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AMERICAN AMMUNITION INC/FL  
Form 10QSB  
September 20, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

Form 10-QSB

(Mark one)

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

For the quarterly period ended June 30, 2007

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

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

Commission File Number: 0-32379

American Ammunition, Inc.

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

Nevada

91-2021594

-----  
(State of incorporation)

-----  
(IRS Employer ID Number)

3545 NW 71st Street, Miami, FL 33147

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

(305) 835-7400

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

-----  
Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

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

State the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date: As of September 17, 2007:, the Transfer Agent's records indicate that there are 28,372,922 shares outstanding. Of these shares, a total of 21,803,335 shares were subject to an escrow agreement referenced in later filings.

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

American Ammunition, Inc.

Form 10-QSB for the Quarter ended June 30, 2007

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Part I  
Item 1 - Financial Statements

American Ammunition, Inc. and Subsidiaries  
Consolidated Balance Sheets  
June 30, 2007 and 2006  
(Unaudited)

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|   | June 30, 2007 | J     |
|---|---------------|-------|
|   | -----         | ----- |
| ASSETS  |               |       |
| Current Assets  |               |       |
| Cash on hand and in bank  | \$ 141,989    | \$    |
| Accounts receivable - trade, net of allowance for<br>doubtful accounts of \$-0- and \$10,000, respectively                                  | 301,490       |       |
| Inventory   | 350,350       |       |
| Prepaid interest  |               |       |
| Prepaid expenses  | 87,700        |       |
|   | -----         |       |
| Total Current Assets  | 881,529       |       |
|   | -----         |       |
| Property and Equipment - at cost  | -             |       |
|   | -----         |       |
| Other Assets  | 208,765       |       |
|   | -----         |       |
| TOTAL ASSETS  | \$ 1,090,294  | \$    |
|   | =====         | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)  |               |       |
| Current Liabilities   |               |       |
| Working capital advance   | \$ -          | \$    |
| Convertible debenture   | -             |       |
| Customer deposits   | 134,637       |       |
| Accounts payable - trade  | 725,155       |       |
| Accrued Federal excise taxes payable  | 23,563        |       |
| Accrued salaries and wages  | 488,904       |       |
| Accrued interest payable  | 74,650        |       |
| Accrued dividends payable   | 88,228        |       |
|   | -----         |       |
| Total Current Liabilities   | 1,535,137     |       |
|   | -----         |       |
| Long-Term Liabilities   |               |       |
| Notes payable to stockholders   | 1,075,000     |       |
|   | -----         |       |
| Derivative liability from note conversion features  | 3,146,963     |       |
|   | -----         |       |
| Total Long-Term Liabilities   | -----         |       |
|   | -----         |       |
| Total Liabilities   | 5,757,100     |       |
|   | -----         |       |
| Commitments and Contingencies   |               |       |
| Stockholders' Equity (Deficit)  |               |       |
| Preferred stock - \$0.001 par value<br>20,000,000 shares authorized.<br>2,004,562 and 2,072,902 shares issued and outstanding, respectively | 2,004         |       |
| Common stock - \$0.001 par value.<br>300,000,000 shares authorized.<br>23,029,320 and 5,122,931 shares issued and outstanding, respectively | 23,029        |       |
| Additional paid-in capital  | 33,709,835    |       |
| Accumulated other comprehensive loss  |               |       |
| Accumulated deficit   | (35,851,615)  |       |
|   | -----         |       |
|   | (4,494,340)   |       |
| Stock subscription receivable   | -             |       |
|   | -----         |       |
| Total Stockholders' Equity (Deficit)  | (4,494,340)   |       |

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TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY -----  
\$ 1,262,760  
=====

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

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

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American Ammunition, Inc. and Subsidiaries  
Consolidated Statements of Operations and Comprehensive Income (Loss)  
Six and Three months ended June 30, 2007 and 2006  
(Unaudited)

|  | Six months<br>ended<br>June 30, 2007<br>----- | (Restated)<br>Six months<br>ended<br>June 30, 2006<br>----- | Three months<br>ended<br>June 30, 2007<br>----- |
|--|---|---|---|
| Revenues   | \$ 1,390,377                                  | \$ 1,379,497  | \$ 699,988                                      |
| Cost of Sales                                      |   |   |   |
| Materials, Direct Labor<br>and other direct costs  | 1,733,467                                     | 2,012,170   | 857,704   |
| Depreciation                                       | 41,376  | 31,024  | -   |
| Total Cost of Sales                                | 1,774,843                                     | 2,043,194   | 857,704   |
| Gross Profit                                       | (384,466)                                     | (663,697)   | (157,716)                                       |
| Operating Expenses                                 |   |   |   |
| Research and development expenses                  | 567   | -   | -   |
| Selling and marketing expenses                     | 40,726  | 74,075  | 8,354   |
| Other operating expenses                           | 439,532                                       | 852,390   | 155,193   |
| Interest expense                                   | 72,0665                                       | 302,789   | 44,063  |
| Depreciation and amortization                      | 27,569  | 27,569  | 13,784  |
| Total Operating Expenses                           | 580,460                                       | 1,256,823   | 221,394   |
| Loss from Operations                               | (964,926)                                     | (1,920,520)   | (63,678)  |
| Other Income (Expense)                             |   |   |   |
| Interest and other income                          | 30,091  | 189,492   | 30,002  |
| Income (Loss) before Income Taxes                  | (995,017)                                     | (1,731,028)   | (33,676)  |
| Provision for Income Taxes                         | -   | -   | -   |
| Net Income (Loss)                                  | (995,017)                                     | (1,731,028)   | (33,676)  |
| Other Comprehensive Income                         |   |   |   |
| Change in derivative related<br>to note conversion | 1,910,578                                     | (2,694,571)   | (491,681)                                       |

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|  |                |                |              |
|--|----------------|----------------|--------------|
| Comprehensive Income (Loss)  | \$ 915,561     | \$ (4,425,599) | \$ (525,357) |
|  | =====          | =====          | =====        |
| Preferred Stock Dividends  | (26,134)       | (43,492)       | (13,094)     |
|  | -----          | -----          | -----        |
| Net Loss available to<br>Common Shareholders   | \$ (1,021,151) | \$ (1,774,520) | \$ (46,770)  |
|  | =====          | =====          | =====        |
| Loss per weighted-average share of<br>common stock outstanding,<br>computed on net loss -<br>basic and fully diluted | \$ (0.04)      | \$ (0.39)      | \$ (0.00)    |
|  | =====          | =====          | =====        |
| Weighted-average number of<br>common shares outstanding  | 23,021,823     | 4,537,640      | 23,027,997   |
|  | =====          | =====          | =====        |

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

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

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American Ammunition, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Six months ended June 30, 2007 and 2006  
(Unaudited)

|   | Six months<br>ended<br>June 30, 2006 |
|---|--------------------------------------|
|   | -----                                |
| Cash flows from operating activities  |                                      |
| Net loss for the year   | \$ (995,017)                         |
| Adjustments to reconcile net loss to<br>net cash provided by operating activities |                                      |
| Depreciation and amortization   | 97,678                               |
| Bad debt expense  | -                                    |
| Operating expenses paid with common stock   | -                                    |
| Consulting expense related to common stock sales<br>at less than air value        | -                                    |
| Gain on disposition of fixed assets   | (30,000)                             |
| (Increase) Decrease in  |                                      |
| Accounts receivable   | 95,148                               |
| Inventory   | 159,754                              |
| Prepaid expenses, deposits and other  | (107,365)                            |
| Increase (Decrease) in  |                                      |
| Accounts payable - trade  | (10,106)                             |
| Other accrued expenses  | (220,503)                            |
| Accrued interest payable  | 39,863                               |
| Customer deposits   | (55,203)                             |
|   | -----                                |
| Net cash used in operating activities   | (1,025,751)                          |
|   | -----                                |
| Cash flows from investing activities  |                                      |

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|  |             |    |
|--|-------------|----|
| Purchase of property and equipment   | (41,376)    |    |
|  | -----       |    |
| Net cash used in investing activities  | (41,376)    |    |
|  | -----       |    |
| Cash flows from financing activities   |             |    |
| Cash advanced on loans from stockholders   | -           |    |
| Cash received on working capital advance   | -           |    |
| Cash received from the sale of preferred stock                                       | -           |    |
| Cash received from sale of common stock  | -           |    |
| Cash paid to acquire capital   | -           |    |
|  | -----       |    |
| Net cash provided by financing activities  | -           |    |
|  | -----       |    |
| Increase (Decrease) in Cash  | (1,067,127) |    |
| Cash at beginning of year  | 1,209,116   |    |
|  | -----       |    |
| Cash at end of period  | \$ 141,989  | \$ |
|  | =====       |    |
| Supplemental disclosure of interest and income taxes paid                            |             |    |
| Interest paid for the period   | \$ 3,470    | \$ |
|  | =====       |    |
| Income taxes paid for the period   | \$ -        | \$ |
|  | =====       |    |
| Supplemental disclosure of non-cash investing and financing activities               |             |    |
| Conversion of debt and/or accrued interest payable into common stock                 | \$ -        | \$ |
|  | =====       |    |
| Common stock issued in payment for costs of raising capital                          | \$ -        | \$ |
|  | =====       |    |
| Common stock issued in payment of accrued dividends<br>on Preferred Stock - Series B | \$ 8,542    | \$ |
|  | =====       |    |

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

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

American Ammunition, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
June 30, 2007 and 2006

Note A - Organization and Description of Business

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

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

Industrial Plating Enterprise Co. (IPE), which was incorporated and commenced production on June 14, 2002. IPE is a fully licensed and approved state of the

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art electrochemical metallization facility for processing the Company's line of small arms projectiles as well as other products and services while employing environmentally sound water conservation and proven waste treatment techniques. The facility meets or exceeds all current environmental requirements and enjoys the "conditionally exempt small quantity generator" status for State and Federal regulations. All activities of IPE since its inception were dedicated solely to the needs and demands of F&F. During the 2nd quarter of 2007, the Company closed the operations of this entity, disposed of related fixed assets as per environmental requirements. The company may have a continuing obligation or liability related to this portion of the Company's manufacturing process.

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

### Note B - Preparation of Financial Statements

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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

During interim periods, the Company follows the accounting policies set forth in its annual audited financial statements filed with the U. S. Securities and Exchange Commission on its Annual Report on Form 10-KSB for the year ended December 31, 2006. The information presented within these interim financial statements may not include all disclosures required by generally accepted accounting principles and the users of financial information provided for interim periods should refer to the annual financial information and footnotes when reviewing the interim financial results presented herein.

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

In the opinion of management, the accompanying interim financial statements, prepared in accordance with the U. S. Securities and Exchange Commission's instructions for Form 10-QSB, are unaudited and contain all material adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial condition, results of operations and cash flows of the Company for the respective interim periods presented. The current period results of operations are not necessarily indicative of results which ultimately will be reported for the full fiscal year ending December 31, 2007.

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

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

### Note C - Going Concern Uncertainty

The Company continues to experience fluctuating periodic revenues, as demonstrated in Note P. The Company's operations consistently demonstrate a negative cash flow position as evidenced by net cash used in operating activities of approximately \$(1,716,000), \$(1,802,000), \$(649,000), \$(2,918,000), \$(1,236,000) and \$(1,100,000) for each of the respective years ended December 31, 2006, 2005, 2004, 2003, 2002 and 2001.

The Company has sustained liquidity through the sale of equity securities, restricted and unrestricted, domestically and in international markets and significant working capital advances have been made by members of management and/or existing shareholders. Future liquidity may be dependent upon future offerings of debt and/or equity securities; however, the availability of further liquidity from these sources is uncertain.

The Company's continued existence is principally dependent upon its ability to generate sufficient cash flows from operations to support its daily operations on a timely basis. There is no assurance that the Company will be able to obtain raw materials in sufficient quantity, due to its financial condition, to ensure success of its business plan. Further the ability to obtain additional funding through the sales of additional equity securities or, that such funding, if available, will be obtained on terms favorable to or affordable by the Company is uncertain.

The Company anticipates that additional working capital will be necessary to support and preserve the integrity of the corporate entity. However, there is no assurance that the Company will be able to obtain additional funding through either bank lines-of-credit or the sale of additional equity securities or, that such funding, if available, will be obtained on terms favorable to or affordable by the Company.

If no additional operating capital is received during the next twelve months, the Company will be forced to rely on existing cash in the bank, the cash generated from operating activities and/or additional funds loaned by the Company's management and/or shareholders to preserve the integrity of the corporate entity. In the event, the Company is unable to acquire advances from management and/or significant stockholders, the Company's ongoing operations

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would be negatively impacted to the point that all operating activities are ceased.

While the Company is of the opinion that good faith estimates of the Company's ability to secure additional capital in the future to reach our goals have been made, there is no guarantee that the Company will receive sufficient funding to sustain operations or implement any future business plan steps.

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### American Ammunition, Inc. and Subsidiaries Notes to Consolidated Financial Statements - Continued June 30, 2007 and 2006

#### Note D - Summary of Significant Accounting Policies

##### 1. Cash and cash equivalents

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

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

##### 2. Accounts receivable and Revenue Recognition

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

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

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

##### 3. Inventory

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

In November 2004, Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("Statement") No. 151, "Inventory Costs - an amendment of Accounting Research Bulletin No. 43, Chapter 4." Statement No. 151 requires that abnormal amounts of costs,

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including idle facility expense, freight, handling costs and spoilage, should be recognized as current period charges. The provisions of this Statement became effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Statement No. 151 was adopted the Company on January 1, 2006. There was no material impact resulting from the adoption of Statement No. 151 on the Company's financial statements.

#### 4. Property, plant and equipment

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

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

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### American Ammunition, Inc. and Subsidiaries Notes to Consolidated Financial Statements - Continued June 30, 2007 and 2006

#### Note D - Summary of Significant Accounting Policies - Continued

#### 5. Income Taxes

The Company uses the asset and liability method of accounting for income taxes. At June 30, 2007 and 2006, the deferred tax asset and deferred tax liability accounts, as recorded when material to the financial statements, are entirely the result of temporary differences. Temporary differences represent differences in the recognition of assets and liabilities for tax and financial reporting purposes, primarily accumulated depreciation and amortization, allowance for doubtful accounts and vacation accruals.

As of June 30, 2007 and 2006, the deferred tax asset related to the Company's net operating loss carryforward is fully reserved. The Company's net operating loss carryforwards, if not fully utilized, began to expire at December 31, 2005.

#### 6. Earnings (loss) per share

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

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

Common stock equivalents represent the dilutive effect of the assumed exercise of the outstanding stock options and warrants, using the treasury stock method, at either the beginning of the respective period presented or the date of issuance, whichever is later, and only if the common stock equivalents are considered dilutive based upon the Company's net income (loss) position at the calculation date.

As of June 30, 2007 and 2006, and subsequent thereto, the Company had no options outstanding. The outstanding warrants, mandatory convertible

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preferred stock and mandatory convertible debentures are anti-dilutive due to the Company's net operating loss position.

### 7. Advertising costs

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

### 8. Pending and/or New Accounting Pronouncements

The Company is of the opinion that any pending accounting pronouncements, either in the adoption phase or not yet required to be adopted, will not have a significant impact on the Company's financial position or results of operations.

### Note E - Fair Value of Financial Instruments

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

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American Ammunition, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements - Continued  
June 30, 2007 and 2006

### Note E - Fair Value of Financial Instruments - Continued

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

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

### Note F - Inventory

As of June 30, 2007 and 2006, inventory, as valued using the lower-of-cost or market, consisted of the following components:

|                 | June 30,<br>2007 | June 30,<br>2006 |
|-----------------|------------------|------------------|
| Raw materials   | \$ 267,443       | \$ 398,511       |
| Work in process | 57,896           | 19,313           |
| Finished goods  | 25,011           | 8,852            |
| Totals          | \$ 350,350       | \$ 425,337       |

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### Note G - Property and Equipment

Property and equipment consist of the following components:

|                               | June 30,<br>2007 | June 30,<br>2006 | Estimated<br>useful life |
|-------------------------------|------------------|------------------|--------------------------|
|                               | -----            | -----            | -----                    |
| Manufacturing equipment       | \$ 7,752,656     | \$ 7,939,335     | 3-10 years               |
| Office furniture and fixtures | 71,437           | 69,889           | 3- 7 years               |
| Leasehold improvements        | 184,939          | 190,277          | 8-20 years               |
|                               | -----            | -----            |                          |
| Accumulated depreciation      | 8,009,032        | 8,199,501        |                          |
| Impairment of recoverability  | (5,561,851)      | (5,575,782)      |                          |
| of carrying value             | (2,447,181)      | (2,623,719)      |                          |
|                               | -----            | -----            |                          |
| Net property and equipment    | \$ -             | \$ -             |                          |
|                               | =====            | =====            |                          |

Total depreciation expense charged to operations for each of the six month periods ended June 30, 2007 and 2006, respectively, was approximately \$41,376 and \$31,024.

In accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company follows the policy of evaluating all property and equipment as of the end of each reporting quarter. Pursuant to the requirements of this accounting standard, there were no impairments for the future recoverability of these assets during either of the six month periods ended June 30, 2007 and 2006.

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American Ammunition, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements - Continued  
June 30, 2007 and 2006

### Note H - Loans from Shareholders

|   | June 30,<br>2007 | June 30,<br>2006 |
|---|------------------|------------------|
|   | -----            | -----            |
| Notes payable to three separate stockholders. Interest at 8.0%, payable monthly. Principal due at maturity on December 31, 2008. Shareholder/lender has the option to convert the principal amount into common stock of the Company at the lesser of 66-2/3% of the average closing bid and ask price on the date of conversion or \$0.07 per share, whichever is less. Each note is unsecured. | \$ 1,075,000     | \$ 1,075,000     |
|   | =====            | =====            |

### Note I - Federal Excise Taxes Payable

On March 29, 2007, the Company reached a settlement and executed a Payment Agreement with the Department of the Treasury, Bureau of Alcohol, Tobacco and

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Firearms, related to a audit, which commenced during 2006, of the Company's Federal Excise Taxes obligation. The Department of Treasury, Bureau of Alcohol, Tobacco and Firearms ratified and affirmed this settlement in writing on April 4, 2007. The Payment Agreement calls for the Company to pay an aggregate total of \$300,000, plus interest at the statutory rate starting on March 29, 2007. This obligation was fully accrued in the Company's financial statements as of December 31, 2006.

The Company paid this obligation in full during the quarter ended June 30, 2007 for approximately \$303,470 cash, including approximately \$3,470 in accrued interest. To the best of the Company's knowledge, there are no continuing liabilities or obligations related to this situation.

### Note J - Convertible Debenture

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

As of September 30, 2006, the outstanding balance on the La Jolla convertible debenture has been retired. A recap of the debenture activity is as follows:

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

In addition to retiring the debenture, the Company repaid \$200,000 in prepaid warrant exercises and approximately \$158,635 in negotiated prepayment and penalty fees for an aggregate payment of \$585,000.

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American Ammunition, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements - Continued  
June 30, 2007 and 2006

### Note J - Convertible Debenture-Continued

Additionally, the Company recognized a charge to operations, including the aforementioned \$158,635 cash payment, of approximately \$354,450 for the issuance of 56,003 shares of common stock to La Jolla and the forgiveness of \$175,000 in monies due from La Jolla for common stock issued on warrant exercises in prior periods.

On September 13, 2006, La Terraza Trading and Asset Management Ltd. ("Investor") deposited a total of \$2,150,000 in escrow for the use and benefit of the Company. The escrow deposit was for the following:

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1. The sum of \$585,000 was paid to La Jolla Cove Investors, Inc. ("La Jolla") to acquire for Investor a full and complete assignment of any and all of La Jolla's right, title and interest in any and all of AAMU indebtedness to La Jolla and specifically including La Jolla's rights under the active SB-2 Registration Statement for the issuance and registration of securities thereunder; the consent of AAMU to the foregoing subject to the right of AAMU to prepay any and all indebtedness thereunder in AAMU common stock, without penalty, at any time before or after default.
2. The sum of \$275,000 to be used by AAMU to redeem and satisfy in full the Series E Preferred Stock funded by third party investors on or about July 12, 2006, including a prepayment redemption penalty of \$25,000.
3. The sum of \$215,000 payable as fees to Capital Investment Services, Inc. ("CIS") for locating, negotiating and closing the funding.
4. The sum of \$100,000 to repay in full, without interest, an unsecured bridge loan from Investor to AAMU dated and funded on August 25, 2006.
5. The sum of \$275,000 released to AAMU for working capital.
6. The balance of \$700,000, to be retained in escrow and disbursed to AAMU for payment in reduction of the assigned La Jolla debenture and required warrant exercised thereunder, until the debenture and warrant obligations are satisfied in full in accordance with the terms of the assigned La Jolla documents.

The financing transaction requires AAMU to deposit in escrow with CIS for later delivery a total of 11,470,000 shares of its common stock (to be held as unissued and not outstanding) to guarantee availability of stock as required for the reduction of the debenture and satisfaction of warrant obligations. Escrow agreement calls for Escrow Agent to release such shares for delivery in accordance with the terms of the pending SB-2 Registration Statement of AAMU currently on file with the SEC and in accordance with the terms and conditions of the Financing Agreement dated September 2006 entered into between AAMU and the Investor, and only after reasonable notification thereof to AAMU prior to delivery of any such certificates. Disbursement and distribution of shares shall only be made in accordance with the terms of the applicable SB-2 registration. The Investor and/or the selling stockholder has contractually agreed to restrict its ability to convert or exercise its warrants and receive shares of AAMU common stock such that the number of shares held by them and their affiliates after such conversion or exercise does not exceed 4.9% of the then issued and outstanding shares of common stock. The agreement also calls for an additional 5,000,000 shares of the restricted common stock of AAMU to be deposited in a separate escrow to be used for any other expenses and compensation to third parties that may be agreed upon between Investor and AAMU for future services to advance the overall business of AAMU. In addition AAMU granted Investor 600,000 warrants exercisable at the lesser of \$0.1875 per share or the average closing price per share for the common stock during the twelve (12) month period prior to the date of exercise, such warrants exercisable at any time on or before five (5) years from and after July 24, 2006. All shares required to be deposited into escrowed have in fact been deposited in escrow on September 26, 2006 as required.

The Investor provided additional funding in the amount of \$1,000,000 to AAMU on December 21, 2006 for an additional 5,333,335 shares. The sum of \$100,000 was paid as fees to CIS for locating, negotiating and closing the additional funding. All other terms and conditions of the escrow agreement and related financing agreement, including in corporation of the terms of the SB-2 requirements, remain the same.

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June 30, 2007 and 2006

### Note J - Convertible Debenture-Continued

We have included additional disclosure under Part II, Item 5, regarding La Terraza's breaches of the agreement, and possible securities laws violations by La Terraza.

#### Discussion of retired debenture

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

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

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

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

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

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

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

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### American Ammunition, Inc. and Subsidiaries Notes to Consolidated Financial Statements - Continued June 30, 2007 and 2006

#### Note J - Convertible Debenture-Continued

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

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

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

On various dates between January 1, 2004 and December 31, 2004, the Debenture Holder elected to convert an aggregate \$125,000, through 6 separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 4,150,000 shares of common stock to the Debenture Holder. Additionally, pursuant to the contract terms, the Debenture Holder concurrently exercised a portion of the outstanding Warrant to purchase 1,250,000 shares of the Company's common stock for gross proceeds of \$1,250,000. As of December 31, 2004, an aggregate of 1,000,000 shares of the Company's common stock have been issued by the Company and are being held in escrow by the Company's counsel pending receipt of the final \$175,000 from the Debenture Holder. As of December 31, 2005, this amount remains unpaid.

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

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concurrently exercised a portion of the outstanding Warrant to purchase 400,000 shares of the Company's common stock for gross proceeds of \$400,000.

As of December 31, 2006, the Company has no continuing obligation under the convertible debenture and attached warrant.

### Note K - Derivative Liability arising from Warrants

The Company accounts for debt with embedded conversion features and warrant issues in accordance with EITF 98-5: "Accounting for convertible securities with beneficial conversion features or contingency adjustable conversion" and EITF No. 00-27: "Application of issue No 98-5 to certain convertible instruments". Conversion features determined to be beneficial to the holder are valued at fair value and recorded to additional paid in capital. The Company determines the fair value to be ascribed to the detachable warrants issued with the convertible debentures utilizing the Black-Scholes method. Any discount derived from determining the fair value to the debenture conversion features and warrants is amortized to financing cost over the life of the debenture. The unamortized discount, if any, upon the conversion of the debentures is expensed to financing cost on a pro rata basis.

Debt issues with the variable conversion features are considered to be embedded derivatives and are accountable in accordance with FASB 133; "Accounting for Derivative Instruments and Hedging Activities". The fair value of the embedded derivative is recorded to derivative liability. This liability is required to be marked each reporting period. The resulting discount on the debt is amortized to interest expense over the life of the related debt.

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American Ammunition, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements - Continued  
June 30, 2007 and 2006

### Note L - Common Stock Transactions

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

In April 2007, the Company issued approximately 269,934 shares of restricted, unregistered common stock, valued at approximately \$21,595, to an existing stockholder as for payment of accrued interest associated with approximately \$975,000 short-term working capital loans to the Company and reimbursement of various operating expenses paid in cash on behalf of the Company. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In April 2007, the Company issued an aggregate 10.948 shares of restricted, unregistered common stock in payment of approximately \$3,668 in accrued dividends payable on the Company's outstanding Series B Preferred Stock for the

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quarter ended March 31, 2007. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

### Note M - Contingent Liability

The Company and the Miami-Dade County Property Appraiser are in negotiations related to an audit of the Company's Tangible Personal Property assessments for the years ended December 31, 2002, 2003, 2004 and 2005. The Company is cooperating fully with all requests and is aggressively challenging all claims and using all defenses available to it. The ultimate outcome, and impact on the Company's financial statements, is not readily determinable at this time.

During the 2nd quarter of 2007, the Company closed the operations of IPE, disposed of related fixed assets as per environmental requirements. The company may have a continuing obligation or liability related to this portion of the Company's manufacturing process.

### Note N - Employment Contracts

During the quarter ended June 30, 2007, the Company executed employment contracts with Emilio Jara, who is a current employee, member of management and stockholder of the Company and Joe Fernandez, Jr., who is a current employee and brother of the Company's Chief Executive Officer and son of the Company's Chairman of the Board, to formalize their employment and significance to the Company's production activities. Mr. Jara and Mr. Fernandez, Jr. will each receive an increase in compensation to \$75,000 annually, plus normal and customary benefits. Through June 30, 2007, Mr. Jara and Mr. Fernandez, Jr. are continuing to be paid in cash at the weekly pay rate in place immediately prior to the execution of the related employment contract and the difference between the paid cash compensation and the contractual amount has been accrued in the accompanying financial statements.

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

### Caution Regarding Forward-Looking Information

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

Such factors include, among others, the following: international, national and local general economic and market conditions; demographic changes; the ability of the Company to sustain, manage or forecast its growth; the ability of the Company to successfully make and integrate acquisitions; raw material costs and availability; new product development and introduction; existing government

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regulations and changes in, or the failure to comply with, government regulations; adverse publicity; competition; the loss of significant customers or suppliers; fluctuations and difficulty in forecasting operating results; changes in business strategy or development plans; business disruptions; the ability to attract and retain qualified personnel; the ability to protect technology; and other factors referenced in this and previous filings.

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

### Restatement issues

The June 30, 2006 financial statements have been restated to account for the derivative liability that was incurred in connection with the common stock conversion features and the warrants issued with certain notes payable.

The Company accounts for debt with embedded conversion features and warrant issues in accordance with EITF 98-5: "Accounting for convertible securities with beneficial conversion features or contingency adjustable conversion" and EITF No. 00-27: "Application of issue No 98-5 to certain convertible instruments". Conversion features determined to be beneficial to the holder are valued at fair value and recorded to additional paid in capital. The Company determines the fair value to be ascribed to the detachable warrants issued with the convertible debentures utilizing the Black-Scholes method. Any discount derived from determining the fair value to the debenture conversion features and warrants is amortized to financing cost over the life of the debenture. The unamortized discount, if any, upon the conversion of the debentures is expensed to financing cost on a pro rata basis.

Debt issues with the variable conversion features are considered to be embedded derivatives and are accountable in accordance with FASB 133; "Accounting for Derivative Instruments and Hedging Activities". The fair value of the embedded derivative is recorded to derivative liability. This liability is required to be marked each reporting period. The resulting discount on the debt is amortized to interest expense over the life of the related debt.

### General

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

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

In June 2002, American Ammunition, Inc. formed a wholly owned subsidiary, Industrial Plating Enterprise Co. (IPE), which started production on June 14, 2002. IPE is a fully licensed and approved electrochemical metallization facility with significant capacity for processing our line of projectiles as

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well as other products and services while employing environmentally sound water conservation and proven waste treatment techniques. All of the activities of IPE since it's inception were dedicated solely to the needs and demands of F&F. During the 2nd quarter of 2007, management elected to outsource this operation and closed the operations of this entity through the sale of the related fixed assets and cleaning of the leased facility in accordance with the terms and conditions of the lease agreement, under the supervision of and approval of the appropriate governmental oversight agencies.

### Results of Operations

Six months ended June 30, 2007 compared with the six months ended June 30, 2006.

During the six months ended June 30, 2007, we experienced aggregate net revenues of approximately \$1,390,000 (approximately \$700,000 in the current quarter) as compared to approximately \$1,379,000 (approximately \$669,000 corresponding to the current quarter).

We experienced costs of goods sold of approximately \$1,775,000 (approximately \$858,000 in the current quarter) for the six months ended June 30, 2007 as compared to approximately \$2,043,000 (approximately \$665,000 corresponding to the current quarter) for the six months ended June 30, 2006.

We have expanded our product line during the last quarter of 2006 and the first quarter of 2007 as we have identified a market demand for additional rifle cartridges and "cowboy action shooting" calibers. We continue to experience strong interest and/or demand and are continue to receive larger orders for these products, our current volumes cause production delays in managing our production tooling setups to produce all of the products in our catalog. We continue to believe that our order quantities will increase to a level to allow for more efficient utilization of our production capacities.

The various raw materials that are integral components of our manufacturing processes are currently subject to rapidly increasing pressures caused by foreign demand, limitations on mining/production and commodity market speculation for both our costs and the overall availability of these resources. We are experiencing direct pressure in the marketplace for the brass component of our ammunition manufacture by recent orders for copper placed by the People's Republic of China. We have also experienced periodic limitations or allocations on the availability of lead for projectile manufacture due to increased demand for this commodity and limitations on the opening of new domestic mines for lead due to various Federal and State environmental laws and regulations. In conjunction with the large order for raw copper placed by the Chinese, the marketplace has experienced a substantial increase in futures speculation on this and other comparable commodities in the financial exchanges. Further, we experience competition for raw materials from our competitors that are better funded and have earned priority status among our suppliers.

We are also experiencing the effect of rapidly increasing energy costs, not only in our own plant; but, in the costs of our raw materials and supplies being purchased from other vendors that are forced to pass these costs through to their customers, including us.

All of these discussed factors are causing significant fluctuation in the prices that we must pay for our raw materials that may or may not be able to be passed through to our customers through price increases. Our management is monitoring both the cost side of this equation and the availability of price increases to our customers and to their end-users. The balancing of these events is highly unpredictable and uncertain as we go forward into future periods.

We are aware that a major manufacturer of ammunition, and one of our competitors, ATK, has advised its customers in writing of a pending 15.0% price

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increase in all small arms ammunition. Our management is currently studying the impact of this action by our competitor on the marketplace and the possible impact on our operations.

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During 2006 and 2005, we experienced negative trends off of our standard production costs for material and labor due to difficulties in employee turnover and the related training requirements, adding new products to our catalog and lower than expected orders due to uncontrollable delays in ordering by various U. S. Governmental entities. Management is of the opinion that the production labor force is relatively stable and able to maintain a constant standard of quality for future periods. At the present time, our payroll burden averages approximately \$20,000 per week in cash resources, inclusive of officer salaries, payroll taxes and workers compensation insurance coverage.

In the second quarter of 2006, management took drastic steps to reduce excess labor capacity through the elimination of the 2nd shift, which was never able to reach full utilization. This action is not expected to have any adverse impact on our ability to meet our existing and future product demands.

We have recognized depreciation expense on production equipment of approximately \$41,300 and \$31,000, respectively, in the above cost of goods expense totals. These depreciation levels are anticipated to fluctuate nominally in future periods based upon either the full depreciation of older equipment and/or the addition of new equipment to expand capacity.

For the respective six month periods ended June 30, 2007 and 2006, respectively, we generated a negative gross profit of approximately \$(384,000) or approximately (27.65%), and approximately \$(664,000) or approximately (48.11%). While we continue to maintain a backlog of orders and future order commitments from retail customers, distributors and/or governmental agencies, we anticipate that we should be able to generate a positive gross profit in future periods; however, there are no guarantees or any certainty that this will occur.

We experienced nominal research and development expenses of approximately \$600 and \$-0-, during each of the six month periods ended June 30, 2007 and 2006, principally related to research related to the potential expansion of our product line.

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

During the six months of 2007 and 2006, we expended approximately \$41,000 and \$74,000, respectively, in advertising and marketing expenses, principally in continuing the promotion and expansion of our retail dealer direct program. We anticipate to continue our marketing efforts in this area in future periods; however, the volume and frequency of our expenditures may fluctuate as management allocates available capital to these efforts.

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Other general and administrative expenses declined to approximately \$612,000 for the six months ended June 30, 2007 from approximately \$852,000 for the six months ended June 30, 2006. The six months ended June 30, 2006 includes a charge of approximately \$139,000 for consulting expense related to common stock sales at less than "fair value". After compensating for this non-cash charge, the Company's general and administrative expenditure levels are comparable at approximately \$612,000 and \$713,000, respectively.

Management is of the opinion that these costs are relatively stable and should not experience significant increases except for inflationary pressures caused principally by increases in energy costs which are affecting all businesses in all sectors of the U. S. economy.

We recognized a net loss of approximately \$(1,097,000) and \$(1,731,000) for the respective six month periods ended June 30, 2007 and 2006, respectively, or \$(0.05) and \$(0.39) per share.

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### Liquidity And Capital Resources

As of June 30, 2007, December 31, 2006 and June 30, 2006, respectively, we had working capital of approximately \$(491,000), \$684,000 and \$(658,000). Our working capital position continues to fluctuate based on collections on our trade accounts receivable. We anticipate that we have sufficient inventory levels to support our order demand and have access to raw material suppliers that will enable us to receive raw materials for future periods. We also note that at the end of 2006, we renegotiated \$1,075,000 in notes payable to existing shareholders to long-term status with renewed maturity dates of December 31, 2008. Due to these relationships, these notes may or may not be renegotiated, repaid in common stock of the Company or otherwise reclassified prior to their maturity on December 31, 2008.

We have used cash in operating activities of approximately \$(1,025,000) and \$(750,000) during the six month periods ended June 30, 2007 and 2006, respectively. Due to our history of operating losses, our resources for additional working capital are becoming more scarce.

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

During each of the respective six month periods ended June 30, 2007 and 2006, respectively, we added approximately \$41,000 and \$31,000 in new equipment. Any equipment to be added in future periods is fully dependent upon the Company's cash position, the availability of either new equity or debt capital and the ultimate realization of communicated future product sales demand. However, we may not be able to obtain additional funding or, that such funding, if available, will be obtained on terms favorable to or affordable by us.

During the quarter ended June 30, 2007, the Company executed employment contracts with Emilio Jara, who is a current employee, member of management and stockholder of the Company and Joe Fernandez, Jr., who is a current employee and brother of the Company's Chief Executive Officer and son of the Company's Chairman of the Board, to formalize their employment and significance to the

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Company's production activities. Mr. Jara and Mr. Fernandez, Jr. will each receive an increase in compensation to \$75,000 annually, plus normal and customary benefits. Through June 30, 2007, Mr. Jara and Mr. Fernandez, Jr. are continuing to be paid in cash at the weekly pay rate in place immediately prior to the execution of the related employment contract and the difference between the paid cash compensation and the contractual amount has been accrued in the accompanying financial statements.

### Item 3 - Controls and Procedures

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

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (Exchange Act), for the quarter ended June 30, 2007. As of the end of the period covered by this report, management, including the chief executive officer and chief financial officer evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based upon and as of the date of that evaluation, our CEO and CFO concluded that the disclosure controls and procedures were effective

#### (b) Changes in Internal Controls

There were no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls over financial reporting that occurred during the quarter ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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## Part II - Other Information

### Item 1 - Legal Proceedings

The Company may become involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse impact either individually or in the aggregate on consolidated results of operations, financial position or cash flows of the Company.

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

In April 2007, the Company issued approximately 269,934 shares of restricted, unregistered common stock, valued at approximately \$21,595, to an existing stockholder as for payment of accrued interest associated with approximately \$975,000 short-term working capital loans to the Company and reimbursement of various operating expenses paid in cash on behalf of the Company. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In April 2007, the Company issued an aggregate 10.948 shares of restricted,

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unregistered common stock in payment of approximately \$3,668 in accrued dividends payable on the Company's outstanding Series B Preferred Stock for the quarter ended March 31, 2007. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

### Item 3 - Defaults on Senior Securities

None

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

None

### Item 5 - Other Information

Breaches of Agreement by La Terraza Trading and Asset Management, Ltd. and Capital Investment Services, Inc. and Possible Violations of the Registration Provisions of the Federal Securities Laws

#### Background

The La Jolla Assignment On or about August 17, 2006, in connection with a lawsuit by La Jolla Cove Investors, Inc. ("La Jolla") against us alleging breaches of contract, La Jolla agreed to dismiss such lawsuit against us in exchange for our payment of \$585,000. In connection with that settlement, on September 6, 2006, La Jolla executed an Assignment of Convertible Debenture, Warrant to Purchase Common Stock, Securities Purchase Agreement and Registration Rights Agreement ("the La Jolla Assignment"), which provided that in exchange for the \$585,000 payment, La Jolla would assign its right, title, and interest in the following:

- a) An 8% amended Convertible Debenture dated October 4, 2002 that we issued to La Jolla;
- b) An amended Warrant to purchase our common stock with conversion rights dated October 4, 2002 that we issued to La Jolla;
- c) An amended Registration Rights Agreement dated October 4, 2002 between us and La Jolla;
- d) An amended Securities Purchase Agreement dated October 4, 2002 between us and La Jolla; and
- e) An amended Form SB-2 Registration that we filed on January 14, 2005.

Assumption of La Jolla Assignment by La Terraza Trading and Asset Management, Ltd and La Terraza Agreement

On the same day as the La Jolla Assignment, based upon prior discussions and understandings between our Chief Executive Officer and representatives of La Terraza Trading and Asset Management, Ltd ("La Terraza"), a company based in Spain, that we would assign the La Jolla Assignment to La Terraza, and that as an Investor, La Terraza would complete a financing agreement with us, we completed such agreement on September 6, 2006 ("the La Terraza Agreement"). The La Terraza Agreement stated that on or about July 24, 2006, we and La Terraza

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agreed in principle that La Terraza would finance us in the amount of \$2,150,000, which would be used, as follows: (i) by La Terraza to acquire our indebtedness to La Jolla; and (ii) the balance of the funds that we would use for fees, satisfaction of existing payables, and working capital. The La Terraza Agreement included the following terms:

- a) Based upon the \$0.1875 market price of our shares of common stock on July 24, 2006, 11,470,000 shares would be escrowed and distributed as needed in accordance with the terms of our SB-2 Registration Statement (the "11,470,000 SB-2 Shares");
- b) We would issue an additional 5,000,000 shares of our restricted common stock in escrow to use for expenses and as compensation to third parties "to advance our business", to be agreed upon by us and La Terraza, and that such shares would be used for our benefit;
- c) We would grant 600,000 warrants to La Terraza exercisable at the lesser of \$0.1875 per share or the average closing price per share for our common stock over the 12 months prior to the date of exercise, with a 5 year term for the exercise of the warrants, such term to begin on July 24, 2006;
- d) The shares that we issue in connection with the La Terraza Agreement will be registered upon La Terraza's request, to the extent that such shares are not the subject to issuance as free trading shares under our SB-2 Registration Statement at the time; and
- e) The 11,470,000 SB-2 Shares and the 5,000,000 restricted shares would be delivered in Escrow to Capital Investment Services, Inc. ("Capital Investment"), as the Escrow Agent, for disbursement and distribution in accordance with the terms of our SB-2 Registration Statement.

### Distribution of Funds in Connection with La Terraza Agreement

On or about September 13, 2006, in accordance with the La Terraza Agreement, we received \$2,150,000 from La Terraza, the funds of which were distributed on or about the same day, as follows:

- a) \$585,000 was paid to La Jolla to acquire for La Terraza a full and complete assignment of any and all of La Jolla's right, title and interest in any and all of our indebtedness to La Jolla, including La Jolla's rights under the active SB-2 Registration Statement for the issuance and registration of securities under that Registration Statement;
- b) \$275,000 that we would use to redeem and satisfy in full the Series E Preferred Stock that had been funded by third party investors on or about July 12, 2006, including a prepayment redemption penalty of \$25,000;
- c) \$215,000 payable as fees to Capital Investment for locating, negotiating and closing the La Terraza funding;
- d) \$100,000 to repay in full, without interest, an unsecured bridge loan from an investor to us dated and funded on August 25, 2006;
- e) \$275,000 for our working capital; and
- f) \$700,000 to be retained in escrow and disbursed to us for payment in reduction of the assigned La Jolla debenture and required warrant exercise, until the debenture and warrant obligations are satisfied in full according to the terms of the La Jolla Assignment and related agreements.

### Escrow Agreement with Capital Investment

In connection with rights attendant to and securities that would be tendered to La Terraza as well as the La Terraza Agreement, we completed an Escrow Agreement on September 19, 2006 between us and Capital Investment, which provided that:

- a) We would deliver to the Escrow Agent certain share certificates specified below;

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- b) The Escrow Agent would accept the shares for delivery to the beneficiary indicated; and
- c) The Escrow Agent agreed to release the shares for delivery only in accordance with our SB-2 Registration Statement and in accordance with the terms of the La Terraza Financing Agreement, only after reasonable notification to us prior to delivery of such certificates.

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Then, on or about December 27, 2006, but effective as of September 13, 2006 (the date that La Terraza funded us in the amount of \$2,150,000), we effected the following issuances in the Capital Investment's Escrow account titled in the name of the "Capital Investment Services Irrevocable Escrow Account" so that Capital Investment would effectuate the terms of the Escrow Agreement and the La Terraza Agreement, including that such issuances were required to be consistent with the terms of our existing SB-2 Registration Statement: (a) 11,470,000 free trading shares issued in: (i) 19 certificates of 500,000 shares each; (ii) 5 certificates of 300,000 shares each; and (iii) 1 certificate of 470,000 shares; and (b) 5,000,000 shares of our restricted common stock issued in 10 certificates of 500,000 each.

In our Form 10-QSB for the period ending September 30, 2006 that we filed on November 24, 2006, we disclosed that the 11,470,000 shares were deposited into the Capital Investment Escrow account to be held as unissued and not outstanding to guarantee the availability of stock as required for the reduction of the debenture and satisfaction of the warrant obligations. In connection therewith and as reflected above regarding the terms of the Escrow Agreement, Capital Investment agreed to release the shares for delivery only in accordance with our SB-2 Registration Statement and in accordance with the terms of the La Terraza Financing Agreement, and only after reasonable notification to us prior to delivery of such certificates. As discussed below, however, during the period from the deposit of the 11,470,000 shares on December 27, 2006 to June 2007, we never received any notification, request, instructions, or any communication whatsoever from either La Terraza or Capital Investment notifying us prior to the delivery of any such certificates to third parties or any other information that would enable us to determine and/or monitor whether in fact the release of any one or all of the certificates from the Escrow Account had occurred or complied with the terms of our SB-2 Registration Statement.

Discovery of Matters Pertaining to La Terraza and Capital Investment On or about May 18, 2007, our Chief Executive Office met with Mr. Abe Warshenbrot at our offices, who represented himself as La Terraza's CPA representative and Mr. Alistair Snowie, who had previously been introduced to us as an investor in a La Terraza fund, regarding the possibility of additional financing by La Terraza. Thereafter, we received no communication whatsoever, until June 6, 2007 when we received correspondence from Mr. Warshenbrot stating that he had been granted Power of Attorney to exercise all rights and privileges pertaining to: (a) 12,000,000 shares owned by Alistair Snowie; (b) 5,000,000 shares owned by La Terraza; and (c) other of our shareholders. As a result of this discovery, we commenced an inquiry of these matters to determine whether the terms of both the La Terraza Agreement and the Escrow Agreement had been adhered to by La Terraza and Capital Investment, and to determine whether the terms of our SB-2 Registration Statement had been complied with.

In connection with our inquiry, we obtained documents from our transfer agent, Atlas Stock Transfer, which indicated that Capital Investment had

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instructed our transfer agent to issue the following certificates from the 11,470,000 shares that had been previously deposited into the Escrow Account on December 27, 2006:

- o On September 26, 2006, issuance of 900,000 free trading shares in certificate(s) to Pershing and Company;
- o On September 26, 2006, issuance of 350,000 shares to DP Martin & Associates;
- o On October 20, 2006, issuance of 300,000 free trading shares in certificate(s) to Cede & Company;
- o On October 23, 2006, issuance of 45,455 free trading shares in certificate(s) to Global Consulting;
- o On October 30, 2006, issuance of 500,000 free trading shares in certificate(s) to Cede & Company;
- o On November 15, 2006, issuance of 1,000,000 free trading shares in certificate(s) to Cede & Company;
- o On December 4, 2006, issuance of 5,500,000 free trading shares in certificate(s) to Alistair Snowie;
- o On December 4, 2006, issuance of 689,545 free trading shares in certificate(s) to Revim Development;

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- o On December 4, 2006, issuance of 1,835,000 free trading shares in certificate(s) to RFP Development;
- o On June 7, 2007, issuance of 4,800,000 restricted shares in certificate(s) to La Terraza; and
- o On June 7, 2007, issuance of 45,455 restricted shares in certificate(s) to Manuel Lugo.

Based on our analysis of the above issuances, we determined that both La Terraza and Capital Investment had breached the terms of our agreements with them, including that we received no notification prior to such issuances or thereafter, and each of the issuances violated the terms of our SB-2, which La Terraza and Capital Investment had agreed to -- most importantly, that each such issuance from September 26, 2006 to June 7, 2007, as reflected immediately above, individually and cumulatively, had violated the term of our SB-2 that prohibited distribution and disbursement of 4.9% or more of our outstanding common stock.

We are continuing our investigation of this matter and have recently requested additional documentation from our transfer agent to determine whether there have been unregistered distributions of our securities in violation of the registration provisions of the federal securities laws. We will consider all possible remedies against La Terraza and Capital Investment for their breaches of our agreements with them. Additionally, if we discover that unregistered distributions of our securities have occurred, we will consider all possible remedies against any individual or entity that is responsible for such unlawful securities distributions.

### Related Party Transaction/Contract

During the quarter ended June 30, 2007, the Company executed employment contracts with Emilio Jara, who is a current employee, member of management and stockholder of the Company and Joe Fernandez, Jr., who is a current employee and brother of the Company's Chief Executive Officer and son of the Company's

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Chairman of the Board, to formalize their employment and significance to the Company's production activities. Mr. Jara and Mr. Fernandez, Jr. will each receive an increase in compensation to \$75,000 annually, plus normal and customary benefits. Through June 30, 2007, Mr. Jara and Mr. Fernandez, Jr. are continuing to be paid in cash at the weekly pay rate in place immediately prior to the execution of the related employment contract and the difference between the paid cash compensation and the contractual amount has been accrued in the accompanying financial statements.

Item 6 - Exhibits

Exhibits

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

SIGNATURES

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

American Ammunition, Inc.

Dated: September 18, 2007  
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/s/ Andres F. Fernandez  
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Andres F. Fernandez  
President, Chief Executive Officer  
Chief Financial Officer and Director