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AMERICAN AMMUNITION INC/FL
Form 10QSB
November 15, 2005

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 September 30, 2005

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)

California

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

State the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date: October 28, 2005: 74,9919,791

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

American Ammunition, Inc.

Form 10-QSB for the Quarter ended September 30, 2005

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Part I

Item 1 - Financial Statements

American Ammunition, Inc. and Subsidiaries
Consolidated Balance Sheets
September 30, 2005 and 2004

(Unaudited)

September 30,

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| | 2005 |
|--|-------------|
| ASSETS | |
| Current Assets | |
| Cash on hand and in bank | \$ 107,97 |
| Accounts receivable - trade, net allowance for doubtful accounts of \$-0- and \$-0-, respectively | 105,77 |
| Inventory | 566,87 |
| Prepaid expenses | 61,68 |
| | |
| Total Current Assets | 842,29 |
| | |
| Property and Equipment - at cost or contributed value | |
| Manufacturing equipment | 8,096,28 |
| , Office furniture and fixtures | 55,57 |
| Leasehold improvements | 190,27 |
| | |
| | 8,342,14 |
| Accumulated depreciation | (5,379,11) |
| | |
| Net Property and Equipment | 2,993,03 |
| | |
| Other Assets | |
| Patents, Trademarks and Noncompetition agreement, net of accumulated amortization of approximately \$50,543 | 225,14 |
| Loan costs, net of accumulated amortization of approximately \$2,620 | 21,38 |
| Deposits and other | 83,66 |
| | |
| TOTAL ASSETS | \$ 4,135,51 |
| | |

- Continued -

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 financial statements.

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American Ammunition, Inc. and Subsidiaries
Consolidated Balance Sheets - Continued
September 30, 2005 and 2004

(Unaudited)

September 30,

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| | 2005 |
|---|-------------|
| | ----- |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| Current Liabilities | |
| Current maturities of leases payable | \$ |
| Customer deposits | 201,89 |
| Accounts payable - trade | 957,48 |
| Working capital advance | |
| Other accrued liabilities | 186,79 |
| | ----- |
| Total Current Liabilities | 1,346,16 |
| Long-Term Liabilities | |
| Loans from Shareholders | 650,00 |
| Capital leases payable | |
| | ----- |
| Total Liabilities | 1,996,16 |
| | ----- |
| Commitments and Contingencies | |
| Convertible Debenture | 241,36 |
| | ----- |
| Stockholders' Equity | |
| Preferred stock - \$0.001 par value | |
| 20,000,000 shares authorized. | |
| 1,795,320 shares allocated to Series A | |
| 12,000 shares issued and outstanding | 1 |
| 1,000,000 shares allocated to Series B | |
| 91,700 shares issued and outstanding | 9 |
| 1,905,882 shares allocated to Series C | |
| 1,905,882 and -0- shares issued and outstanding, respectively | 1,90 |
| Common stock - \$0.001 par value. | |
| 300,000,000 shares authorized. | |
| 76,626,631 and 73,686,672 shares issued and outstanding | 76,62 |
| Additional paid-in capital | 25,011,94 |
| Accumulated deficit | (23,154,20) |
| | ----- |
| Stock subscription receivable | 1,936,37 |
| | (38,39) |
| | ----- |
| Total Stockholders' Equity | 1,897,98 |
| | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 4,135,51 |
| | ===== |

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 financial statements.

American Ammunition, Inc. and Subsidiaries
Consolidated Statements of Operations and Comprehensive Income (Loss)
Nine and Three months ended September 30, 2005 and 2004

(Unaudited)

| | Nine months ended September 30, 2005 | Nine months ended September 30, 2004 | Three months ended September 30, 2005 |
|--|---|---|--|
| Revenues | \$2,233,336 | \$1,712,280 | \$ 378,326 |
| Cost of Sales | | | |
| Materials, Direct Labor and other direct costs | 3,447,036 | 1,911,210 | 944,194 |
| Depreciation | 573,466 | 523,815 | 191,155 |
| Total Cost of Sales | 4,020,502 | 2,435,025 | 1,135,349 |
| Gross Profit | (1,787,166) | (722,745) | (757,023) |
| Operating Expenses | | | |
| Research and development expenses | 2,615 | 8,332 | 804 |
| Marketing and promotion expenses | 161,502 | 368,458 | 49,750 |
| Other operating expenses | 910,423 | 845,663 | 278,902 |
| Bad debt expense | - | 27,819 | - |
| Interest expense | 26,639 | 15,825 | 16,508 |
| Depreciation and amortization | 45,305 | 5,681 | 15,102 |
| Compensation expense related to common stock issuances at less than "fair value" | 198,000 | 356,000 | - |
| Total Operating Expenses | 1,344,484 | 1,627,778 | 361,066 |
| Loss from Operations | (3,131,650) | (2,350,523) | (1,118,089) |
| Other Income (Expense) | | | |
| Interest and other income | 8,146 | 1,409 | 1,914 |
| Amortization of Beneficial Conversion Feature Discount on Preferred Stock | - | - | - |
| Loss before Income Taxes | (3,131,650) | (2,349,114) | (1,116,175) |
| Provision for Income Taxes | - | - | - |
| Net Loss | (3,131,650) | (2,349,114) | (1,116,175) |
| Other Comprehensive Income | - | - | - |

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| | | | |
|---|----------------|----------------|----------------|
| | ----- | ----- | ----- |
| Comprehensive Loss | \$ (3,131,650) | \$ (2,349,114) | \$ (1,116,175) |
| | ===== | ===== | ===== |
| Net Loss | \$ (3,131,650) | \$ (2,349,114) | \$ (1,116,175) |
| Preferred Stock dividends | (40,830) | (31,110) | (13,610) |
| | ----- | ----- | ----- |
| Net Loss available to Common Shareholders | \$ (3,172,480) | \$ (2,380,224) | \$ (1,129,785) |
| | ===== | ===== | ===== |
| Loss per weighted-average share of common stock outstanding, computed on net loss - basic and fully diluted | \$ (0.04) | \$ (0.03) | \$ (0.01) |
| | ===== | ===== | ===== |
| Weighted-average number of common shares outstanding | 75,358,091 | 70,873,791 | 76,241,380 |
| | ===== | ===== | ===== |

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 financial statements.

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American Ammunition, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Nine months ended September 30, 2005 and 2004

(Unaudited)

| | |
|---|---|
| | Nine months ended September 30, 2005 |
| | ----- |
| Cash flows from operating activities | |
| Net loss for the year | \$ (3,123,504) |
| Adjustments to reconcile net loss to net cash provided by operating activities | |
| Depreciation and amortization | 621,390 |
| Bad debt expense | - |
| Compensation expense related to common stock issuances at less than "fair value" | 198,000 |
| Common stock issued for fees and services | 17,333 |
| (Increase) Decrease in | |
| Accounts receivable | 533,671 |
| Inventory | 345,554 |
| Prepaid expenses, deposits and other | (2,838) |
| Increase (Decrease) in | |
| Accounts payable - trade | (29,398) |
| Other accrued expenses | 15,773 |

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| | |
|--|-------------|
| Customer deposits | (239,016) |
| Net cash used in operating activities | (1,663,035) |
| Cash flows from investing activities | |
| Purchase of property and equipment | (111,065) |
| Net cash used in investing activities | (111,065) |
| Cash flows from financing activities | |
| Funding of working capital advance | |
| Principal paid on long-term capital leases | |
| Cash paid to obtain capital | (10,000) |
| Cash received loans from shareholders | 650,000 |
| Cash received on sale of common stock | 436,600 |
| Net cash provided by financing activities | 1,076,600 |
| Increase (Decrease) in Cash | (697,495) |
| Cash at beginning of year | 805,460 |
| Cash at end of year | \$ 107,965 |

- Continued -

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 financial statements.

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American Ammunition, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Nine months ended September 30, 2005 and 2004

(Unaudited)

| | |
|--|---|
| | Nine months ended September 30, 2005 |
| Supplemental disclosure of interest and income taxes paid | |
| Interest paid for the period | \$ 10,753 |
| Income taxes paid for the period | \$ - |

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Supplemental disclosure of non-cash investing and financing activities
Asset purchase agreement for equipment, inventory and
intellectual property accrued as a component of accounts payable

=====

\$ -

=====

Common stock issued for payment of loan costs

\$ 24,000

=====

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 financial statements.

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

Note A - Organization and Description of Business

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

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

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

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

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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, 2004. 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.

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, 2005.

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note B - Preparation of Financial Statements - Continued

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

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

Note C - Summary of Significant Accounting Policies

1. Cash and cash equivalents

For Statement of Cash Flows purposes, the Company considers all cash on hand and in banks, certificates of deposit and other highly-liquid

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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.

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

Note C - Summary of Significant Accounting Policies - Continued

4. Property, plant and equipment - continued

In accordance with SFAS No. 144, the Company evaluates the accompanying

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financial statements to determine if any impairment indicators are present related to its fixed assets and other long-term assets. If impairment indicators were present, future cash flows related to the asset group are estimated. The sum of the undiscounted future cash flows attributable to the asset group was then compared to the carrying amount of the asset group. The cash flows were estimated utilizing various assumptions regarding future revenue and expenses, availability of working capital, and proceeds, if any, from asset disposals on a basis consistent with the Company's strategic plan. If the carrying amount exceeded the sum of the future undiscounted future cash flows, the Company discounted the future cash flows using a risk-free discount rate and recorded an impairment charge as the difference between the discounted cash flows and the carrying value of the asset group. Generally, the Company performed its testing of the asset group at the overall corporate level, as this is the lowest level for which identifiable cash flows are available. As a result of the impairment testing described above, management is of the opinion that no impairment charge is appropriate.

5. Income Taxes

The Company uses the asset and liability method of accounting for income taxes. At September 30, 2005 and 2004, 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 September 30, 2005 and 2004, the deferred tax asset related to the Company's net operating loss carryforward is fully reserved. If these carryforwards are not utilized, they will begin to expire at the end of 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 September 30, 2005 and 2004, and subsequent thereto, the Company had no options outstanding. The outstanding warrants and convertible preferred stock and mandatorily convertible debentures are anti-dilutive due to the Company's net operating loss position.

7. Advertising costs

The Company does not conduct any direct response advertising activities. For non-direct response advertising, the Company charges the costs of these

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efforts to operations at the first time the related advertising is published.

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note D - Fair Value of Financial Instruments

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

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

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

Note E - Concentrations of Credit Risk

The Company maintains its cash accounts in a single financial institutions subject to insurance coverage issued by the Federal Deposit Insurance Corporation (FDIC). Under FDIC rules, the Company and its subsidiaries are entitled to aggregate coverage of \$100,000 per account type per separate legal entity per financial institution.

During the period ended September 30, 2005 and the periods subsequent thereto, respectively, the various operating companies maintained deposits in this financial institution with credit risk exposures in excess of statutory FDIC coverage. The Company incurred no losses through September 30, 2005, and subsequent thereto, as a result of any of these unsecured situations.

Note F - Inventory

As of September 30, 2005 and 2004, inventory consisted of the following components:

| | September 30 2005 | September 30, 2004 |
|-----------------|----------------------|-----------------------|
| | ----- | ----- |
| Raw materials | \$ 434,305 | \$ 231,456 |
| Work in process | 122,561 | 515,622 |
| Finished goods | 10,004 | 278,746 |
| | ----- | ----- |

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| | | |
|--------|------------|--------------|
| Totals | \$ 566,870 | \$ 1,025,824 |
| | ===== | ===== |

Note G - Property and Equipment

Property and equipment consist of the following components:

| | September 30, 2005 | September 30, 2004 | Estimated useful life |
|-------------------------------|-----------------------|-----------------------|--------------------------|
| Manufacturing equipment | \$ 8,096,289 | \$ 7,623,415 | 3-10 years |
| Office furniture and fixtures | 55,577 | 82,719 | 3-7 years |
| Leasehold improvements | 190,277 | 187,397 | 8-20 years |
| | ----- | ----- | |
| | 8,342,143 | 7,893,531 | |
| Accumulated depreciation | (5,379,112) | (4,595,887) | |
| | ----- | ----- | |
| Net property and equipment | \$ 2,963,031 | \$ 3,297,644 | |
| | ===== | ===== | |

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note G - Property and Equipment - Continued

Total depreciation expense charged to operations for the nine months ended September 30, 2005 and 2004 was approximately \$577,417 and \$529,496, respectively.

Included in the accompanying balance sheet are the following fixed assets on long-term capital leases:

| | September 30, 2006 | September 30, 2005 |
|-------------------------------|-----------------------|-----------------------|
| | ----- | ----- |
| Manufacturing equipment | \$ - | \$ 153,400 |
| Less accumulated depreciation | - | (81,364) |
| | ----- | ----- |
| | \$ - | \$ 72,036 |
| | ===== | ===== |

Note H- Capital Leases Payable

Capital leases payable consist of the following as of September 30, 2005 and 2004, respectively:

| | |
|-----------------------|-----------------------|
| September 30, 2005 | September 30, 2004 |
|-----------------------|-----------------------|

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Three capital leases, respectively, payable to various equipment financing companies. Interest, at March 31, 2002, ranging between 11.37% and 14.05%. Payable in aggregate monthly installments of approximately \$935, including accrued interest. Final maturities occur between September 2004 and December 2004. Collateralized the underlying leased manufacturing equipment.

| | | | | |
|-------------------------|----|-------|----|-------|
| | \$ | - | \$ | 525 |
| Less current maturities | | - | | (525) |
| | | ----- | | ----- |
| Long-term portion | \$ | - | \$ | - |
| | | ===== | | ===== |

Note I - Loans from Shareholders

Four separate notes payable to three separate shareholders in the amounts of \$50,000, \$50,000, \$50,000 and \$500,000, respectively. Interest at 8.0%, payable monthly. Principal due at maturity on December 31, 2006. 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. Each note is unsecured.

| | | | | |
|-----------|----|-------|--|--|
| \$650,000 | \$ | - | | |
| ===== | | ===== | | |

Note J - Convertible Debenture

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

(Remainder of this page left blank intentionally)

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note J - Convertible Debenture - Continued

As of September 30, 2005, the outstanding balance on the convertible debenture is approximately \$241,365 and we have approximately 2,413,650 warrants outstanding. A recap of the debenture activity is as follows:

| | |
|--------------|-------------|
| Debenture | Warrant |
| (in dollars) | (in shares) |

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| | | |
|---|---------------------|--------------------|
| Initial amount | \$ 600,000 | 6,000,000 |
| 2003 redemptions | (208,635) | (2,086,350) |
| 2004 redemptions | (135,000) | (1,250,000) |
| 2005 redemptions | (25,000) | (250,000) |
| | ----- | ----- |
| Balances outstanding at March 31, 2005 | \$ 241,365 ===== | 2,413,650 ===== |

The debentures bear interest at 8%, mature on June 30, 2007, and are convertible into our common stock, at the selling stockholder's option. The convertible debentures are convertible into the number of our 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 \$.30, we will have the option to prepay the debenture at 125% rather than have the debenture converted. In addition, the selling stockholder is obligated to exercise the warrant concurrently with the submission of a conversion notice by the selling stockholder. As of June 30, 2005, the warrant is exercisable into 2,413,650 shares of common stock at an exercise price of \$1.00 per share.

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

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

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

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

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section for the par value and excess amount over the par value of the respective shares issued.

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

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note J - Convertible Debenture - Continued

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 \$150,000 from the Debenture Holder.

Between January 1, 2005 and June 30, 2005, the Debenture Holder elected to convert an aggregate \$25,000, through a separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 750,000 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 250,000 shares of the Company's common stock for gross proceeds of \$250,000.

On May 6, 2005 and June 21, 2005, the Company authorized the issuance of an aggregate 14,000,000 shares into the A designated escrow account for the purpose of facilitating future conversions of the outstanding Debenture into common stock in conjunction with the exercise of the outstanding Warrants. Subsequent to June 30, 2005, the Debenture Holder, in 4 separate transactions, was issued an aggregate 5,824,758 shares for the conversion of an aggregate \$40,000 in Convertible Debenture and the exercise of 400,000 Warrants at an aggregate price of \$400,000.

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Note K - Preferred Stock Transactions

Preferred stock consists of the following as of September 30, 2005 and 2004, respectively:

| | September 30, 2005 | | September 30, 2004 | |
|-----------------------------|--------------------|-----------|--------------------|------------|
| | # shares | value | # shares | value |
| | ----- | ----- | ----- | ----- |
| Series A Cumulative | | | | |
| Convertible Preferred Stock | 12,000 | \$ 60,000 | 12,000 | \$ 60,000 |
| Series B Cumulative | | | | |
| Convertible Preferred Stock | 91,700 | 458,500 | 91,700 | 458,500 |
| Series C Convertible | | | | |
| Preferred Stock | 1,905,882 | 324,000 | - | - |
| | ----- | ----- | ----- | ----- |
| | 2,009,582 | \$842,500 | 103,700 | \$ 518,500 |
| | ===== | ===== | ===== | ===== |

Series A Convertible Preferred Stock

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

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

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note K - Preferred Stock Transactions - Continued

In September 2001, a creditor of the Company agreed to convert approximately \$10,000 of trade accounts payable into 2,000 shares of Series A Preferred Stock.

In December 2001, concurrent with a modification in the holding period prior to conversion, certain holders of the Series A Preferred Stock orally notified the Company of their intent to exercise the conversion features on 1,749,720 issued and outstanding shares of Series A Preferred Stock into 19,246,920 shares of

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common stock prior to December 31, 2001. Due to the timing of the requisite documentation, the clerical activities related to this conversion were not completed until February 2002.

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

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

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

Series B Convertible Preferred Stock

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

Series C Convertible Preferred Stock

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

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

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

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note L - Common Stock Transactions

Calendar 2004 transactions

During the period from February 13, 2004 through June 4, 2004, the Company issued an aggregate 4,150,000 shares of common stock, in 5 separate transactions, in exchange for the redemption of approximately \$125,000 in outstanding debenture balance and approximately \$1,250,000 in cash from the exercise of the affiliated warrant. Where the closing price of the Company's common stock was in excess of the respective price per share on the respective transaction date, the Company recognized a charge to operations for "compensation expense related to common stock issuances at less than "fair value". The cumulative effect of transactions where the transaction price, as established in the Debenture Agreement, was less than the closing price on the date of the respective transactions resulted in a cumulative charge to operations of approximately \$356,000 during this time period.

Additionally, on June 29, 2004, the Company issued an additional 1,000,000 shares of common stock in advance of the exercise of a \$25,000 redemption on the outstanding debenture payable and a \$250,000 cash payment on the exercise of the affiliated warrant. As of December 31, 2004, the Company has received \$100,000 in cash on the warrant exercise and has not applied the debt reduction portion of this transaction.

In January 2004, the Company issued 38,038 shares of restricted, unregistered common stock in payment of approximately \$10,000 in accrued dividends payable on the Company's outstanding Series A and Series B Preferred Stock for the quarter ended December 31, 2003. 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 May 2004, the Company issued 25,260 shares of restricted, unregistered common stock in payment of approximately \$9,170 in accrued dividends payable on the Company's outstanding Series B Preferred Stock for the quarter ended March 31, 2004. 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.

On May 26, 2004, the Company issued 300,000 shares of restricted, unregistered common stock to two separate corporations in payment and full satisfaction of all amounts due for fees and/or commissions due in conjunction with the Company's convertible debenture financing transaction. This transaction was valued at approximately \$36,000, which was less than the closing price on the date of the respective transaction resulted in a charge to operations of approximately \$24,000. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In August 2004, the Company issued 29,746 shares of restricted, unregistered common stock in payment of approximately \$9,170 in accrued dividends payable on the Company's outstanding Series B Preferred Stock for the quarter ended June 30, 2004. 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.

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On October 19, 2004, the Company issued 1,111,112 shares of restricted, unregistered common stock to acquire certain assets valued at an aggregate \$500,000. The assets consist principally of equipment (approximately \$134,000), inventory (approximately \$89,500) and patents and a covenant not-to-compete (approximately \$276,500).

In November 2004, the Company issued 53,908 shares of restricted, unregistered common stock in payment of approximately \$9,170 in accrued dividends payable on the Company's outstanding Series B Preferred Stock for the quarter ended June 30, 2004. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

Calendar 2005 Transactions

Between January 1, 2005 and June 30, 2005, the Debenture Holder elected to convert an aggregate \$25,000, through a separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 750,000 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 250,000 shares of the Company's common stock for gross proceeds of \$250,000.

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note L - Common Stock Transactions - Continued

Calendar 2005 transactions - continued

On May 6, 2005 and June 21, 2005, the Company authorized the issuance of an aggregate 14,000,000 shares into the A designated escrow account for the purpose of facilitating future conversions of the outstanding Debenture into common stock in conjunction with the exercise of the outstanding Warrants. Subsequent to June 30, 2005, the Debenture Holder, in 4 separate transactions, was issued an aggregate 5,824,758 shares for the conversion of an aggregate \$40,000 in Convertible Debenture and the exercise of 400,000 Warrants at an aggregate price of \$400,000.

In February 2005, the Company issued 55,608 shares of restricted, unregistered common stock in payment of approximately \$9,170 in accrued dividends payable on the Company's outstanding Series B Preferred Stock for the quarter ended December 31, 2004. 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 July and August 2005, the Company issued an aggregate 416,666 shares of restricted, unregistered common stock in 2 separate transactions for the payment of various consulting fees. 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 these transactions.

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In July 2005, the Company issued 166,666 shares of restricted, unregistered common stock as additional compensation to the Company's Director of Dealer Direct Sales. This transaction was valued at approximately \$17,333, which approximated the closing price of the Company's common stock on the transaction date. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In August 2005, the Company issued 250,000 shares of restricted, unregistered common stock for the payment of loan origination costs in connection with a \$500,000 Loan from an existing shareholder. This transaction was valued at approximately \$24,000, which approximated the closing price of the Company's common stock on the transaction date. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In August and September 2005, the Company issued 84,053, 105,400 and 113,212 shares of restricted, unregistered common stock in payment of approximately \$9,170 in accrued dividends due at March 31, 2005, June 30, 2005, and September 30, 2005, respectively, on the Company's outstanding Series B Cumulative Preferred Stock. 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 - Rental Commitments

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

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

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note M - Rental Commitments - Continued

In May 2004, the Company entered into a long-term lease agreement for a

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

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

| Year ended December 31, ----- | Amount ----- |
|-------------------------------------|---------------------|
| 2005 | \$ 166,974 |
| 2006 | 117,244 |
| 2007 | 72,643 |
| 2008 | 68,815 |
| 2007 | 68,815 |
| | ----- |
| Totals | \$ 494,491 ===== |

For the respective years ended December 31, 2004, the Company paid an aggregate of \$131,804 and \$87,826 for rent under these agreements.

Note N - Income Taxes

The components of income tax (benefit) expense for the respective nine month periods ended September 30, 2005 and 2004 are as follows:

| | Nine month ended September 30, 2005 ----- | Nine month ended September 30, 2004 ----- | Period from July 31, 2001 (date of inception) through September 30, 2005 ----- |
|----------|---|---|--|
| Federal: | | | |
| Current | \$ - | \$ - | \$ - |
| Deferred | - | - | - |
| | ----- | ----- | ----- |
| | - | - | - |
| | ----- | ----- | ----- |
| State: | | | |
| Current | - | - | - |
| Deferred | - | - | - |
| | ----- | ----- | ----- |
| | - | - | - |
| | ----- | ----- | ----- |
| Total | \$ - | \$ - | \$ - |
| | ===== | ===== | ===== |

As of December 31, 2004, the Company has a net operating loss carryforward of approximately \$8,150,000 to offset future taxable income. Subject to current regulations, components of this carryforward began to expire at the end of Calendar 2003. The amount and availability of the net operating loss carryforwards may be subject to limitations set forth by the Internal Revenue Code. Factors such as the number of shares ultimately issued within a three year

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look-back period; whether there is a deemed more than 50 percent change in control; the applicable long-term tax exempt bond rate; continuity of historical business; and subsequent income of the Company all enter into the annual computation of allowable annual utilization of the carryforwards.

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American Ammunition, Inc. and Subsidiaries

Notes to Consolidated Financial Statements - Continued

Note N - Income Taxes - Continued

The Company's income tax expense (benefit) for the nine months ended September 30, 2005 and 2004, respectively, differed from the statutory federal rate of 34 percent as follows:

| | Nine months ended September 30, 2005 | Nine months ended September 30, 2004 |
|---|---|---|
| | ----- | ----- |
| Statutory rate applied to loss before income taxes | \$ (1,062,000) | \$ (799,000) |
| Increase (decrease) in income taxes resulting from: | | |
| State income taxes | - | - |
| Other, including reserve for deferred tax asset | 1,062,000 | 799,000 |
| | ----- | ----- |
| Income tax expense | \$ - | \$ - |
| | ===== | ===== |

Temporary differences, consisting primarily of the net operating loss carryforward and statutory differences in the depreciable lives for property and equipment, between the financial statement carrying amounts and tax bases of assets and liabilities give rise to deferred tax assets and liabilities as of December 31, 2004 and 2003, respectively:

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|--------------------------------------|------------------------------------|------------------------------------|
| | ----- | ----- |
| Deferred tax assets - long-term | | |
| Net operating loss carryforwards | \$2,669,000 | \$2,900,000 |
| Deferred tax liabilities - long-term | | |
| Statutory depreciation differences | (690,000) | (250,000) |
| | ----- | ----- |
| | 1,979,000 | 2,650,000 |
| Less valuation allowance | (1,979,000) | (2,650,000) |
| | ----- | ----- |

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| | | | | |
|------------------------|-------|---|-------|---|
| Net Deferred Tax Asset | \$ | - | \$ | - |
| | ===== | | ===== | |

During the years ended December 31, 2004 and 2003, respectively, the valuation allowance increased (decreased) by approximately \$(671,000) and \$656,000.

Note 0 - Subsequent Events

On October 7, 2005, the Company issued an aggregate 667,100 shares of restricted, unregistered common stock in exchange for the conversion of 9,170 shares of Series B Convertible Preferred Stock in accordance with the terms and conditions afforded the Preferred shareholders.

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

(1) Caution Regarding Forward-Looking Information

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

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

Given these uncertainties, readers of this Quarterly Report and investors 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.

Overview

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We were incorporated on February 1, 2000 in the State of California as FirstTelevision.com. We subsequently changed our corporate name to FBI Fresh Burgers International which unsuccessfully marketed a business plan concept of a national "fast food" restaurant chain.

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

F&F Equipment, Inc. was incorporated on October 4, 1983 under the laws of the State of Florida. The company 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., which started production on June 14, 2002. Industrial Plating is a fully licensed and approved electrochemical metallization facility with significant capacity for processing our line of projectiles as well as other products and services while employing environmentally sound water conservation and proven waste treatment techniques.

During the third quarter of 2003, the Company's operations experienced the negative impact of a lower than anticipated or budgeted purchases by Elliot Brothers, a significant customer. However, during this same time period, the Company has entered into a strategic alliance with Israel Military Industries (IMI), an entity owned by the State of Israel, for the cross-production and sale of various small arms ammunition. This alliance is anticipated to greatly expand the Company's catalog of products and assist in utilizing existing production capacity. While this relationship has not generated the initially anticipated volumes, management remains positive on this relationship.

In prior periods, the Company executed a private labeling agreement with Century International Arms, Inc. (Century). Under this agreement, the Company was to produce its standard catalog of small arms ammunition plus one specialty small arms cartridge to Century's specifications for packaging in Century's designated labeling. This agreement required no modifications to the Company's production line and did not require the addition of supplemental personnel or equipment. The Company made an initial shipment under this agreement to Century during December 2003. Virtually immediately, the Company began to experience problems with Century regarding Century's compliance with their performance criteria under this agreement. During the first quarter of 2004, Century defaulted on certain agreed-upon payment schedules on merchandise sold during December 2003. In repayment of the outstanding trade debt, the Company accepted unscheduled product returns as payment of the trade debt. As a result of these issues, the Company recognized a charge to operations of approximately \$28,000 on its business activity with Century. The returned merchandise was repackaged and is resalable by the Company to other customers. As of June 30, 2004, the Company has cancelled this agreement, and is contemplating litigation against Century for breach of contractual obligations under this agreement.

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Additionally, the Company has been awarded three (3) separate contracts from various departments of the U. S. Government. Each contract is for an initial term of one year (commencing between April 24, 2003 and September 30, 2003) with four (4) successive individual one-year extension options. The contracts, which remain in force as of September 30, 2004 and subsequent thereto) are summarized

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as follows:

- Contract 1: U. S. Department of State. Minimum annual volume of approximately 100,000 rounds of military grade small arms ammunition. Maximum annual volume of approximately 5,000,000 rounds. Maximum volume may be increased at the discretion of the Contracting Officer and respective utilization requirements. The Company has received firm orders for 2,265,000 rounds of ammunition under this contract and has approximately 1,265,000 rounds ready for shipment. The ammunition under this contract will be subject to the strategic alliance with Israel Military Industries (IMI). The Company has applied for and received an engineering change to allow for the substitution of Company manufactured items in substitution for the components originally to be supplied by IMI.
- Contract 2: U. S. Department of Energy. This contract covers seven (7) separate products in the Company's standard catalog of products. The U. S. Department of Energy is obligated to purchase an aggregate of 4,549,000 rounds of ammunition under this contract.
- Contract 3: U. S. Department of Homeland Security. This contract covers four (4) separate products being introduced to the Company's catalog through the strategic alliance with IMI and requires no modifications to the Company's production facilities or additions to the labor force. The minimum annual volume is 1,000 rounds of each product and a maximum annual volume of 9,600,000 rounds of two (2) products and 36,000,000 of the remaining two (2) products. The Company has shipped all first article samples, as defined in the contract, and has received favorable feedback on a 20,000 round shipment during the first quarter of 2004. Full scale shipments are anticipated to commence during the second quarter of 2004. The Company has applied for and received an engineering change to allow for the substitution of Company manufactured items in substitution for the components originally to be supplied by IMI.

The Company remains in negotiation for the issuance of purchase orders against these contracts and continues to prepare bids on other contracts from these and other U. S. Governmental agencies.

During the first quarter of 2004, the Company commenced a direct solicitation program for it's "dealer direct" sales program. As this endeavor has received a very positive initial response from the qualified retail resellers of the Company's product, the announcement of this program had a significantly detrimental impact on the Company's relationship with wholesale distributors and, accordingly, had a significant negative impact on first quarter 2004 sales. The Company continues to experience increases in customer demand, order size and reorder quantities in this program by smaller "single store" owner/operators of retail outlets selling the Company's products. It is anticipated that the overall Calendar 2004 sales volume through the "dealer direct" program may well equal or exceed the sales volumes generated by wholesale distributors in prior years.

Results of Operations

Nine months ended September 30, 2005 compared with the nine months ended September 30, 2004

During the nine months ended September 30, 2005, we experienced aggregate net revenues of approximately \$2,233,336, as compared to approximately \$1,712,280 during the comparable period ended September 30, 2004. The second quarter of

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2005 profiles comparably to the same quarter of 2004 with net sales of approximately \$378,000 versus \$862,000. During the third quarter of 2005, management elected to suspend production for a period of time to facilitate the qualification of the production facility for contracting proposals with various U. S. Military channels and/or to provide qualified subcontract production to other prime contractors on U. S. Military contracts. This situation caused a significant decline in production and, accordingly, sales during the third quarter of 2005. Management is of the opinion that these actions will be fruitful in future periods.

During the first quarter of 2004, the Company commenced a direct solicitation program for it's "dealer direct" sales program. As this endeavor has received a very positive initial response from the qualified retail resellers of the Company's product, the announcement of this program had a significantly detrimental impact on the Company's relationship with wholesale distributors and, accordingly, had a significant negative impact on first quarter 2004 sales.

The Company continues to experience high demand for small arms ammunition from both the retail channel market and domestic and foreign governments. The Company has identified certain production issues which has inhibited the full realization of existing product demands and has begun to take the necessary steps to add specific machinery to counteract these issues.

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Through September 30, 2005, and subsequent thereto, we continue to experience negative trends off of our standard production costs for material and labor due to difficulties in training new employees, adding new products to our catalog and lower than expected orders due to uncontrollable delays in ordering by various U. S. Governmental entities. Further, as previously discussed, management invested considerable time and resources into qualifying the production facility for U. S. Department of Defense orders and/or being a participant with other prime manufacturers of small-arms ammunition for U. S. Military contracts. This effort involved shutting down production for a period of time; however, management is of the opinion that future U. S. Military contracts will be obtained as a result of this effort.

Management remains of the opinion that the production labor force is stable and able to maintain a constant standard of quality for future periods. We continue to experience considerable variable costs in the area of material consumption and direct labor.

For the nine month periods ended September 30, 2005 and 2004, we generated a negative gross profit of approximately \$(1,787,000), or (80.02%), and approximately \$(723,000), or (42.21%). Based on orders received and products shipped during the first six months of 2005 and our ongoing conversations with various customers, management continues to believe that the Company should be able to generate a positive gross profit in future periods based on our estimated backlog going into the 4th quarter of approximately \$3,000,000.

We experienced nominal research and development expenses of approximately \$2,600 and \$8,300, respectively, during the respective nine month periods ended September 30, 2005 and 2004, principally related to refinements in and the expansion of our product line.

During the first nine months of 2005 and 2004, we expended approximately

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\$162,000 and \$368,000, respectively, in advertising and marketing expenses, principally in developing and promoting our retail dealer direct program. We anticipate to continue our marketing efforts in this area in future periods; however, the volume and frequency of our expenditures may fluctuate as management allocates available capital to these efforts.

Other general and administrative expenses increased by approximately \$64,000 from approximately \$846,000 for the nine months ended September 30, 2005 as compared to approximately \$910,000 for the nine months ended September 30, 2004. These increases are not identifiable by one specific area; however, relate to general corporate expenses, office and administrative wages and salaries and other related office overhead.

Included in our results of operations for the first nine months of 2005 and 2004 are certain non-cash expenditure charges to operations of approximately \$198,000 and \$356,000 for compensation expense related to common stock issuances at less than "fair value". The calculation of these charges result from our issuing common stock for either cash or services at valuations below the closing quoted market price of our common stock and either the cash received or the value of the services provided to us by third parties.

We recognized a net loss of approximately \$(3,132,000) and \$(2,349,000) for the respective nine month periods ended September 30, 2005 and 2004, respectively, or approximately \$(0.04) and \$(0.03) per share in each respective period.

Nine months ended September 30, 2004 compared with the nine months ended September 30, 2003.

During the nine and three months ended September 30, 2004, we experienced net revenues of approximately \$1,712,000 and \$862,000, respectively, as compared to approximately \$1,216,000 and \$317,000 for the same respective periods of 2003.

During the first quarter of 2004, the Company commenced a direct solicitation program for it's "dealer direct" sales program. As this endeavor has received a very positive initial response from the qualified retail resellers of the Company's product, the announcement of this program had a significantly detrimental impact on the Company's relationship with wholesale distributors and, accordingly, had a significant negative impact on first quarter 2004 sales. The Company continues to experience significant increases in customer demand, order size and reorder quantities in this program by smaller "single store" owner/operators of retail outlets selling the Company's products.

During November 2004, the Company qualified it's 1,000th dealer under this program for direct sales and it is anticipated that the overall Calendar 2004 sales volume through the "dealer direct" program may well equal or exceed the sales volumes generated by wholesale distributors in prior years.

We experienced costs of goods sold of approximately \$2,435,000 for the nine months ended September 30, 2004

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as compared to approximately \$2,209,000 for the nine months ended September 30, 2003. Included in these amounts are approximately \$524,000 and \$495,000, respectively, for depreciation expense on manufacturing equipment and leasehold improvements on our production facility.

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Management is of the opinion that the production labor force is stable and able to maintain a constant standard of quality for future periods. We experience variable costs in the area of material consumption and direct labor.

These depreciation levels are anticipated to remain fairly constant as compared to the first quarter of 2004. Management has placed on order, and placed initial deposits on, new manufacturing equipment to automate the product packaging process and to add new quality assurance equipment on the production line. These commitments aggregate approximately \$450,000, of which the majority has been expended through September 30, 2004.

Management, at this time, does not anticipate any further significant capital equipment acquisitions.

Further, the addition of the Industrial Plating Enterprise Co. equipment during 2003 allows us to produce certain components which were previously outsourced to unrelated third parties.

For the nine month periods ended September 30, 2004 and 2003, respectively, we have generated a negative gross profit of approximately \$(723,000), or (42.21%), and approximately \$(993,000), or (81.66%).

As previously reported, our research during the second quarter of 2004 has revealed that the various governmental agencies which have issued purchase contracts to us either purchased large quantities during the last 60 days of the Federal Government's year ended September 30, 2003 or are experiencing transitional purchasing problems or issues surrounding the reorganization of various agencies into the Department of Homeland Security, with the related issues of Congressional appropriations for funding the necessary expenditures of these reorganized agencies. The actions of the third quarter proved this research to be correct and we received several purchase order releases on our contract with the Department of Homeland Security. The timing of Congressional approval of the related appropriation bills to fund the various executive branch departments of the United States of America continues to impact the timing and release of purchase orders under our contracts as previously discussed.

We continue to anticipate that with the fulfillment of the government contracts discussed above, continually expanding retail consumer demand for our product line, lower production costs being experienced from internally generated plating activities and adequate liquidity, we will be able to generate a positive gross profit in future periods. Further, based on production cost information developed during the 4th quarter of 2002 and further refined during 2003, management has developed a new model for the pricing of its products to its customers. It is anticipated that this model will allow management to better manage expense levels, control labor costs and maximize revenue opportunities.

We had minimal costs allocated to research and development expenses during either of the quarters ended September 30, 2004 and 2003.

Through the nine months ending September 30, 2004, we expended approximately \$368,000 in advertising and marketing expenses, principally in developing and promoting our retail dealer direct program. We anticipate to continue our marketing efforts in this area in future periods; however, the volume and frequency of our expenditures may fluctuate as management allocates available capital to these efforts.

Other general and administrative expenses increased by approximately \$57,000 from approximately \$789,000 for the nine months ended September 30, 2003 as compared to approximately \$846,000 for the nine months ended September 30, 2004. These increases are not identifiable by one specific area; however, relate to general corporate expenses, office and administrative wages and salaries and other related office overhead.

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Included in our results of operations for the first nine months of 2004 are certain non-cash expenditure charges to operations of approximately \$356,000 for compensation expense related to common stock issuances at less than "fair value". The calculation of these charges result from our issuing common stock for either cash or services at valuations below the closing quoted market price of our common stock (as discounted, as applicable) and either the cash received or the value of the services provided to us by third parties. During Calendar 2003, we experienced a charge of approximately \$94,000 for the amortization of the Beneficial Conversion Feature Discount on our Preferred Stock. This charge results from the difference between the closing quoted market price on our common stock and the equivalent converted price of our Mandatory Convertible Preferred Stock which was sold and converted during 2003.

We recognized a net loss of approximately \$(2,350,000) and \$(2,662,000) for the respective three month periods ended September 30, 2004 and 2003, respectively, or \$(0.03) and \$(0.04) per share.

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Liquidity And Capital Resources

As of September 30, 2005, December 31, 2004 and September 30, 2004, respectively, we had working capital of approximately \$(504,000), \$872,000 and \$960,000. Our working capital position continues to fluctuate based on our sales volume, collections on our trade accounts receivable and cash received from the contractually mandatory exercise of our outstanding warrant related to our convertible debenture. Further, we anticipate that we have sufficient inventory levels to support our retail dealer direct program and our existing and anticipated U. S. Government contracts.

We have used cash in operating activities of approximately \$(1,663,000) and \$(728,000) during the nine month periods ended September 30, 2005 and 2004, respectively.

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 inquiries which have previously been denied due to the lack of production capacity and liquidity.

During the nine months ended September 30, 2005 and 2004, respectively, we added approximately \$111,000 and \$436,000 in new equipment. Based on communicated future demand for our products, we have instituted a program to expand our production capacity through the addition of additional equipment from the open market. The equipment ultimately to be added 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. Management is of the opinion that sufficient demand will be present, as supported by new product development and increased product marketing efforts, to justify this expansion. However, we may not be able to obtain additional funding or, that such funding, if available, will be obtained on terms favorable to or affordable by us.

Convertible Debenture

The Company entered into a Securities Purchase Agreement with La Jolla Cove

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

As of September 30, 2005, the outstanding balance on the convertible debenture is approximately \$241,365 and we have approximately 2,413,650 warrants outstanding.

The debentures bear interest at 8%, mature on June 30, 2007, and are convertible into our common stock, at the selling stockholder's option. The convertible debentures are convertible into the number of our 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 \$.30, we will have the option to prepay the debenture at 125% rather than have the debenture converted. In addition, the selling stockholder is obligated to exercise the warrant concurrently with the submission of a conversion notice by the selling stockholder. As of June 30, 2005, the warrant is exercisable into 2,413,650 shares of common stock at an exercise price of \$1.00 per share.

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

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

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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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

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"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 \$150,000, through 6 separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 4,900,000 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 1,500,000 shares of the Company's common stock for gross proceeds of \$1,500,000. 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 \$150,000 from the Debenture Holder.

Between January 1, 2005 and September 30, 2005, the Debenture Holder elected to convert an aggregate \$25,000, through a separate transactions, in outstanding Debenture principal into registered common stock. This election caused the Company to issue 750,000 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 250,000 shares of the Company's common stock for gross proceeds of \$250,000.

On May 6, 2005 and June 21, 2005, the Company authorized the issuance of an aggregate 14,000,000 shares into the A designated escrow account for the purpose of facilitating future conversions of the outstanding Debenture into common stock in conjunction with the exercise of the outstanding Warrants. Subsequent to June 30, 2005, the Debenture Holder, in 4 separate transactions, was issued an aggregate 5,824,758 shares for the conversion of an aggregate \$40,000 in Convertible Debenture and the exercise of 400,000 Warrants at an aggregate price of \$400,000.

Item 3 - Controls and Procedures

As required by Rule 13a-15 under the Exchange Act, within the 90 days prior to the filing date of this report, the Company carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures. This evaluation was carried out under the supervision and with the participation of the Company's President, Chief Executive and Chief Financial Officer. Based upon that evaluation, the Company's President, Chief Executive and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. There have been no significant changes in

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the Company's internal controls or in other factors, which could significantly affect internal controls subsequent to the date the Company carried out its evaluation.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in Company reports filed under the Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure.

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Part II - Other Information

Item 1 - Legal Proceedings

None

Item 2 - Recent Sales of Unregistered Securities and Use of Proceeds

In July 2005, the Company issued 166,666 shares of restricted, unregistered common stock as additional compensation to Paul Goebel, the Company's Director of Dealer Direct Sales. This transaction was valued at approximately \$17,333, which approximated the closing price of the Company's common stock on the transaction date. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In August 2005, the Company issued 250,000 shares of restricted, unregistered common stock for the payment of loan origination costs in connection with a \$500,000 Line of Credit facility. This transaction was valued at approximately \$24,000, which approximated the closing price of the Company's common stock on the transaction date. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction.

In August and September 2005, the Company issued 84,053, 105,400 and 113,212 shares of restricted, unregistered common stock in payment of approximately \$9,170 in accrued dividends due at March 31, 2005, June 30, 2005, and September 30, 2005, respectively, on the Company's outstanding Series B Cumulative Preferred Stock. 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

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

None

Item 5 - Other Information

None

Item 6 - Exhibits and Reports on Form 8-K

(a) The exhibits required to be filed herewith by Item 601 of Regulation S-B, as described in the following index of exhibits are incorporated herein.

| Exhibit number | Descriptions |
|-------------------|--|
| ----- | ----- |
| 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: October 28, 2005

/s/ Andres F. Fernandez

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