service coverage ratio to result in a negative number, and therefore is not a meaningful ratio.

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**Current Ratio:** The Company is required to maintain a current ratio of 1.10x to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. The actual current ratio as of September 30, 2009 is 0.61x to 1.00.

**Debt to Equity Ratio:** The Company is required to maintain a debt to equity ratio of not more than 4.00x to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. The actual debt to equity ratio as of September 30, 2009 is 1.10x to 1.00.

**Accounts Payable:** The Company agrees that not more than 20 percent of the Company's accounts payable shall be in excess of 75 days past due. The actual percentage as of September 30, 2009 is 3 percent.

**Accounts Receivable:** The Company agrees that not more than 20 percent of the Company's accounts receivable will be in excess of 90 days past due. The actual percentage as of September 30, 2009 is less than 1 percent.

Capital lease obligations consist of the following:

	September 30, 2009 (unaudited)	December 31, 2008
8.95 - 9.19% Equipment leases	\$ 146,932	\$ 297,429
8.62% Equipment lease	-	722
	146,932	298,151
Less current portion	146,932	203,672
Net long-term debt	\$ -	\$ 94,479

**Annual Debt Service Requirements**

The unaudited annual principal payment requirements to maturity, for long-term debt and capital lease obligations at September 30, 2009 are as follows:

Year Ending September 30,	Long-Term Debt	Capital Lease Obligations	Total
2010	\$ 1,107,048	\$ 146,932	\$ 1,253,980
2011	1,145,352	-	1,145,352
2012	507,770	-	507,770
2013	545,876	-	545,876
2014	584,775	-	584,775
Thereafter	4,714,684	-	4,714,684
Principal outstanding at September 30, 2009	\$ 8,605,505	\$ 146,932	\$ 8,752,437

Total interest costs for the three and nine months ended September 30, 2009 and 2008, were as follows:

Three months ended September 30, 2009 (unaudited)	2008 (unaudited)	Nine months ended September 30, 2009 (unaudited)	2008 (unaudited)
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Interest expense	\$	306,074	\$	200,447	\$	821,954	\$	603,835
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(9) **Accrued Liabilities**

A summary of accrued liabilities follows:

	<b>September 30, 2009 (unaudited)</b>	<b>December 31, 2008</b>
Rebates and commissions	\$ 1,042,250	\$ 1,122,673
Interest expense	113,228	88,652
Compensation	528,263	195,071
Workers compensation	101,843	283,566
Promotions and incentives	194,513	154,113
Property taxes	98,866	5,977
Other	2,813	653
 Total accrued liabilities	 \$ 2,081,776	 \$ 1,850,705

(10) **Intangible Assets**

The Company holds an intangible asset, a customer list acquired by the Company in the amount of \$154,210. The Company began amortizing the asset to expense over a period of five years beginning July 1, 2007, resulting in amortization expense of \$7,712 and \$7,712, respectively during the three months ended September 30, 2009 and 2008. Amortization expense was \$23,136 and \$23,136 during the nine months ended September 30, 2009 and 2008, respectively. Accumulated amortization expense as of September 30, 2009 was \$69,408 resulting in a net carrying amount of \$84,802.

(11) **Income Taxes**

Income tax expense (benefit) for the three and nine months ended September 30, 2009 and 2008, consist of the following:

	<b>Three months ended September 30, 2009 (unaudited)</b>		<b>Nine months ended September 30, 2009 (unaudited)</b>		<b>2008 (unaudited)</b>	
<b>Current:</b>						
Federal	\$	-	\$	-	\$	-
State		-		-		-
		-		-		-
<b>Deferred:</b>						
Federal		(148,783)		(678,158)		(281,657)
State		(13,140)		(79,815)		(28,779)
		(161,923)		(757,973)		(310,436)
		(161,923)		(757,973)		(1,208,335)
 Total income tax expense (benefit)	 \$	 (161,923)	 \$	 (757,973)	 \$	 (310,436)
					\$	(1,208,335)

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Deferred tax assets (liabilities) are as follows:

	<b>September 30, 2009 (unaudited)</b>	<b>December 31, 2008</b>
Net operating loss carryforward	\$ 3,279,249	\$ 3,037,028
Depreciation	(705,291)	(759,901)
Deferred gain on sale of assets	19,977	30,198
Inventory capitalization	114,136	54,789
Reserve for worker compensation expense	38,700	107,755
Allowance for credit losses	49,933	53,531
Federal job credits	37,132	-
Oklahoma job and investment credits	877,310	866,310
Allowance for state job and investment credits	(789,743)	(778,743)
 Net deferred tax asset	 \$ 2,921,403	 \$ 2,610,967
 Current portion	 \$ 310,543	 \$ 310,266
Non-current portion	2,610,860	2,300,701
	 \$ 2,921,403	 \$ 2,610,967

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

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

As of September 30, 2009, the Company has a net operating loss carryforward of \$8.6 million representing a tax asset of \$3.3 million which, if unused, will commence expiring in 2023 and state new jobs/investment credit carryforwards totaling \$867,000 of which the Company has elected to provide a realizability allowance of \$779,000 resulting in a net carrying amount of \$88,000. If unused, the credits will commence expiring on December 31, 2021.

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

	<b>Three months ended September 30, 2009 (unaudited)</b>		<b>Nine months ended September 30, 2008 (unaudited)</b>	
Computed expected income taxes	\$ (129,188)	\$ (651,612)	\$ (264,139)	\$ (1,132,591)
State income taxes, net of federal income tax	(15,047)	(106,361)	(30,764)	(153,768)
Permanent difference due to gain on sale of assets	-	-	-	78,024
Other	(17,688)	-	(15,533)	-
	 \$ (161,923)	 \$ (757,973)	 \$ (310,436)	 \$ (1,208,335)



**(12) Operating Leases**

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

	<b>(unaudited)</b>
2010	\$ 680,788
2011	431,426
2012	294,905
2013	124,739
2014	-
	\$ 1,531,858

**(13) Employee Benefit Plans**

In 2002, the Company adopted a Flexible 401(k) plan covering all full-time employees with a minimum of one year of service. The plan contained a provision for the Company to contribute an amount equal to 25 percent of the employee's elective deferral rate, up to a maximum of 4 percent of the employee's compensation. The Company's contributions to the plan during the three and nine months ended September 30, 2008 were \$2,464 and \$5,039, respectively. The Company terminated the 401(k) plan effective December 31, 2008.

**(14) Stock-Based Compensation Expense**

In August 2006, the Company adopted the 2006 Equity Incentive Plan (the "Plan") providing for potential awards of up to 1,000,000 options to purchase shares of common stock in the Company. On November 26, 2008, the Compensation Committee of the Board of Directors of the Company approved a proposal by management to issue stock options under the Plan to certain employees, directors and consultants of the Company or a Subsidiary. Except as noted below, options shall have a 10-year term, and shall vest at 25% per year, commencing on the first anniversary of the grant date. The grant date was November 26, 2008, and the exercise prices are equal to the closing market price on November 25, 2008 (\$0.69), except for owners of 10% or more of the total shares of the Company. Exercise prices for the 10% and greater owners are 110% of the closing market price on November 25, 2008 (\$0.76) and the options (i) have a term of five (5) years and (ii) vest at the rate of 25% per year. In all cases, the options shall immediately vest upon a Change in Control of the Company, as defined in the Plan. All options granted to employees are intended to qualify as Incentive Stock Options, as defined by Section 422 of the Internal Revenue Code of 1986, as amended, and the stock options granted to non-employee directors and consultants to the Company or a Subsidiary will be Nonqualified Stock Options as provided for in the Plan. The Company uses the Black-Scholes method of valuing the options and charges amounts to earnings using the straight-line method over the vesting period. The Company charged \$7,499 and \$66,094 against earnings during the year ended December 31, 2008, and the nine months ended September 30, 2009, respectively, leaving a total of \$280,106 of unrecognized expense in connection with the issuance of the stock options. The assumptions used to value the options and the options granted to the owners of 10% or more of the total shares of the Company are as follows:

Expected volatility	118.47%
Expected term (months) except for owners of 10% or more of the Company's shares, for which the expected life assumption is 45.02	75.04
Expected dividend yield	0.00%
Risk Free Rate except for owners of 10% or more of the Company's shares, for which the risk free rate assumption is 1.38%	2.43%

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A summary of option activity under the Plan as of September 30, 2009 and changes during the period then ended is as follows:

Options	Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Outstanding at January 1, 2009	605,000	\$ 0.70	\$ 0.58
Granted	14,120	0.69	0.35
Vested	-	-	-
Exercised	-	-	-
Forfeited or expired	(17,500)	0.69	0.60
 Outstanding at September 30, 2009	 601,620	 \$ 0.70	 \$ 0.57
 Exercisable at September 30, 2009	 -	 \$ -	 \$ -

### (15) Major Customers

The Company has supply arrangements with two certain distributors, representing 11 percent and 10 percent of its net sales. Both distributors are composed of numerous distinct purchasing units. No individual purchasing unit of either distributor represents greater than 3 percent of gross revenues. The Company derives 14 percent of its net sales from a certain retailer, servicing all of its distribution centers located within the United States of America.

### (16) Commitments and Contingencies

The Company and its subsidiaries are subject to legal proceedings and claims which arise in the ordinary course of business. Although occasional adverse decisions or settlements may occur, the Company is not aware of any proceeding at September 30, 2009, which would have a material adverse effect on its consolidated financial position, results of operations or liquidity.

### (17) Initial Public Offering

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

Class A warrants entitle the holder to buy one common share at \$9.75 a share. The Class B warrants entitle holders to buy one share at \$13 a share.

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

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

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

A portion of the proceeds from the initial public offering were used to (a) acquire the net assets of Allison's for \$1.5 million in cash and a deferred payment of \$1.0 million, (b) repay a short-term borrowing of \$2.0 million which was used to complete the extension of our

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existing facility, and (c) repay our bank line of credit of \$2.7 million. The remainder of the proceeds were used to supplement our working capital and for general corporate purposes.

On June 30, 2008, the \$1.0 million deferred payment to acquire the net assets of Allison's was partially retired and an amount of \$802,500 was further deferred until June 30, 2009, with a note issued to our current Chief Executive Officer, Herbert Grimes, bearing interest at 10%. On July 17, 2009, the Company notified Herbert Grimes that it was unable to retire the note. On August 13, 2009, Mr. Grimes agreed to a new note with a principal amount of \$882,750, requiring scheduled weekly payments until June 30, 2010. The Company and Mr. Grimes further agreed that payment of the principal amount is subject to the Company's ability to pay.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

**Forward-looking Statements**

Certain written and oral statements set forth below or made by the Company with the approval of an authorized executive officer constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words believe, expect, intend, anticipate, project, will and similar expressions identify forward-looking statements, which convey the uncertainty of future events and generally are not historical in nature. All statements which address operating performance, events or developments that we expect or anticipate will occur in the future, including statements relating to the business, expansion and marketing strategies of the Company, industry projections or forecasts, the impact on our financial statements of inflation, legal action, future debt levels, sufficiency of cash flow from operations and borrowings and statements expressing general optimism about future operating results, are forward-looking statements. Such statements are based upon our management's current estimates, assumptions and expectations, which are based on information available at the time of the disclosure, and are subject to a number of factors and uncertainties, including, but not limited to:

our future operating results and the future value of our common stock;

our ability to obtain financing to fund our operations;

whether our assumptions turn out to be materially correct;

our ability to attain such estimates and expectations;

our ability to execute our strategy;

further material changes in market conditions in any industry, including the economic state of the food industry;

the effects of, or further material changes in, economic and political conditions in the United States of America and the markets in which we serve;

our ability to reasonably forecast prices of the commodities we purchase;

our ability to timely forecast and meet customer demand for fresh-cut salads and refrigerated prepared salads;

our ability to respond to changing consumer spending patterns; and

our ability to attract and retain quality employees and control our labor costs.

Any of the foregoing factors and uncertainties, as well as others, could cause actual results to differ materially from those described herein. We undertake no obligation to affirm, publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with the unaudited consolidated financial statements of the Company and the related notes thereto appearing elsewhere in this report.

**General**

Unless the context requires otherwise, all references in this report to we, our, us, and the Company refer to Vaughan Foods, Inc. and its consolidated subsidiary as a whole.

We are an integrated processor and distributor of value-added, refrigerated foods. We are uniquely able to distribute fresh-cut produce items along with a full array of value-added refrigerated prepared food multiple times per week. We sell to both food service and retail sectors. Our products consist of fresh-cut vegetables, fresh-cut fruits, salad kits, prepared salads, dips, spreads, soups, sauces and side dishes.

**Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the Company's consolidated financial statements and accompanying notes. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and our estimates,

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assumptions and judgments routinely require adjustment. The amounts of our assumptions regarding assets and liabilities reported in our consolidated balance sheets and the amounts of revenues and expenses reported for each of our fiscal periods are affected by the critical estimates and assumptions which are used for, but not limited to, the accounting for inventory, customer rebates, allowance for credit losses, impairment of

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long-lived assets, intangible assets, income taxes and stock-based compensation expense. Actual results could differ from these estimates and such differences could be material.

*Inventory.* Inventory purchases and purchase commitments are based upon forecasts of demand. Our inventory is stated at the lower of average cost (which approximates first-in, first-out) or market. Inventory turns rapidly due to the nature of our fresh products and, accordingly, we do not generally experience material inventory valuation issues. However, in the instance where we may believe that demand no longer allows us to sell certain inventory above cost or at all, then we revalue that particular inventory to market or charge-off excess inventory levels. If customer demand subsequently differs from our forecasts, requirements for inventory revaluations and charge-offs could differ from our estimates. We have not historically experienced any material inventory revaluations or charge-offs and manage inventory levels of both perishable and non-perishable supplies to minimize the effects of any revaluations.

*Customer Rebates.* Estimates and reserves for rebates are based on specific rebate programs, expected usage and historical experience. Actual results could differ from these estimates. With respect to some programs, we make a provision for rebates based on anticipated purchase volume. Greater than anticipated volume under a program would result in an additional charge to earnings. We have not historically experienced any material charges to earnings under our rebate programs; however, we could experience such charges in the future.

*Allowance for Credit Losses.* The allowance for credit losses is based on various factors including among other things, (a) our assessment of the collectibility of specific customer accounts, (b) our macro assessment of political and economic risks, (c) the overall aging of our accounts receivable portfolio, and (d) the effects each of these and other factors have on the consolidated portfolio. If there is a change in a customer's creditworthiness or actual defaults differ from our historical experience, our estimates of recoverability of amounts due us will be affected. We continually monitor customer accounts for indications of a customer's inability to pay. Our recent losses on charged-off accounts have not been material.

*Long-lived Assets.* Long-lived assets such as property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not ultimately be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its ultimate disposition. Cash flow estimates used in evaluating for impairment represent management's best estimates using appropriate assumptions and projections at the time. We have not experienced any write downs due to impairment for equipment in use. The depreciation lives of these assets are short (generally 5 to 7 years), resulting in relatively low net book values. Equipment not in use is depreciated in full or held for sale at its estimated recovery value.

*Intangible Assets.* We evaluate the recoverability of intangible assets annually or more frequently if impairment indicators arise. Under FASB ASC Topic 350 Intangibles—Goodwill and Other, Subtopic 30, intangible assets are evaluated whenever events or changes in circumstances indicate that the carrying value exceeds its fair value, which is determined based upon the estimated undiscounted future cash flows expected to result from the use of the asset, including disposition. Cash flow estimates used in evaluating for impairment represent management's best estimates using appropriate assumptions and projections at the time. We believe that accounting for intangible assets is a critical accounting policy due to the requirement to estimate the value in accordance with FASB ASC Topic 350. Our intangible assets consist primarily of customer relationship intangibles of purchased entities.

*Income taxes.* We account for income taxes 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. In assessing the realizability of the net deferred tax assets, management considers whether it is more likely than not that some or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon either (a) the generation of future taxable income during the periods in which those temporary differences become deductible, or (b) the carryback of losses to recover income taxes previously paid during the carryback period. As of September 30, 2009, we have net operating loss carryforwards of \$ 8.6 million, representing a deferred tax asset of \$3.3 million which, if unused, will commence expiring in 2023 and state new jobs/investment credit carryforwards totaling \$867,000 of which we have elected to provide a realizability allowance of \$779,000, resulting in a net carrying amount of \$88,000. If unused, the credits will commence expiring on December 31, 2021.

*Stock-Based Compensation Expense.* We measure stock based compensation costs at the grant date based on the fair value of the award and recognize as expense ratably over the requisite service period, net of estimated forfeitures. We use the Black-Scholes option-pricing model to determine the fair-value of stock option awards. We have awarded stock options to employees, executive officers, directors and certain consultants.

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### Comparison of Three Months Ended September 30, 2009 and 2008

We recorded a net loss for the third quarter of 2009 of \$218,000, or \$0.05 per share compared to a net loss of \$1,159,000, or \$0.25 per share in the third quarter of 2008. We generally continue to experience stabilization of diesel fuel and commodity food prices, such as corn, wheat and soybeans, particularly in comparison to the third quarter of 2008 when prices for these products increased at rates that we were not able to manage effectively to avert an adverse effect to our earnings in the short term. We continue to evaluate and align our pricing with our input costs, however we can provide no assurance that diesel fuel and commodity food prices will remain stable.

*Net sales.* Net sales increased 1.0 percent to \$24.1 million in the third quarter of 2009 compared to \$23.9 million in the same period of 2008. The increase is attributable to increases in the average selling price per pound, due to (a) higher prices for products sold, and (b) sales mix, specifically, increased sales of higher priced products. Our volume as measured in total pounds of food products sold, decreased primarily as a result of lower sales of bulk products to foodservice distributors, and increased sales of smaller size products sold to retail customers, resulting in net lower pounds of product sold. We expect that, during periods of weak economic conditions throughout our service areas generally, customers tend to lower their purchases at restaurants and increase their purchases at grocery stores.

*Gross profit.* Our gross profit margin increased to 8.2 percent in the third quarter of 2009 compared to 4.0 percent in the third quarter of 2008. Our raw material, packaging and transportation costs decreased in comparison to those costs in the same period of 2008 due to stabilization of diesel fuel and commodity food prices. Our labor and labor related costs increased by \$124,000 in the third quarter of 2009 in comparison to the same period in 2008. We believe that our higher labor costs are the result of changes in the workforce in Oklahoma caused by stricter immigration enforcement legislation. Disregarding the effects of future automation or product mix changes, we expect our labor costs to continue to be higher on a per-pound-produced basis than we have experienced historically.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses decreased from \$2.6 million in the third quarter of 2008 to \$2.1 million in the third quarter of 2009 as a result of decreasing our sales and administrative costs by \$256,000, primarily by integrating the functions of finance and sales between our facilities. Efforts to reduce our expenses resulted in a decrease of our consulting, legal and professional expenses by \$255,000.

*Other income and expense.* Other income and expense resulted in a net expense of \$297,000 in the third quarter of 2009 compared to a net expense of \$289,000 in the third quarter of 2008. Interest expense increased to \$306,000 in the third quarter of 2009 from \$200,000 in the third quarter of 2008 due primarily to interest expense and amortization of loan origination fees associated with borrowings and completion of our new revolving line of credit. We had borrowings of \$2.3 million under our revolving line of credit at September 30, 2009 and \$0.9 million under our previous line of credit on September 30, 2008. The interest rate on our new revolving line of credit is prime plus 4.5 percent or 7.75 percent compared to prime plus 1.0 percent or 6.0 percent under our previous line of credit. We recognized a gain on sale of transportation equipment in the third quarter of 2009 of \$9,000 compared to a loss on sale of certain transportation equipment of \$94,000 in the third quarter of 2008. We had no interest income in the third quarter of 2009 compared to \$5,000 of interest income in the third quarter of 2008, as we have employed all of our available cash resources to fund our operations and restricted assets, service our indebtedness and provide for a minimal level of capital expenditures.

*Income tax expense (benefit).* We recognized an income tax benefit of \$162,000 in the third quarter of 2009 compared to a benefit of \$758,000 in the third quarter of 2008, both of which are primarily attributable to operating losses and the creation of net operating loss carryforwards to be utilized for income tax purposes in future periods.

### Comparison of Nine Months Ended September 30, 2009 and 2008

We recorded a net loss of \$466,000 or \$0.10 cents per share in the nine month period ending on September 30, 2009 compared to a net loss of \$2,123,000 or \$0.46 cents per share in the same nine month period of 2008. Improvement in our results of operations is attributable to the general stabilization of diesel fuel and commodity food prices, such as corn, wheat and soybeans, particularly in comparison to the third quarter of 2008 when prices for these products increased at rates that we were not able to manage effectively to avert an adverse effect to our earnings in the short term. We made price adjustments in the first quarter of 2009 to align our pricing with higher, but more stable input costs and we continue to evaluate the need for further price adjustments.

*Net sales.* Net sales increased 6.9 percent or \$4.8 million in the nine month period ending on September 30, 2009 compared to same nine month period of 2008. The increase is attributable to increases in the average selling price per pound, due to (a) higher prices for products sold, and (b) sales mix, specifically, increased sales of higher priced products. Our volume as measured in total pounds of food products sold, decreased primarily as a result of lower sales of bulk products to foodservice distributors, and increased sales of smaller size products sold to retail customers, resulting in net lower pounds of product sold. We expect that, during periods of weak economic conditions throughout our service areas generally, customers tend to lower their purchases at restaurants and increase their purchases at grocery stores.

*Gross profit.* Our gross profit margin increased to 8.9 percent in the nine month period ending on September 30, 2009 from 6.9 percent in the same nine month period of 2008. Our raw material cost were higher in the nine months ending on September 30, 2009 in comparison to the



same nine month period in

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2008 due primarily to sales of smaller size, and higher priced products. Our transportation costs decreased in comparison to those costs in the same period of 2008 due to stabilization of diesel fuel costs. Our labor and labor related costs increased by \$2.1 in the nine month period of 2009 in comparison the same period in 2008. We believe that our higher labor costs are the result of changes in the workforce in Oklahoma caused by immigration enforcement legislation. Disregarding the effects of future automation or product mix changes, we expect our labor costs to continue to be higher on a per-pound-produced basis than we have experienced historically.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses decreased to \$6.6 million in the nine month period ending on September 30, 2009 compared to \$7.5 million in the same nine month period of 2008. Efforts to reduce our expenses resulted in decreasing our consulting, legal and professional expenses by \$744,000. Integration of the functions of finance and sales between our facilities resulted in expense decreases of \$135,000.

*Other income and expense.* Other income and expense resulted in a net expense of \$807,000 in the nine month period ending on September 30, 2009 compared to a net expense of \$645,000 in the same nine month period of 2008. Interest expense increased to \$822,000 for the nine month period ended on September 30, 2009 compared to \$604,000 in the same nine month period of 2008 due primarily to interest expense and amortization of loan origination fees associated with borrowings and completion of our new revolving line of credit. We had borrowings of between \$1.0 million and \$2.3 million under our revolving line of credit during the nine month period ending on September 30, 2009 and between \$0 and \$1.0 million under our previous line of credit during the same nine month period ending on September 30, 2008. The interest rate on our new revolving line of credit is prime plus 4.5 percent or 7.75 percent compared to prime plus 1.0 percent or 6.0 percent under our previous line of credit. We recognized a gain on the sale of transportation equipment of \$15,000 in the nine month period ending on September 30, 2009 compared to a loss on sale of assets, primarily transportation equipment in the same nine month period ending September 30, 2008 of \$76,000. We had no interest income in the nine month period ending on September 30, 2009 compared to interest income of \$35,000 in the same nine month period ended September 30, 2008, as we have employed all of our available cash resources to fund our operations and restricted assets, service our indebtedness and provide for a minimal level of capital expenditures.

*Income tax expense (benefit).* We recognized an income tax benefit of \$310,000 in the nine month period ending on September 30, 2009 compared to a benefit of \$1,208,000 in the same nine month period of 2008, both of which are primarily attributable operating losses and the creation of net operating loss carryforwards to be utilized for income tax purposes in future periods.

### Liquidity and Capital Resources

Our Form 10-K filed with the U.S. Securities and Exchange Commission on April 15, 2009, includes a detailed discussion of our liquidity and capital resources and our analysis of the current economic and credit conditions. The following is an update and should be read in conjunction with the Liquidity and Capital Resources discussion on our Form 10-K.

We completed the refinancing of our revolving line of credit on March 18, 2009, extending our availability from \$1.0 million to \$3.0 million, and extended to \$3.5 million with an amendment to the March 18, 2009 agreement on September 30, 2009. Proceeds of the refinancing were used to (a) payoff the previous line of credit of \$1.0 million (b) fund letters of credit of \$0.4 million and (c) provide additional working capital to continue implementation of our enterprise resource planning ( ERP ) system and complete the refinancing of our new revolving line of credit. We experienced an overall decrease in working capital of \$1.2 million during the first nine months of 2009 as we increased our short-term borrowings on our new revolving line of credit. Our operating activities have not provided adequate liquidity to, among other things, fund our operations and restricted assets, service our indebtedness and provide for a minimum level of capital expenditures, causing us to increase our short term borrowings and aggressively manage our cash resources.

The terms of our new revolving line of credit are significantly more expensive than would be expected during times of less restrictive credit conditions and matures in the second quarter of 2010. However, we can provide no assurance that economic and credit conditions will improve, that we can obtain any additional financing which may be required to fund our business, that we can replace our revolving line of credit when it matures or that our actual cash requirements will not be greater than we currently anticipate. We continue to seek alternatives to strengthen our liquidity and capital resources.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risk is the risk of loss to future earnings or future cash flows that may result from changes in economic factors. In the normal course of business, we are exposed to market risks related to changes in interest rates and prices of our raw materials.

*Interest Rate Risk.* We are subject to market risk from exposure to fluctuations in interest rates. Some of our debt instruments contain variable interest rates adjusted quarterly and upon date of change, and indexed by different published rates. At September 30, 2009 our revolving line of credit variable interest rate was 7.75 percent, or Wall Street Journal Prime Rate plus 4.5 percent. As of September 30, 2009 there were borrowings of \$2.3 million. Other long-term debt, totaling \$3.3 million, secured by real estate and other assets also have variable rates indexed by LIBOR and other lending institution Base



Rates. A change in interest rates of 1.0 percent on our total debt outstanding at September 30, 2009, of \$12.0 million would cause an increase in interest expense of \$0.1 million.

*Commodity Price Risks.* The supply and price of fresh vegetables, fruits and other food commodities is subject to volatility due to growing seasons, the risk of crop failure, catastrophic or abnormal weather events, and other factors beyond our control. We enter into agreements (which are specific as to price and quantity within a range and are cancelable by us and the supplier upon 60 or 90 days' notice, depending on the term of the agreement and which contain Act of God or Force Majeure clauses) for supply at fixed prices to provide a limited amount of ability to maintain an adequate supply of raw materials, so that we may service our customers in the event of a market shortage. Our purchase agreements may cause our purchase costs to be higher than prevailing market conditions in the event of a low market with excessive supply. In contrast, our purchase agreements may cause our purchase costs to be lower than prevailing market conditions in the event of a high market with limited supply. There can be no assurance that our suppliers will be able to fulfill our contracts or will not invoke Force Majeure clauses in our agreements in the event of a limited supply market. We may also make purchase commitments for more product than we will require over a period of time, and may have to pay our suppliers for that product for which we have made a commitment, but that we do not require.

*Fuel Cost.* Our business is highly dependent upon timely delivery of our products by our fleet of delivery equipment. Increases in diesel fuel prices increased our delivery costs during the last three years and more significantly during 2008. Diesel fuel prices have moderated during the first nine months of 2009. Our diesel fuel purchases for use in our delivery equipment represent 2.2 percent and 4.7 percent of our total cost of sales for the three months ended September 30, 2009 and the year ended December 31, 2008, respectively. An increase of \$1.00 per gallon of diesel fuel purchased would cause an increase in our total cost of sales of approximately \$850,000 annually, or 1 percent of our net sales at our 2008 rate. Increases in diesel fuel costs included increased raw material costs for inbound freight, and our cost to deliver products to our customers. Material increases in fuel costs put us at a competitive disadvantage compared to suppliers located closer to their customers.

#### **ITEM 4. CONTROLS AND PROCEDURES.**

##### **(a) Evaluation of disclosure controls and procedures**

The Company maintains disclosure controls and procedures that are designed to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management.

Management of the Company, including the Chief Executive Officer and the Chief Financial Officer, conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in the Exchange Act Rule 13a-15(e)) as of September 30, 2009. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2009.

##### **(b) Changes in internal control over financial reporting**

There were no changes in our internal control over financial reporting that occurred during the period covered by this report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are not a party to any material legal proceedings. We could become involved in litigation from time to time relating to claims arising out of our ordinary course of business.

**Item 1A. Risk Factors**

Our Form 10-K filed with the U.S. Securities and Exchange Commission on April 15, 2009, includes a detailed discussion of our risk factors. Since that time, there have been no material changes to our risk factors.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

We held our 2009 annual meeting of stockholders at our offices located at 1005 Messenger Lane, Moore, Oklahoma 73160 on August 6, 2008, pursuant to due notice.

The following directors were elected at the meeting: Herbert B. Grimes, Mark E. Vaughan, Robert S. Dillon, Richard A. Kassar, Laura J. Pensiero.

The matters for consideration were:

- (1) Elect directors to hold office until the Annual Meeting of Stockholders in 2010, and until their successors are elected and qualified.
- (2) Ratify the selection of Cole & Reed, P.C. as the independent registered public accounting firm for the fiscal year ended December 31, 2009

The result of the shareholder voting is noted below:

1. Election of Directors. Presented below are the votes cast for each director nominee.

NAME	FOR	WITHHELD AUTHORITY
Herbert B. Grimes	4,070,064	62,145
Mark E. Vaughan	4,071,064	61,145
Robert S. Dillon	4,071,064	61,145
Richard A. Kassar	4,070,064	62,145
Laura J. Pensiero	4,071,064	61,145

2. Ratification of the selection of Cole & Reed, P.C. as the independent registered public accounting firm for the fiscal year ended December 31, 2009.

FOR	AGAINST	ABSTAIN
4,071,569	58,484	2,156

**Item 5. Other Information**

None.



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### Item 6. Exhibits

The following exhibits are filed herewith or incorporated by reference as indicated as required by Item 601 of Regulation S-K.

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: November 10, 2009

**Vaughan Foods, Inc.**

By: /s/ Herbert B. Grimes  
Herbert B. Grimes  
*Chairman of the Board of Directors and  
Chief Executive Officer  
(Principal Executive Officer)*

Dated: November 10, 2009

**Vaughan Foods, Inc.**

By: /s/ Gene P. Jones  
Gene P. Jones  
*Chief Financial Officer  
(Principal Financial Officer)*



**EXHIBIT INDEX**

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