Vaughan Foods, Inc.
Form 10-Q
August 10, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2007

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______to
Commission file number 001-33446

VAUGHAN FOODS, INC.

(Exact name of registrant as specified in its charter)

Oklahoma (State or other jurisdiction of incorporation or organization)	**73-1342046** (I.R.S. Employer Identification No.)
216 N.E. 12th Street, Moore, OK (Address of principal executive offices)	**73160** (Zip Code)

(405) 794-2530
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes o No x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

Number of shares outstanding of the registrant s common stock, as of August 7, 2007:

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

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PART 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS.

VAUGHAN FOODS, INC.
Consolidated Balance Sheets
June 30, 2007 and December 31, 2006

	June 30, 2007 (unaudited)	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 471,525	$ 868,377
Accounts receivable, net of allowance for doubtful accounts of $94,270 at June 30, 2007 and $65,045 at December 31, 2006	6,573,224	3,414,843
Accounts receivable, related party		144,243
Inventories	2,452,663	631,674
Prepaid expenses and other assets	163,612	79,793
Bridge loan asset, net of amortization		562,500
Deferred tax assets	23,727	24,717
Total current assets	9,684,751	5,726,147
Restricted assets:		
Cash	277	270
Investments	813,959	597,181
Certificate of deposit	250,000	250,000
Total restricted assets	1,064,236	847,451
Property and equipment, net	16,602,506	13,102,988
Other assets:		
Assets held for sale		40,000
Loan origination fees, net of amortization	390,458	516,410
Intangible assets	865,461	
Deferred tax assets, noncurrent	148,994	202,119
Deferred cost of public offering	1,062,428	566,955
Total other assets	2,467,341	1,325,484
Total assets	$ 29,818,834	$ 21,002,070
Liabilities and Stockholders Equity (Deficiency)		
Current liabilities:		
Accounts payable	$ 7,039,282	$ 4,221,635
Amounts payable to former owners of Allison s Gourmet Kitchens	1,500,000	
Accounts payable, related party		69,502

Disbursements in transit	373,095	
Line of credit	2,726,578	2,726,578
Short-term borrowings	3,000,000	3,000,000
Bridge funding liability	1,125,000	1,125,000
Note payable to former owners of Allison s Gourmet Kitchens	1,000,000	
Accrued liabilities	2,174,297	1,011,985
Current portion of long-term debt	932,745	606,885
Current portion of capital lease obligation	181,052	172,370
Amounts payable to former owners of Wild About Food	500,000	
Total current liabilities	20,552,049	12,933,955
Long term liabilities:		
Long-term debt, net of current portion	9,902,443	8,187,067
Capital lease obligation, net of current portion	393,868	479,618
Amounts payable to former owners of Wild About Food, net of current portion	126,780	
Total long-term liabilities	10,423,091	8,666,685
Stockholders equity (deficiency):		
Common stock, $0.001 par value; authorized 50,000,000 shares; 2,300,000 shares issued and outstanding at December 31, 2006 and June 30, 2007	2,300	2,300
Preferred stock, $0.001 par value; authorized 5,000,000 shares; 0 shares issued and outstanding at December 31, 2006 and June 30, 2007		
Paid in Capital	413,693	413,693
Member Capital (deficit)	(28,748)	(22,921)
Retained Earnings (deficit)	(1,543,551)	(991,642)
Total stockholders equity (deficiency)	(1,156,306)	(598,570)
Total liabilities and stockholders equity (deficiency)	$ 29,818,834	$ 21,002,070

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

VAUGHAN FOODS, INC.
Unaudited Consolidated Statements of Operations
For the Three Months and Six Months Ended June 30, 2007 and 2006

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(unaudited)			
Net sales	$ 13,945,725	$ 13,820,293	$ 26,478,941	$ 26,317,960
Cost of sales	12,858,724	13,677,419	24,005,232	24,486,599
Gross profit	1,087,001	142,874	2,473,709	1,831,361
Selling, general and administrative expenses	969,755	1,177,009	1,803,200	2,206,912
Operating income (loss)	117,246	(1,034,135)	670,509	(375,551)
Rent income	124,624	83,850	219,805	166,425
Interest expense	(777,932)	(253,333)	(1,396,967)	(516,387)
Loss on sale of asset	(21,486)		(21,486)	
Interest and other income	13,543	16,139	24,518	28,314
Other income and expense, net	(661,251)	(153,344)	(1,174,130)	(321,648)
(Loss) before income taxes	(544,005)	(1,187,479)	(503,621)	(697,199)
Income tax expense (benefit)	(97,633)	(486,651)	54,115	(248,797)
Net (loss)	$ (446,372)	$ (700,828)	$ (557,736)	$ (448,402)
Weighted average shares outstanding - basic and diluted	2,300,000	2,300,000	2,300,000	2,300,000
Net income (loss) per share - basic and diluted	$ (0.19)	$ (0.30)	$ (0.24)	$ (0.19)

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

VAUGHAN FOODS, INC.

Unaudited Consolidated Statements of Stockholders Equity

For the Year Ended December 31, 2006 and Six Months Ended June 30, 2007

	Common Stock					
	Shares issued	Amount	Paid in Capital	Member Capital (Deficit)	Retained Earnings (Deficit)	Total Stockholders Equity (Deficiency)
Balance at January 1, 2006	2,300,000	$ 2,300	$ 413,693	$ (12,839)	$ 202,784	$ 605,938
Net income (loss)				(10,082)	(1,194,426)	(1,204,508)
Balance at December 31, 2006	2,300,000	2,300	413,693	(22,921)	(991,642)	(598,570)
Net income (loss) (unaudited)				(5,827)	(551,909)	(557,736)
Balance at June 30, 2007 (unaudited)	2,300,000	$ 2,300	$ 413,693	$ (28,748)	$ (1,543,551)	$ (1,156,306)

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

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VAUGHAN FOODS, INC.
Unaudited Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2007 and 2006

	Six Months Ended June 30,	
	2007	**2006**
	(unaudited)	
Cash flows from operating activities:		
Net (loss)	$ (557,736)	$ (448,402)
Adjustments to reconcile net (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,235,912	547,158
Provision for bad debts	(2,605)	
Loss on sale of asset	21,486	
Deferred income taxes	54,115	(262,818)
Changes in operating assets and liabilities:		
Accounts receivable	(746,933)	(1,467,277)
Accounts receivable - related party	(210,085)	33,585
Inventories	(96,049)	3,919
Prepaid expenses and other assets	(58,775)	(81,368)
Disbursements in transit		83,859
Accounts payable	776,225	1,958,063
Accounts payable, related party	(32,703)	
Accrued liabilities	630,346	207,051
Net cash provided by operating activities	1,013,198	573,770
Cash flows from investing activities:		
Cash paid for property and equipment	(685,326)	(2,016,618)
Restricted assets	(216,785)	(118,681)
Proceeds from sale of assets	18,514	
Distributions from restricted assets		1,449,763
Cash acquired in acquisition	222,411	
Net cash (used in) investing activities	(661,186)	(685,536)
Cash flows from financing activities:		
Cash paid for deferred public offering expense	(495,473)	
Proceeds from long-term debt		90,140
Proceeds from line of credit		500,000
Repayment of long-term debt and capital leases	(253,391)	(440,473)
Net cash provided by (used in) financing activities	(748,864)	149,667
Net increase (decrease) in cash and cash equivalents	(396,852)	37,901
Cash and cash equivalents at beginning of period	868,377	36,163
Cash and cash equivalents at end of period	$ 471,525	$ 74,064

Supplemental disclosures of cash flow information:				
Cash paid during the period for:				
Interest paid, net of capitalized interest	$	307,758	$	494,554
Supplemental disclosures of noncash financing and investing activities:				
Fair value of assets acquired and liabilities assumed in acquisition:				
Accounts receivable	$	2,054,514	$	
Inventories		1,724,940		
Prepaids		25,044		
Property and equipment		3,354,543		
Intangible assets		872,569		
Total assets acquired	$	8,031,610	$	
Accounts payable and accrued expenses	$	3,770,987	$	
Long-term debt and capital leases		1,983,034		
Total liabilities assumed	$	5,754,021	$	

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

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Vaughan Foods, Inc.
Notes to Unaudited Consolidated Financial Statements
June 30, 2007 and 2006

(1) Nature of Operations

Vaughan Foods, Inc. (the Company) is an Oklahoma-based specialty food processor serving customers in a multi-state region. The Company and its subsidiaries operate from manufacturing facilities in Moore, Oklahoma and Fort Worth, Texas.

(2) Summary of Significant Accounting Policies

(a) Basis of Reporting

The accompanying financial statements and notes thereto have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain disclosures normally prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. The accompanying financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s S-1 Registration Statement (Amendment No. 10).

This summary of significant accounting policies is presented to assist in understanding the Company s consolidated financial statements. The consolidated financial statements and notes are representations of the Company s management which is responsible for the integrity and objectivity of the consolidated financial statements. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the consolidated financial statements.

(b) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and of Cimarron Holdings, LLC (Cimarron). Cimarron is owned by the two individual stockholders of the Company prior to the initial public offering. Cimarron owns an airplane that is used by Company management. The Company is paying the debt service payments on the liability associated with the airplane, as well as all costs of maintenance and operations. Because the Company is the primary beneficiary of Cimarron, it is considered a variable interest entity subject to FIN 46R, and has been consolidated by the Company in its consolidated financial statements. All significant intercompany transactions and balances have been eliminated in consolidation. See Note 20 to the consolidated financial statements.

On June 30, 2007, the Company acquired 100 percent of Allison s Gourmet Kitchens, LP (Allison s) and its wholly-owned subsidiary, Wild About Food - Oklahoma, a Texas Limited Liability Company (Wild). The accompanying consolidated balance sheet as of June 30, 2007 includes the accounts of Allison s and Wild. All intercompany balances have been eliminated in consolidation.

(c) Unaudited Interim Financial Information

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

(d) Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, the Company considers investments with maturities of three months or less at date of purchase to be cash equivalents.

(e) Accounts Receivable and Credit Policies

Trade accounts receivable are customer obligations due under normal trade terms generally requiring payment within 15 to 21 days from the invoice date. Receivables are recorded based on the amounts invoiced to customers. Interest and delinquency fees are not generally assessed and, if they are assessed, are not included in income or trade accounts receivable until realized in cash. Discounts allowed for early payment, if any, are charged against income when the payment is received. Payments of accounts receivable are allocated to the specific invoices identified on the customer s remittance advice or, if unspecified, are applied to the earliest unpaid invoices.

The carrying amount of accounts receivable is reduced by an allowance for doubtful accounts that reflects management s best estimate of the amounts that will not be collected. Management provides for probable uncollectible amounts through a charge to earnings and a credit to the allowance for doubtful accounts based on historical collection trends and an assessment of the creditworthiness of current customers. The adequacy of the valuation allowance is evaluated periodically through an individual assessment of potential losses on customer accounts giving particular emphasis to accounts with invoices unpaid more than 60 days past the due date. Balances still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to trade accounts receivable. Recoveries on accounts previously written off are credited to the valuation allowance.

A lien exists on certain receivables related to fresh produce under the Perishable Agricultural Commodities Act of 1930, which partially subordinates the lien placed by the line of credit.

(f) Inventories

Inventories consist principally of food products and are stated at the lower of average cost (which approximates first-in, first-out) or market. Costs included in inventory consist of materials, packaging supplies, and labor. General and administrative costs are not charged to inventory.

(g) Property and Equipment

Property and equipment are recorded at cost. Equipment acquired under capital leases is recorded at the present value of the future minimum lease payments, and amortized on a straight-line basis over the shorter of the lease term or the estimated useful life of the asset. Expenditures for major additions and improvements are capitalized, while minor replacements, maintenance and repairs are charged to expense as incurred. When property and equipment are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in other income and expense.

Depreciation, including assets acquired under capital leases, is provided using the straight-line method over the following estimated useful lives:

Plant and improvements	15 - 40 years
Machinery and equipment	5 - 15 years
Transportation equipment	3 - 10 years
Office equipment	5 - 7 years

(h) Concentrations of Credit Risk

The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

(i) Revenue Recognition

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

(j) Accounting for Rebates

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

(k) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(l) Earnings (Loss) Per Share

Basic earnings (loss) per share (EPS) excludes dilution and is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of shares of common stock outstanding during the period. Diluted EPS is computed in a manner similar to that of basic EPS except that the weighted-average number of common shares outstanding is increased to include the number of incremental common shares (computed using the treasury stock method) that would have been outstanding if all potentially dilutive common shares (such as stock options) were issued during the period. Diluted EPS is not presented if the effect of the incremental shares is anti-dilutive. The Company has agreed to issue shares of common stock in connection with its short-term borrowing when any initial public offering is consummated. The details of this agreement are described in Note 8. The Company has not included these shares in diluted earnings per share due to the Company s net loss for the period, the effects of inclusion would be anti-dilutive.

(m) Use of Estimates

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

(n) Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities are measured at cost which approximates fair value because of the short-term nature of these instruments. The carrying amount of the Company s borrowings under the line of credit and long-term debt approximates fair value because the interest rate on the instruments fluctuate with market interest rates or represents borrowing rates available with similar terms.

(o) Investments

All of the Company s investments are classified as available for sale and reported at fair value. Any related unrealized gains and losses are excluded from earnings and reported net of income tax as a separate component of shareholders equity until realized. There were no unrealized gains or losses for the three and six months ended June 30, 2007 and 2006. Realized gains and losses on sales of securities are based on the specific identification method. Declines in the fair value of investment securities below their carrying value that are other than temporary are recognized in earnings. As of June 30, 2007 and December 31, 2006, the Company s investments consisted primarily of guaranteed investment contracts at a fixed interest rate of 2.25 percent.

(p) Classification of Consolidated Financial Statement Items

Certain amounts in previously reported consolidated financial statements have been reclassified to conform to the current presentation.

(q) Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, and Related Implementation Issues (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a Company s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, the Company may recognize the benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the consolidated financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. FIN 48 is effective as of the beginning of fiscal years that begin after December 15, 2006. The Company is not currently subject to any specific audit by any federal, state or local taxing authority, and therefore does not expect the adoption of this interpretation to have any effect on its consolidated financial statements. The Company has taken the position that the acquisition of Allison s is a non-taxable transaction.

In September of 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company has not determined the effect, if any, the adoption of this statement will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which provides companies an option to report selected financial assets and liabilities at fair value. SFAS No. 159 requires companies to provide information helping financial statement users to understand the effect of a company s choice to use fair value in determining its earnings, as well as to display the fair value of the assets and liabilities a company has chosen to use fair value for on the face of its balance sheet. Additionally, SFAS No. 159 establishes presentation and disclosure requirements designed to simplify comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The statement is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. The Company has not determined the effects if any, the adoption of this statement will have on its consolidated financial statements.

In September 2006, the United States Securities and Exchange Commission released Staff Accounting Bulletin No.108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements , which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB No. 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The adoption of SAB No. 108 did not have an effect on the Company s consolidated financial statements.

(3) Inventories

A summary of inventories follows:

	June 30, 2007 (unaudited)	December 31, 2006
Raw materials and supplies	$ 1,858,863	$ 543,787
Finished goods	593,801	87,887
Total inventory	$ 2,452,663	$ 631,674

(4) Restricted Assets

The Company is required to hold cash in reserve in separate trust accounts applicable to its $5.0 million Cleveland County Industrial Authority Industrial Development Revenue Bonds, issued December 2004, and to secure a letter of credit for purposes of self insurance for worker s compensation. The project construction account represents proceeds of the bond offering to be drawn for approved capital expenditures. The debt reserve account represents funds to be used for debt service in the event of default. The interest and principal accounts represent deposits to be used for debt service. These assets are as follows:

	June 30, 2007 (unaudited)	December 31, 2006
Project construction account	$ 277	$ 270
Debt reserve account	501,908	525,620
Interest fund account	246,420	71,391
Principal fund account	65,631	170
Certificate of deposit	250,000	250,000
Total restricted assets	$ 1,064,236	$ 847,451

(5) Property and Equipment

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

	June 30, 2007 (unaudited)	December 31, 2006
Land	$ 238,162	$ 199,762
Plant and improvements	11,301,853	5,919,477
Machinery and equipment	7,574,523	4,685,688
Transportation equipment	2,034,838	2,096,857
Office equipment	187,158	78,382
Construction in progress	186,088	4,598,530
	21,522,622	17,578,696
Less accumulated depreciation	(4,920,116)	(4,475,708)
Net Property, Plant and Equipment	$ 16,602,506	$ 13,102,988

During the three months and six months ended June 30, 2007 and 2006, depreciation expense, including depreciation on assets held under capital lease obligations, was $270,416, $254,846, $516,782 and $505,883, respectively.

(6) Assets Held for Sale

At December 31, 2006, the Company held plant and improvements for sale with a net book value of $40,000, which it sold on June 18, 2007, for net proceeds of $18,514, representing a loss on the sale of $21,486.

(7) Line of Credit

At June 30, 2007 and December 31, 2006, the Company had a $4.0 million secured bank line of credit, due on October 31, 2006, providing for interest at Wall Street Journal prime rate plus 0.75 percent, with an initial rate of 6.75 percent. The line of credit was secured by accounts receivable, inventory and general intangibles.

At June 30, 2007 and December 31, 2006, short-term borrowings under the line were $2,726,578. The line of credit contains certain financial covenants which replicate those covenants of the Cleveland County Industrial Authority Bond Issue. The Company was in violation of certain covenants, as more fully defined in Note 9. The Company has not obtained a waiver of the financial covenants. In December 2006, the Company reached an informal agreement with the lender, subject to credit approval of the Company and the execution of a formal note extension agreement, to extend the line until April 30, 2007. Under the terms of the proposed extension, the maximum amount that could be borrowed under the line would be fixed at $2,726,578 and a new financial covenant would be added providing that if subsequent monthly collateral valuations are less than the value of the collateral at November 30, 2006, the borrower would immediately be deemed to be in default without any available grace period to cure such default. Further, the interest rate on borrowed funds under the line will increase from 0.75 percent over the specified prime rate to 2 percent over that prime rate and the Company would be required to pay the lender a 1 percent extension fee on borrowed funds on the execution of the extension agreement and a 2 percent extension fee on borrowed funds on the earlier of the maturity date or the completion of the Company s pending initial public offering (See Note 13). The Company repaid the line of credit on July 3, 2007 following the completion of its initial public offering. (See Note 13).

Allison s has a $1.0 million secured bank line of credit, initiated on March 3, 2006, at an interest rate of the Wall Street Journal prime rate plus 0.50 percent, with an initial rate of 8.00 percent. Interest is payable on a monthly basis. The line of credit was secured by all of Allison s assets, including accounts receivable, inventory, equipment and personal guaranties of all of the former partners. At June 30, 2007 and December 31, 2006, no amounts were outstanding pursuant to this agreement. The bank line of credit agreement was subject to certain covenants for which Allison s was in compliance as of June 30, 2007, and December 31, 2006.

Wild has a $600,000 secured bank line of credit, initiated on June 7, 2006, at an interest rate of the Wall Street Journal prime rate plus 1.00 percent. At June 30, 2007 and December 31, 2006, short-term borrowings under this line of credit were $253,995, and $0, respectively. Wild was in compliance with all covenants.

(8) Short-term Borrowings

The Company entered into 10 percent secured subordinated promissory notes on July 17, 2006 for a maximum of $2.0 million. The notes are secured by the pledge by certain partners of 60 percent of the limited partnership interests in Allison s. The entire principal amount of the notes and all accrued and unpaid interest thereon is due and payable on the earlier of June 30, 2007 (the Maturity Date), or the third business day following the completion of an underwritten public offering or a private placement by the Company resulting in gross proceeds of $5 million or more (a Qualified Offering).

The notes are subordinate to all other existing indebtedness of the Company. Borrowings under these notes were $2.0 million at June 30, 2007. As additional consideration for their purchase of notes, each purchaser of $1.5 million principal amount of notes (First Notes) will receive that number of equity securities to be issued in any initial public offering consummated before June 30, 2007, having a value, at the initial public offering price, of 50 percent of the notes purchased by that investor. Further, the holders of notes totaling $0.5 million which are junior to First Notes (Junior Notes) are to receive that number of equity securities to be issued having a value of 75 percent of the notes purchased by that investor. Proceeds of the note will be used to complete construction of the addition to the existing facility.

The liability for additional compensation of $1,125,000 is shown as Bridge funding liability on the accompanying balance sheet. In addition to the liability, an intangible asset related to the loan origination was recorded in the original amount of $1,125,000, net of amortization of $1,125,000 and $562,500 at June 30, 2007 and December 31, 2006 in the accompanying balance sheet. At June 30, 2007 and December 31, 2006, the carrying amount of this intangible asset was $562,500 and $0, respectively. The amortization of this intangible asset is recorded as interest expense in the consolidated statements of operations. The number of shares to be issued using the expected offering price of $6.50 is 173,077.

The Company repaid the notes subsequent to June 30, 2007 using a portion of the proceeds of the initial public offering.

The Company agreed to enter into a 10 percent non-secured promissory note on September 21, 2006 for a maximum of $1.0 million. The maturity date is the earlier of April 30, 2007, or the consummation of any initial public offering consummated before the maturity date. Borrowings under this note were $1.0 million at June 30, 2007. This note is payable to the underwriter that the Company was working on its initial public offering (see Note 13). Following the completion of the initial public offering, the Company entered into an agreement to extend the note to the earlier of June 30, 2008 or the closing of an equity financing in which the Company receives at least $4.0 million in gross proceeds.

(9) Long-Term Debt and Capital Lease Obligations

Long-term debt consists of the following:

	June 30, 2007 (unaudited)	December 31, 2006
6.75 - 7.10% Cleveland County Industrial Revenue Bonds secured by real property final payment due December 1, 2024	$ 4,690,000	$ 4,690,000
5.75 - 9.00% Real estate loans secured by real property final payments due July 22, 2009 and August 1, 2028	3,488,384	3,518,267
6.50 - 7.00% Equipment loans secured by various manufacturing equipment final payments due from 2007 thru 2008	9,856	43,552
4.75 - 6.50% Vehicle loans secured by various transportation equipment final payments due from 2008 thru 2010	210,421	299,547
Consolidated entities:		
8.75% Equipment loan secured by manufacturing equipment final payment due March 3, 2011	1,948,268	
9.56% Equipment loans secured by refrigeration equipment final payment due May 1, 2021	116,971	
9.56% Real estate loan secured by real property final payment due May 1, 2021	146,444	
8.00 - 10.00% Equipment loans secured by aircraft final payments due November 30, 2007 and April 25, 2019	224,844	242,586
Total long-term debt	10,835,188	8,793,952
Less current portion	932,745	606,885
Net long-term debt	$ 9,902,443	$ 8,187,067

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

Debt Service Coverage Ratio: The Company is required to maintain a debt service coverage ratio of 1.50 to 1.00. The ratio will be reported to the Trustee and notice given to Beneficial Owners quarterly for each of the previous four quarters. If the Debt Service coverage ratio reported for each of the previous four quarters is less than 1.50 to 1.00 the Company is required to retain a consultant. For the three months ended June 30, 2007, the Company s Debt Service Coverage ratio is 1.03 to 1.00. The trustee has not required the Company to retain a consultant.

Current Ratio: The Company is required to maintain a current ratio 1.10 to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. As of June 30, 2007, the Company s current ratio is 0.40 to 1.00.

Debt to Equity Ratio: The Company is required to maintain a debt to equity ratio of not more than 4.00 to 1.00 calculated as of the last day of each calendar quarter beginning after January 1, 2006. As of June 30, 2007, the Company s debt to equity ratio could not be calculated due to a negative equity balance.

Accounts Payable: The Company agrees that not more than 20 percent of its accounts payable shall be in excess of 90 days past due. The Company is in compliance with this covenant as of June 30, 2007.

Accounts Receivable: The Company agrees that not more than 20 percent of accounts receivable will be in excess of 90 days past due. The Company is in compliance with this covenant as of June 30, 2007. Noncompliance with the debt service coverage ratio, the current ratio, or the debt to equity ratio will not be considered an event of default under the terms of the agreement. Noncompliance with the above ratios has resulted in an increase in the interest rate on each of the Bonds of 1 percent until the Company is in compliance with the required ratios.

Capital lease obligations consist of the following:

	June 30, 2007 (unaudited)	December 31, 2006
8.95 - 9.19% Equipment leases	$ 569,043	$ 651,988
8.62% Equipment lease	5,877	
	574,920	651,988
Less current portion	(181,052)	(172,370)
Capital lease obligations, net of current portion	$ 393,868	$ 479,618

Annual Debt Service Requirements

The annual principal payment requirements to maturity, for long-term debt and capital lease obligations at June 30, 2007 are as follows:

Year Ending June 30,	Long-Term Debt	Capital Lease Obligations	Total
2008	$ 932,745	$ 181,052	$ 1,113,797
2009	844,622	196,344	1,040,966
2010	1,069,326	186,445	1,255,771
2011	723,228	11,079	734,307
2012	1,833,141		1,833,141
Thereafter	5,432,126		5,432,126
Principal outstanding at June 30, 2007	$ 10,835,188	$ 574,920	$ 11,410,108

During the three months and six months ended June 30, 2007 and 2006, total interest costs were $777,932, $253,333, $1,396,967 and $516,387, respectively. The amount of interest costs capitalized to construction projects during the six months ended June 30, 2007 was $106,988.

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(10) Accrued Liabilities

A summary of accrued liabilities follows:

	June 30, 2007 (unaudited)	December 31, 2006
Rebates	$ 776,393	$ 403,071
Interest expense	473,324	156,420
Compensation	389,569	179,379
Workers compensation	279,479	158,976
Payroll taxes	106,907	40,515
Promotions and incentives	89,725	41,102
Property taxes	51,549	32,522
Other	7,351	
Total accrued liabilities	$ 2,174,297	$ 1,011,985

(11) Amounts Payable to Former Owners of Wild

Allison s has current liabilities in the amount of $500,000 and long-term liabilities in the amount of $126,780 which are related to contingent payments to former owners of Wild.

(12) Intangible Assets

Allison s holds an intangible asset, a customer list related to its acquisition by the Company in the amount of $154,210. The Company will begin amortizing the asset to expense over a period of five years beginning July 1, 2007. Allison s holds an intangible asset, a customer relationship with a certain customer of Wild. The value of the customer relationship is $700,333 net of amortization of $76,863 at June 30, 2007. The Company amortizes the asset to expense over a period of five years. The amount of annual amortization expense related to the June 30, 2007 value of the customer relationship is $172,000. The earnings of Wild will cause an increase in the value, which will add additional amortization expense.

(13) Initial Public Offering

Subsequent to June 30, 2007, the Company completed an initial public offering of its shares. The offering consisted of 2.15 million units, with each unit consisting of one share of common stock, one Class A warrant and one Class B warrant. The units were priced at $6.50 each in the offering.

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

Each Class A warrant entitles its holder to purchase one share of common stock at an exercise price equal to 150 percent of the initial unit offering price.

Each Class B warrant entitles its holder to purchase one share of common stock at an exercise price equal to 200 percent of the initial unit offering price.

The Class A and Class B warrants are exercisable at any time after they become separately tradable. The Company may redeem some or all of the warrants commencing six months after this offering, after they become separately tradeable, at a price of $0.25 per warrant, on 30 days notice to the holders. On July 27, 2007, the units separated into common stock and warrant and the stock and each warrant commenced trading,

individually, on that date, on the NASDAQ Capital Market under the symbols: FOOD for the common stock, FOODW for the Class A warrants and FOODZ for the Class B warrants. The Units will cease to trade on that date.

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

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

A portion of the proceeds from the offering were used to (a) acquire the partnership interests in Allison s for $1.5 million in cash and a deferred payment of $1.0 million (see Note 19), (b) repay a short-term borrowing of $2.0 million which has been used to complete the extension of our existing facility, and (c) repay our bank line of credit of $2.7 million. The remainder of the proceeds are expected to be used to construct or acquire one or more new facilities and to supplement our working capital for general corporate purposes.

(14) Income Taxes

Income tax expense (benefit) for the three months and six months ended June 30, 2007 and 2006, consist of the following:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
	(unaudited)		(unaudited)	
Current:				
Federal	$	$	$	$
State				
Deferred:				
Federal	(87,352)	(435,407)	48,417	(222,599)
State	(10,281)	(51,244)	5,698	(26,198)
	(97,633)	(486,651)	54,115	(248,797)
Total income tax expense (benefit)	$ (97,633)	$ (486,651)	$ 54,115	$ (248,797)

Deferred tax assets (liabilities) are as follows:

	June 30, 2007 (unaudited)	December 31, 2006
Net operating loss carryforward	$ 554,265	$ 613,749
Oklahoma Job and Investment Credits	99,737	99,737
Depreciation	(529,035)	(535,394)
Other	47,754	48,744
Net deferred tax asset	$ 172,721	$ 226,836
Current portion	$ 23,727	$ 24,717
Non-current portion	148,994	202,119
	$ 172,721	$ 226,836

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

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

As of June 30, 2007, the Company has a net operating loss carryforward of $1,458,591 which, if unused, will commence expiring in 2018 and state new jobs/investment credit carryforwards totaling $99,737 of which, if unused, $12,170 will expire on December 31, 2007.

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

	Three months ended June 30, 2007 (unaudited)	Three months ended June 30, 2006 (unaudited)	Six months ended June 30, 2007 (unaudited)	Six months ended June 30, 2006 (unaudited)
Computed expected income taxes	$ (184,962)	$ (403,743)	$ (171,231)	$ (237,047)
State income taxes, net of federal income tax	(32,640)	(71,249)	(30,217)	(41,832)
Permanent difference due to amortization of equity transactions	95,625		191,250	
Utilization of net operating loss carryforwards against current income and other, net	24,344	(11,659)	64,313	30,082
	$ (97,633)	$ (486,651)	$ 54,115	$ (248,797)

(15) Operating Leases

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

	(unaudited)	
2008	$	332,758
2009		232,930
2010		87,747
2011		44,828
2012		
	$	698,263

(16) Employee Benefit Plans

In 2002, the Company adopted a Flexible 401(k) plan covering all full-time employees with a minimum of one year of service. The Company makes contributions under the plan at an amount equal to 25 percent of the employee s elective deferral rate, up to a maximum of 4 percent of the employee s compensation. The Company s contributions to the plan during the three months and six months ended June 30, 2007 and 2006 were $2,560, $2,105, $4,441 and $3,269, respectively.

In August 2006, the Company adopted a stock option plan providing for potential awards of up to 1,000,000 shares. No shares or options have been issued under the plan.

(17) Major Customers

The Company has supply arrangements with a certain retailer, representing about 8 percent of its customer sales, and supply arrangements with a certain distributor which account for approximately 22 percent of gross revenues. While such purchasers are each independent, it is possible that a termination of a purchasing arrangement with any such entity could adversely affect business relationships with related entities.

Allison s has two customers that represent 30 percent and 27 percent of Allison s sales, respectively. A change in one of these customer relationships could adversely affect the Company s financial position, results of operations or cash flows.

On a pro-forma basis, taking into account the acquisition of Allison s on June 30, 2007, the supply agreements with the certain retailer and distributor represent 5.3 percent and 14.3 percent of consolidated proforma revenues, respectively, for the three months ended June 30, 2007. The two significant Allison s customers represent 10.6 percent and 9.5 percent, respectively of those proforma consolidated revenues.

(18) Related Party Transactions

On March 1, 2003, the two stockholders of the Company became limited partners in Allison s. During the normal course of business, the Company sells raw materials and finished goods, provides freight services to Allison s and purchases finished goods for resale to its customers.

The Company provides a discounted price for products sold to Allison s for use as ingredients in Allison s products. All other transactions between the companies are at fair market value.

On June 30, 2007, Allison s merged into the Company.

During the three months and six months ended June 30, 2007 and 2006, the Company s sales, including freight services, to Allison s and purchases from Allison s were as follows (unaudited):

	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
Sales of product to Allison s	$ 299,774	$ 266,423	$ 491,739	$ 440,260
Freight revenue from Allison s	119,191	185,714	207,634	310,496
Purchases from Allison s	136,624	185,271	285,403	280,414

The Company leases a portion of its facilities to Allison s on an annual lease agreement. The lease agreement provides for nine consecutive one year options to extend the lease agreement. The Company and Allison s share utilities, sales and administration staff, and other facility expenses. Allison s reimburses the Company for its portion of the shared expenses through periodic reimbursement. A summary of the shared expenses for the three months and six months ended June 30, 2007 and 2006 are as follows (unaudited):

	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
Rents	$ 124,624	$ 83,850	$ 219,805	$ 166,425
Utilities	34,127	55,223	79,220	93,871
Salaries	40,369	59,248	86,812	109,215

At June 30, 2007 and December 31, 2006 amounts due from Allison s were $354,328 and $144,243, respectively. Accounts payable related to purchases from Allison s were $36,799 and $69,502 at June 30, 2007 and December 31, 2006, respectively. The amounts are eliminated on the June 30, 2007 consolidated balance sheet.

(19) Commitments and Contingencies

The Company and its subsidiaries are subject to legal proceedings and claims which arise in the ordinary course of business. Although occasional adverse decisions or settlements may occur, the Company is not aware of any proceeding at June 30, 2007, which would have a material adverse effect on its consolidated financial position, results of operations or liquidity.

(20) Cimarron Holdings, L.L.C.

The Company s two shareholders (prior to the initial public offering) each had a 50 percent ownership in Cimarron Holdings, LLC. (Cimarron). Cimarron owns an airplane that is used by Company management. The Company has not guaranteed the obligations of Cimarron, but is making the debt service payments for Cimarron, as well as all of the costs of maintenance and operations of the airplane.

The Company s consolidated financial statements include the financial statements of Cimarron. The consolidation of Cimarron increased the Company s consolidated total assets and liabilities at June 30, 2007 and December 31, 2006 as follows:

	June 30, 2007 (unaudited)	December 31, 2006
Total assets	$ 196,096	$ 219,665
Total liabilities	224,844	242,586

(21) Acquisition of Wild

Effective June 1, 2006, Allison s acquired certain assets and assumed certain liabilities of Wild and All For One, Inc. (together, Wild). Wild produces refrigerated food products for food service and retail customers. The purchase price was comprised of a cash payment of $7,000, Notes payable to the sellers totaling $250,000, assumption of (i) a mortgage loan of $154,000, (ii) a line of credit loan of $23,000, (iii) a capital lease of $9,000, and (iv) accounts payable and other liabilities of $236,000.

Assets acquired amounted to cash and accounts receivable of $25,000, inventory of $131,000 and property and equipment of $523,000. In addition, the acquisition provides for a contingent payment equal to 65 percent of operating income over and above $250,000, as defined, during the three-year period following the closing.

Customer relationships have been recorded as identifiable intangible assets in connection with the acquisition of Wild, and are being amortized to expense over a five year period commencing with the first period of capitalization and increasing as the capitalization of the intangible asset increases.

The following is a summary of the amounts capitalized and amortized to expense since the inception of the agreement to acquire Wild:

	From Acquisition Through December 31, 2006	During the Six Months Ended June 30, 2007 (unaudited)	Cumulative as of June 30, 2007
Contingent purchase price costs capitalized	$ 220,605	$ 556,591	$ 777,196
Less: amortization of intangible assets	(7,920)	(68,943)	(76,863)
Net book value	$ 212,685	$ 487,648	$ 700,333

(22) Acquisition of Allison s

On June 30, 2007, we acquired (i) for nominal consideration, 60 percent of the limited partnership interests in Allison s from Mark Vaughan, our President and Chief Operating Officer, and Vernon J. Brandt, our Vice President Operations, (ii) the general partnership interest in Allison s from Braxton Management, Inc., in return for our agreement to indemnify it from all liability as the former general partner of Allison s, and (iii) for a total price of $2,500,000, the remaining 40 percent of the limited partnership interests in Allison s from Herbert Grimes, our Chairman and Chief Executive Officer and Stan Gustas, our Chief Financial Officer.

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Depreciation of equipment and leasehold improvements	734,664	840,224
Amortization of product software development expenditures	364,539	1,558,318
Stock-based compensation	684,554	583,069

expense		
Deferred income taxes	(2,608,369)	729,720
Change in cash surrender value of life insurance	(120,627)	(51,972)
Deferred compensation	(210,204)	198,642
Net changes in operating assets and liabilities (see note 17)	4,176,502	(6,015,360)
Cash provided by operating activities	3,591,432	3,496,217
Investing activities:		
Life insurance premiums paid	(243,940)	(259,279)
Purchase of equipment and leasehold improvements	(535,868)	(655,480)
Cash used in investing activities	(779,808)	(914,759)
Financing activities:		
Dividends paid to stockholders	(1,771,849)	(1,771,849)
Cash used in financing activities	(1,771,849)	(1,771,849)
Net increase in cash and cash equivalents	1,039,775	809,609
Cash and cash equivalents at beginning of year	859,636	50,027
Cash and cash equivalents at end of year	$ 1,899,411	$ 859,636

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

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KOSS CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Paid in	Retained	
	Shares	Amount	Capital	Earnings	Total
Balance, July 1, 2012	7,382,706	$36,914	$2,625,039	$14,433,286	$17,095,239
Net income	—	—	—	5,427,715	5,427,715
Dividends declared	—	—	—	(1,771,849)	(1,771,849)
Stock-based compensation expense	—	—	583,069	—	583,069
Income tax benefit from stock-based compensation	—	—	55,500	—	55,500
Balance, June 30, 2013	7,382,706	$36,914	$3,263,608	$18,089,152	$21,389,674
Net loss	—	—	—	(5,553,554)	(5,553,554)
Dividends declared	—	—	—	(1,328,887)	(1,328,887)
Stock-based compensation expense	—	—	684,554	—	684,554
Income tax benefit from stock-based compensation	—	—	48,080	—	48,080
Balance, June 30, 2014	7,382,706	$36,914	$3,996,242	$11,206,711	$15,239,867

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

KOSS CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING POLICIES

NATURE OF BUSINESS — Koss Corporation (“Koss”), a Delaware corporation, and its 100%-owned subsidiary (collectively the “Company”), reports its finances as a single reporting segment, as the Company’s principal business line is the design, manufacture and sale of stereo headphones and related accessories. The Company leases its plant and office in Milwaukee, Wisconsin. In addition, the Company has more than 200 domestic dealers and its products are carried by approximately 24,000 domestic retailers and numerous retailers worldwide. International markets are served by domestic sales representatives and a sales office in Ireland which utilizes independent distributors in several foreign countries. The Company has one subsidiary, Koss U.K. Limited ("Koss UK"), which was formed in the year ended June 30, 2014 to comply with certain European Union (EU) requirements. Koss U.K. is non-operating and holds no assets.

BASIS OF CONSOLIDATION — The consolidated financial statements include the accounts of Koss and its subsidiary, Koss UK, which is a 100%-owned subsidiary. All significant intercompany accounts and transactions have been eliminated.

REVENUE RECOGNITION — Revenue is recognized by the Company upon shipment of product, which is generally when title passes to the customer, the price is fixed and collectibility is reasonably assured. Provisions for slotting fees, cooperative advertising programs, rebates, sales discounts, estimated returns and allowances, and other estimated costs are provided for in the same period the sales are recorded. These provisions are recorded as a reduction to sales.

SHIPPING AND HANDLING FEES AND COSTS — Shipping and handling costs charged to customers have been included in net sales. Shipping and handling costs incurred by the Company have been included in cost of goods sold.

RESEARCH AND DEVELOPMENT — Research and development activities charged to operations as a component of selling, general and administrative expenses in the accompanying Consolidated Statements of Operations amounted to $1,024,885 in fiscal year 2014 and $1,436,493 in fiscal year 2013.

ADVERTISING COSTS — Advertising costs included within selling, general and administrative expenses in the accompanying Consolidated Statements of Operations were $211,196 in 2014 and $230,455 in 2013. Such costs are expensed as incurred.

INCOME TAXES — The Company operates as a C Corporation under the Internal Revenue Code of 1986, as amended (the “Code”). Amounts provided for income tax expense are based on income reported for financial statement purposes and do not necessarily represent amounts currently payable under tax laws. Deferred income tax assets and liabilities are computed annually for differences between the financial statements and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. As changes in tax laws or rates are enacted, deferred income tax assets and liabilities are adjusted through the provision for income taxes. The differences relate principally to different methods used for depreciation and amortization for income tax purposes, net operating losses, capitalization requirements of the Code, allowances for doubtful accounts, stock-based compensation, warranty reserves, and other income tax related carryforwards. Valuation allowances are established when necessary to reduce deferred income tax assets to the amount expected to be realized.

INCOME (LOSS) PER COMMON AND COMMON STOCK EQUIVALENT SHARE — Income (loss) per common and common stock equivalent share is calculated under the provisions of Topic 260 in the Accounting Standards Codification ("ASC") which provides for calculation of “basic” and “diluted” income (loss) per share. Basic income (loss) per common and common stock equivalent share includes no dilution and is computed by dividing net income by the weighted average common shares outstanding for the period. Diluted income (loss) per common and common stock equivalent share reflects the potential dilution of securities that could share in the earnings of an entity. See Note 14 for additional information on income (loss) per common and common stock equivalent share.

CASH AND CASH EQUIVALENTS — The Company considers depository accounts and investments with a maturity at the date of acquisition and expected usage of three months or less to be cash and cash equivalents. The Company maintains its cash on deposit at commercial banks located in the United States of America. The Company periodically has cash balances in excess of insured amounts. The Company has not experienced and does not expect to incur any losses on these deposits.

ACCOUNTS RECEIVABLE — Accounts receivable consists of unsecured trade receivables due from customers. An allowance for doubtful accounts is recorded for significant past due receivable balances based on a review of the past due item, general economic conditions and the insurance coverage in place. See Note 3 for additional information on accounts receivable.

INVENTORIES — The Company's inventory was valued at the lower of last-in, first-out ("LIFO") cost or market. The carrying value of inventory is reviewed for impairment on at least a quarterly basis or more frequently if warranted due to changes in market conditions. See Note 5 for additional information on inventory.

EQUIPMENT AND LEASEHOLD IMPROVEMENTS — Equipment and leasehold improvements are stated at cost. Depreciation and amortization is calculated using the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the asset. Major expenditures for property and equipment and significant renewals are capitalized. Maintenance, repairs and minor renewals are expensed as incurred. When assets are retired or otherwise disposed of, their costs and related accumulated depreciation and amortization are removed from the accounts and any resulting gains or losses are included in operations.

PRODUCT SOFTWARE DEVELOPMENT EXPENDITURES — The Company follows the guidance of ASC 985-20 "Costs of Software to be Sold, Leased, or Marketed" when capitalizing software development expenditures associated with software embedded in or to be incorporated into its products. The cost of purchased software technology is capitalized and stated at the lower of unamortized cost or expected net realizable value. At a minimum, we review for impairment on a quarterly basis. Amortization is being recorded over a three year period or a fixed amount per unit sold, whichever is greater. See Note 7 for additional information.

LIFE INSURANCE POLICIES — Life insurance policies are stated at cash surrender value or at the amount the Company would receive in the case of split-dollar arrangements. Increases in cash surrender value are included in selling, general and administrative expenses in the Consolidated Statements of Operations, which is where the annual premiums are recorded.

PRODUCT WARRANTY OBLIGATIONS — Estimated future warranty costs related to products are charged to cost of goods sold during the period the related revenue is recognized. The product warranty liability reflects the Company's best estimate of probable obligations under those warranties. See Note 11 for additional information on product warranty obligations.

DEFERRED COMPENSATION — The Company's deferred compensation liabilities are for a current and former officer and are calculated based on compensation, years of service and mortality tables. The related expense is calculated using the net present value of the expected payments and is included in selling, general and administrative expenses in the Consolidated Statements of Operations. See Note 12 for additional information on deferred compensation.

FAIR VALUE OF FINANCIAL INSTRUMENTS — Cash equivalents, accounts receivable and accounts payable approximate fair value based on the short maturity of these instruments.

IMPAIRMENT OF LONG-LIVED ASSETS — The Company evaluates the recoverability of the carrying amount of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. The Company evaluates the recoverability of equipment and leasehold improvements annually or more frequently if events or circumstances indicate that an asset might be impaired. If an asset is considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell. Management determines fair value using a undiscounted future cash flow analysis or other accepted valuation techniques. The Company recorded an impairment of capitalized software in the year ended June 30, 2014, detailed in Note 4. No impairments of the Company's long-lived assets were recorded in the year ended June 30, 2013.

LEGAL COSTS — All legal costs related to litigation are charged to operations as incurred, except settlements, which are expensed when a claim is probable and can be estimated. Recoveries of legal costs are recorded when the amount and items to be paid are confirmed by the insurance company. Proceeds from the settlement of legal disputes are recorded in income when the amounts are determinable and the collection is certain.

STOCK-BASED COMPENSATION — The Company has a stock-based employee compensation plan, which is described more fully in Note 15. The Company accounts for stock-based compensation in accordance with ASC 718 "Compensation - Stock Compensation". Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period.

USE OF ESTIMATES — 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

RECLASSIFICATIONS — Certain amounts previously reported have been reclassified to conform to the current presentation.

2. UNAUTHORIZED TRANSACTION RELATED RECOVERIES

In December 2009, the Company learned of significant unauthorized transactions as previously reported. The Company has ongoing costs and recoveries associated with the unauthorized transactions. For the years ended June 30, 2014 and 2013, the costs incurred were for legal fees related to claims initiated against third parties (see Note 21). The Company has received various recoveries related to the unauthorized transactions which are summarized below. The Company will continue to incur legal fees for the claims initiated against third parties. There have been other recoveries of the assets previously owned and forfeited by the former Vice President of Finance. The Company expects to receive additional forfeiture related funds in the fiscal year ended June 30, 2015. However, the remaining amounts to be received are not expected to be significant. For the years ended June 30, 2014 and 2013, the costs and recoveries were as follows:

	2014	2013
Legal fees incurred	$388,287	$2,598,454
Recoveries:		
Insurance proceeds	—	(15,014)
Gross proceeds from the settlement of the third party lawsuit	—	(8,500,000)
Proceeds from asset forfeitures	(1,134,082)	(1,670,487)
Total recoveries	(1,134,082)	(10,185,501)
Unauthorized transaction related costs and recoveries, net	$(745,795)	$(7,587,047)

3. ACCOUNTS RECEIVABLE

Accounts receivable includes unsecured trade receivables due from customers. In addition, at June 30, 2013, accounts receivable included $8,500,000 of proceeds from the settlement of the lawsuit against a third party (see Notes 2 and 21).

The Company performs credit evaluations of its customers and does not require collateral to establish an account receivable. Accounts receivable from our two largest customers represented 11.0% and 20.5% of trade accounts receivable as of June 30, 2014 and 2013, respectively.

The Company evaluates collectibility of accounts receivable based on a number of factors. Accounts receivable are considered to be past due if unpaid one day after their due date. An allowance for doubtful accounts is recorded for past due receivable balances based on a review of the past due item and general economic conditions. The Company writes off accounts receivable when they become uncollectible. The Company recovered $112,417 of previously written-off accounts receivable during fiscal 2014 and there were no recoveries of previously written off accounts receivable during fiscal 2013. Changes in the allowance for doubtful accounts were as follows:

	Balance,	Provision	Amounts	Balance,

Fiscal Year Ended June 30,	beginning of year	charged to expense	written-off	end of year
2014	$43,405	(182,020)	159,116	$20,501
2013	$31,559	13,561	(1,715)	$43,405

The vast majority of international customers, outside of Canada, are sold to on a cash against documents or cash in advance basis. Approximately 14% and 16% of the Company's trade accounts receivable at June 30, 2014 and 2013, were foreign receivables denominated in U.S. dollars.

4. IMPAIRMENT OF CAPITALIZED SOFTWARE, INVENTORY AND RELATED ITEMS

The Company recorded an impairment charge in the Consolidated Statements of Operations line item titled "Impairment of capitalized software, inventory and related items" during the fiscal year ended 2014. The impairment is detailed in the following table:

	2014
Product software development expenditures	$2,308,752
Inventories	3,451,911
Product design costs	246,588
Tooling	298,696
Impairment of capitalized software, inventory and related items	$6,305,947

The Company determined that the capitalized software needed to be replaced by a new architecture under development, which began in the three months ended December 31, 2013. As a result, the remaining value of the capitalized software was expensed for the three months ended December 31, 2013. In conjunction with the review of the capitalized software, it was determined that certain inventory items were obsolete or the Company had quantities that are not expected to be used over the product forecast period. These inventory items are included net of expected recoveries. Product design costs and assumed liabilities to wrap up the current architecture design were expensed. Tooling related to products that are no longer expected to be launched was expensed. Additional review, which was completed in the three months ended June 30, 2014, indicated that the remaining inventory and tooling should be expensed as these products are not expected to be sold in the current design configuration.

5. INVENTORIES

As of June 30, 2014 and 2013, the Company's inventory was valued using the lower of last-in, first-out ("LIFO") cost or market. If the first-in, first-out ("FIFO") method of inventory accounting had been used by the Company for inventories valued at LIFO, inventories would have been $1,172,262 and $1,313,498 higher than reported at June 30, 2014 and 2013, respectively.

The components of inventories at June 30, 2014 and 2013 were as follows:

	2014	2013
Raw materials	$5,593,159	$5,019,597
Finished goods	6,327,221	6,690,301
	11,920,380	11,709,898
Reserve for obsolete inventory	(4,865,448)	(1,208,726)
Total inventories	$7,054,932	$10,501,172

6. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

The major categories of equipment and leasehold improvements at June 30, 2014 and 2013 are summarized as follows:

	Estimated useful lives	2014	2013
Machinery and equipment	5-10 years	$675,670	$527,450
Furniture and office equipment	5-10 years	374,616	374,616
Tooling	5 years	3,607,314	3,363,464
Display booths	5-7 years	287,180	287,180

Computer equipment	3-5 years	1,414,517	1,401,056
Leasehold improvements	7-10 years	2,288,706	2,288,706
Assets in progress	N/A	259,328	318,758
		8,907,331	8,561,230
Less: accumulated depreciation and amortization		7,066,840	6,223,248
Equipment and leasehold improvements, net		$1,840,491	$2,337,982

7. PRODUCT SOFTWARE DEVELOPMENT EXPENDITURES

The Company follows the guidance of ASC 985-20 “Costs of Software to be Sold, Leased, or Marketed” when capitalizing software development costs associated with software embedded in or to be incorporated into its products. The cost of purchased software technology is capitalized and stated at the lower of unamortized cost or expected net realizable value. Software is subject to rapid technological obsolescence and future revenue estimates supporting the capitalized software cost can be negatively affected based upon competitive products, services and pricing. Such adverse developments could reduce the estimated net realizable value of our product software development costs and could result in impairment or a shorter estimated life. Such events would require us to take a charge in the period in which the event occurs or to increase the amortization expense in future periods and would have a negative effect on our results of operations. At a minimum, we review for impairment on a quarterly basis.

The Company launched a new product offering in 2012 and began amortization of the related capitalized software. Amortization was being recorded over a three year period or a fixed amount per unit sold, whichever is greater. In the quarter ending December 31, 2013, the Company determined that the capitalized software needed to be replaced by a new architecture under development. As a result, the remaining asset value of $2,308,752 was expensed as of December 31, 2013 (charged to the Consolidated Statements of Operations line item titled "Impairment of capitalized software, inventory, and related items" which is detailed in Note 4). The Company continues to believe in the viability of this technology but has temporarily suspended its research and development effort until the base business is restored to more profitable levels.

Changes in the product software development costs net of accumulated amortization were as follows:

Fiscal Year Ended June 30,	Balance, beginning of year	Amortization charged to expense	Impairment charged to expense	Balance, end of year
2014	$2,673,291	(364,539)	(2,308,752)	$—
2013	$4,231,609	(1,558,318)	—	$2,673,291

8. INCOME TAXES

The Company utilizes the liability method of accounting for income taxes. The liability method measures the expected income tax impact of future taxable income and deductions implicit in the consolidated balance sheets. The income tax provision in 2014 and 2013 consisted of the following:

Year Ended June 30,	2014	2013
Current:		
Federal	$(1,863,204)	$1,697,085
State	69,984	(156,039)
Deferred	(2,608,369)	729,720
Total income tax provision (benefit)	$(4,401,589)	$2,270,766

The 2014 and 2013 tax results in an effective rate different than the federal statutory rate because of the following:

Year Ended June 30,	2014	2013
Federal income tax expense (benefit) at statutory rate	$(3,382,307)	$2,617,484
State income tax expense (benefit), net of federal income tax benefit	(285,802)	147,516
Increase in valuation allowance	148,000	21,890
Stock-based compensation	58,187	49,561
Adjustments for unrecognized tax benefits	(546,113)	(449,938)

Federal income tax credits	(187,349)	—
Other	(206,205)	(115,747)
Total income tax provision (benefit)	$(4,401,589)	$2,270,766

Temporary differences which give rise to deferred income tax assets and liabilities at June 30, 2014 and June 30, 2013 include:

	2014	2013
Deferred income tax assets:		
Deferred compensation	$858,434	$886,750
Stock-based compensation	714,350	524,387
Accrued expenses and reserves	2,701,144	1,177,771
Federal and state net operating loss carryforwards	371,744	267,944
Valuation allowance	(370,409)	(222,409)
Other	22,806	—
Total deferred income tax assets	4,298,069	2,634,443
Deferred income tax liabilities:		
Equipment and leasehold improvements	(98,717)	(22,025)
Capitalized research and development costs	—	(1,015,838)
Other	—	(5,597)
Net deferred income tax assets	$4,199,352	$1,590,983

Deferred income tax assets as presented on the consolidated balance sheets:

	2014	2013
Current deferred income tax assets	$2,576,023	$1,171,453
Noncurrent deferred income tax assets	1,623,329	419,530
Net deferred income tax assets	$4,199,352	$1,590,983

Deferred income tax balances reflect the effects of temporary differences between the tax bases of assets and liabilities and their carrying amounts. These differences are stated at enacted tax rates expected to be in effect when taxes are actually paid or recovered. The recognition of these deferred tax balances will be realized through normal recurring operations and, as such, the Company has recorded the full value of such expected benefits. The Company utilized all of the federal net operating loss carryforwards in the fiscal year ended and will carry back the net operating loss generated in the current year to fiscal year ended June 30, 2013. The Company has net operating loss carryforwards in the state of Wisconsin totaling $5,470,820 of which $4,096,353 and $1,374,467 will expire in fiscal years 2026 and 2030, respectively.

ASC Topic 740 "Income Taxes" prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken, in a tax return. There were no additional significant matters determined to be unrecognized tax benefits taken or expected to be taken in a tax return that have been recorded on the Company's consolidated financial statements for the year ended June 30, 2014. As part of the unauthorized transactions, the Company has accrued interest of $0 and $49,150 as of June 30, 2014 and 2013, respectively.

	2014	2013
Accrued interest at beginning of year	$49,150	$150,624
Interest charges to expense	24,575	44,014
Interest charges reversed	(73,725)	(145,488)
Accrued interest at end of year	$—	$49,150

Additionally, ASC Topic 740 provides guidance on the recognition of interest and penalties related to income taxes. There were no penalties related to income taxes that have been accrued or recognized as of and for the years ended June 30, 2014 and 2013. The Company records interest related to unrecognized tax benefits in interest expense. For the year ended June 30, 2014, the Company decreased the interest it had accrued related to its tax reporting of the unauthorized transactions. The Company reversed the accrued interest related to the tax return that was filed for the year ended June 30, 2008 because the statute of limitations expired for this return.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	2014	2013
Unrecognized tax benefits at beginning of year	$696,113	$1,146,051
Gross increases - tax positions in prior years	25,000	—
Reductions due to lapse in statute	(546,113)	(249,938)
Reductions based on settlements with taxing authorities	—	(200,000)
Unrecognized tax benefits at end of year	$175,000	$696,113

All of the Company's unrecognized tax benefits as of June 30, 2014 and 2013 would affect the effective tax rate.

The Company files income tax returns in the United States federal jurisdiction and in several state jurisdictions. The Company’s federal tax returns through tax year June 30, 2010 are settled and the income tax returns for tax years beginning July 1, 2010 are open. For states in which the Company files state income tax returns, the statue of limitations is generally open for tax years ended June 30, 2010 and forward. The Company's Federal return for the fiscal year ended June 30, 2013 is currently under examination.

The following are the changes in the valuation allowance:

Year Ended June 30,	Balance, beginning of year	Increase in valuation allowance	Release of valuation allowance	Balance, end of year
2014	$(222,409)	(148,000)	—	$(370,409)
2013	$(200,486)	(21,923)	—	$(222,409)

9. CREDIT FACILITY

On May 12, 2010, the Company entered into a secured credit facility with JPMorgan Chase Bank, N.A. (“Lender”). The Credit Agreement dated May 12, 2010 between the Company and the Lender (“Credit Agreement”) provided for an $8,000,000 revolving secured credit facility with interest rates either ranging from 0.0% to 0.75% over the Lender’s most recently publicly announced prime rate or 2.0% to 3.0% over LIBOR, depending on the Company’s leverage ratio. The Company pays a fee between 0.3% to 0.45% for unused amounts committed in the credit facility. On July 24, 2013, the Credit Agreement was amended to extend the expiration to July 31, 2015. On July 23, 2014, the Credit Agreement was amended to reduce the facility to $5,000,000 and to amend certain financial covenants. In addition to the revolving loans, the Credit Agreement also provides that the Company may, from time to time, request the Lender to issue letters of credit for the benefit of the Company up to a sublimit of $2,000,000 and subject to certain other limitations. The loans may be used only for general corporate purposes of the Company.

The Credit Agreement contains certain affirmative, negative and financial covenants customary for financings of this type. The negative covenants include restrictions on other indebtedness, liens, fundamental changes, certain investments, asset sales, sale and leaseback transactions and transactions with affiliates, among other restrictions. The amended financial covenants include minimum EBITDA and minimum tangible net worth requirements. The Company and the Lender also entered into the Pledge and Security Agreement dated May 12, 2010 under which the Company granted the Lender a security interest in substantially all of the Company’s assets in connection with the Company’s obligations under the Credit Agreement. The balance on this facility was $0 as of June 30, 2014 and 2013.

10. ACCRUED LIABILITIES

Accrued liabilities for the years ended June 30, 2014 and 2013 are as follows:

	2014	2013
Legal and professional fees	$79,900	$2,234,584
Customer credit balances	1,988,052	—
Cooperative advertising and promotion allowances	750,433	622,695
Accrued severance	123,720	—
Accrued returns	89,663	179,723
Product warranty obligations	385,852	371,500
Interest	—	53,692
Employee benefits	129,518	131,905
Management bonuses and profit-sharing	37,500	845,762
Sales commissions and bonuses	148,278	197,914
Other	120,557	67,679
	3,853,473	$4,705,454

Customer credit balances relate to customer returns in process as of year ended June 30, 2014. These credit balances will be refunded to customers in the year ended June 30, 2015 if there are not sufficient new sales with those customers to offset the credit balances. Accrued severance relates to the suspension of operations at the facility in Juarez, Mexico.

11. PRODUCT WARRANTY OBLIGATIONS

The Company records a liability for product warranty obligations at the time of sale based upon historical warranty experience. The majority of the Company’s products carry a lifetime warranty. The Company also records a liability for specific warranty matters when they become known and are reasonably estimated. The Company’s current and non-current product warranty obligations are included in accrued liabilities and other liabilities, respectively, in the consolidated balance sheets. However, the Company is continuously releasing new and more complex and technologically advanced products. Even though some of these products have a shorter warranty period, it is at least reasonably possible that products could be released with certain unknown quality or design problems resulting in higher than expected warranty and related costs. These costs could have a materially adverse effect on the Company's results of operations and financial condition in the near term.

Changes to the product warranty obligations for the years ended June 30, 2014 and 2013 are as follows:

Year Ended June 30,	Balance, beginning of year	Provision charged to expense	Warranty expenses incurred		Balance, end of year
2014	$1,111,500	97,300	(486,176	)	$722,624
2013	$1,132,500	541,585	(562,585	)	$1,111,500

12. DEFERRED COMPENSATION

The Company has deferred compensation agreements with a former and current officer. The related expense is calculated using the net present value of the expected payments and is included in selling, general and administrative expenses in the Consolidated Statements of Operations. The net present value was calculated for the former officer using a discount factor of 2.60% and 2.06% as of June 30, 2014 and 2013, respectively. The net present value was calculated for the current officer using a discount factor of 4.62% and 4.85% at June 30, 2014 and 2013, respectively.

The Board of Directors entered into an agreement to continue the Chairman's 1991 base salary for the remainder of his life. These payments begin upon the Chairman's retirement, and since the Chairman has not retired, he is not currently receiving any payments under this arrangement. The Company has a deferred compensation liability of $704,306 and $501,923 recorded as of June 30, 2014 and 2013, respectively. Deferred compensation expense of $202,383 was recognized under this arrangement in 2014 and deferred compensation expense reversal of $120,580 was recognized in 2013.

The Board of Directors has approved a supplemental retirement plan with an officer that calls for annual cash compensation following retirement from the Company in an amount equal to 2% of base salary, as defined in the agreement, multiplied by the number of years of service to the Company. The retirement payments are to be paid monthly to the officer until his death and then to his surviving spouse monthly until her death. The Company has a deferred compensation liability of $1,615,785 and $1,873,627 recorded as of June 30, 2014 and 2013, respectively. Deferred compensation expense reversal of $257,842 was recognized under this arrangement in 2014 and deferred compensation expense of $299,810 was recognized under this arrangement in 2013, respectively.

The Company uses life insurance policies to provide funds to meet its deferred compensation obligations.

13. INTEREST EXPENSE

The Company incurs interest expense primarily related to its secured credit facility (see Note 8) and to its liabilities for its tax positions related to the unauthorized transactions. As the tax returns have been settled and statute of limitations have expired, the accrued interest expense on certain items has been reversed. Interest expense detail was as follows for the fiscal years ended June 30, 2014 and 2013, respectively:

	2014	2013
Interest benefit (expense) on secured credit facility	$587	$(44,993)
Interest expense for tax positions related to unauthorized transactions	(24,575)	(44,014)
Interest reversals for tax positions related to unauthorized transactions	73,725	145,488
Other interest expense	(148)	(391)
Interest reversal	$49,589	$56,090

14. INCOME (LOSS) PER COMMON AND COMMON STOCK EQUIVALENT SHARE

Basic income (loss) per share is computed based on the weighted-average number of common shares outstanding. The weighted-average number of common shares outstanding was 7,382,706 for the years ended June 30, 2014 and 2013. When dilutive, stock options are included in income (loss) per share as share equivalents using the treasury stock method. For the years ended June 30, 2014 and 2013 there were no common stock equivalents related to stock option grants that were included in the computation of the weighted-average number of shares outstanding for diluted income (loss) per share. Shares under option of 2,066,000 and 1,741,000 were excluded from the diluted weighted average common shares outstanding for the years ended June 30, 2014 and 2013, respectively, as they would be anti-dilutive.

15. STOCK OPTIONS

In 2012, pursuant to the recommendation of the Board of Directors, the stockholders ratified the creation of the Company’s 2012 Omnibus Incentive Plan (the “2012 Plan”), which superseded the 1990 Flexible Incentive Plan (the "1990 Plan"). The 2012 Plan is administered by a committee of the Board of Directors and provides for granting of various stock-based awards including stock options to eligible participants, primarily officers and certain key employees. A total of 2,000,000 shares of common stock were available under the terms of the 2012 Plan plus shares outstanding under the 1990 Plan which expire or are otherwise forfeited, canceled or terminated after July 25, 2012, the Effective Date of the 2012 Plan. As of June 30, 2014, there were 1,448,308 options available for future grants. Options vest over a three to five year period from the date of grant, with a maximum term of five to ten years.

The fair value of each stock option grant was estimated as of the date of grant using the Black-Scholes pricing model. The resulting compensation cost for fixed awards with graded vesting schedules is amortized on a straight-line basis over the vesting period for the entire award. The expected term of awards granted is determined based on historical experience with similar awards, giving consideration to the expected term and vesting schedules. The expected volatility is determined based on the Company's historical stock prices over the most recent period commensurate with the expected term of the award. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a remaining term commensurate with the expected term of the award. Expected pre-vesting option forfeitures are based on historical data.

As of June 30, 2014, there was approximately $1,119,787 of total unrecognized compensation cost related to stock options granted under the 2012 Plan and 1990 Plan. This cost is expected to be recognized over a weighted average period of 2.58 years. Total unrecognized compensation cost will be adjusted for any future changes in estimated and actual forfeitures. The

Company recognized stock-based compensation expense of $684,554 and $583,069 in 2014 and 2013, respectively. These expenses were included in selling, general and administrative expenses.

There was no cash received from stock option exercises during 2014 or 2013.

The per share weighted average fair value of the stock options granted during the years ended June 30, 2014 and 2013 were $1.47 and $1.67, respectively. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model. For the options granted in 2014 and 2013, the Company used the following weighted-average assumptions:

	2014		2013	
Expected stock price volatility	47	%	58	%
Risk free interest rate	1.27	%	0.52	%
Expected dividend yield	4.00	%	4.00	%
Expected forfeitures	1.50	%	1.50	%
Expected life of options	4.6 years		4.6 years	

The following table identifies options granted, exercised, canceled, or available for exercise pursuant to the 1990 Plan and the 2012 Plan:

	Number of Shares		Stock Options Price Range	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life - Years	Aggregate Intrinsic Value of In-The-Money Options
Shares under option at July 1, 2012	1,514,308		$3.90 - $13.09	$6.99	4.36	$88,352
Granted	430,000		$4.97 - $5.47	$5.29		
Exercised	—		—	—		
Expired	(203,308	)	$7.88 - $8.53	8.45		
Forfeited	—		—	$—		
Shares under option at June 30, 2013	1,741,000		$3.90 - $13.09	$6.40	4.39	$55,160
Granted	445,000		$5.30 - $5.83	$5.64		
Exercised	—		—	—		
Expired	(120,000	)	$11.01	$11.01		
Forfeited	—		—	$—		
Shares under option at June 30, 2014	2,066,000		$3.90 - $13.09	$5.97	4.13	$—
Exercisable as of June 30, 2013	672,582		$3.90 - $13.09	$7.52		
Exercisable as of June 30, 2014	904,918		$3.90 - $13.09	$6.39		

A summary of intrinsic value and cash received from stock option exercises and fair value of vested stock options for the fiscal years ended June 30, 2014 and 2013 is as follows:

	2014	2013
Total intrinsic value of stock options exercised	$—	$—
Cash received from stock option exercises	$—	$—
Total fair value of stock options vested	$586,342	$436,047

During the years ended June 30, 2014 and 2013 total options of 445,000 and 430,000, respectively, were granted during the year at a price equal to or greater than the market value of the common stock on the date of grant. These options had a weighted-average exercise price of $5.64 and $5.29 for the years ended June 30, 2014 and 2013, respectively.

16. STOCK PURCHASE AGREEMENTS

The Company has an agreement with its Chairman, John C. Koss, in the event of his death, at the request of the executor of his estate, to repurchase his Company common stock from his estate. The Company does not have the right to require the estate to sell stock to the Company. As such, this arrangement is accounted for as a written put option with the fair value of the put option recorded as a derivative liability.

As of June 30, 2014, the estate of John C. Koss does not hold a material amount of Company stock. As such, there is no exposure that the executor of John C. Koss' estate may require the Company to repurchase a material amount of stock in the event of his death. The fair value of the written put option at June 30, 2014 and 2013 was $0 and $154,745, respectively. The repurchase price is 95% of the fair market value of the common stock on the date that notice to repurchase is provided to the Company. The total number of shares to be repurchased will be sufficient to provide proceeds which are the lesser of $2,500,000 or the amount of estate taxes and administrative expenses incurred by the Chairman’s estate. The Company may elect to pay the purchase price in cash or may elect to pay cash equal to 25% of the total amount due and to execute a promissory note for the balance, payable over four years, at the prime rate of interest. The Company maintains a $1,150,000 life insurance policy to fund a substantial portion of this obligation.

In April 1995, the Board of Directors approved a stock repurchase program authorizing the Company to purchase from time to time up to $2,000,000 of its common stock for its own account. Subsequently, the Board of Directors periodically has approved increases in the amount authorized for repurchase under the program. As of June 30, 2014, the Board had authorized the repurchase of an aggregate of $45,500,000 of common stock under the stock repurchase program, of which $43,360,247 had been expended. No shares were repurchased in 2014 or 2013.

17. ADDITIONAL CASH FLOW INFORMATION

The net changes in cash as a result of changes in operating assets and liabilities consist of the following:

	2014	2013
Accounts receivable	$9,206,295	$(6,872,186)
Inventories	(5,672)	(1,104,822)
Income taxes receivable	(1,109,276)	—
Prepaid expenses and other current assets	317,389	(78,523)
Income taxes payable	(2,509,444)	1,641,973
Accounts payable	(467,581)	(1,918,832)
Accrued liabilities	(851,981)	2,331,030
Other liabilities	(403,228)	(14,000)
Net change	$4,176,502	$(6,015,360)

	2014	2013
Net cash (refunded) paid during the year for:		
Income taxes	$1,867,181	$(92,253)
Interest	$—	$45,545

18. EMPLOYEE BENEFIT PLANS

Substantially all domestic employees are participants in the Koss Employee Stock Ownership Trust (KESOT) under which an annual contribution in either cash or common stock may be made at the discretion of the Board of Directors. No cash contributions were made for the fiscal years 2014 or 2013.

The Company maintains a retirement savings plan under Section 401(k) of the Internal Revenue Code. This plan covers all employees of the Company who have completed one full fiscal quarter of service. Matching contributions can be made at the discretion of the Board of Directors. For fiscal years 2014 and 2013, the matching contribution was 100% of employee contributions to the plan. Vesting of Company contributions occurs immediately. Company contributions were $431,190 and $425,301 during 2014 and 2013, respectively.

19. FOREIGN SALES AND SIGNIFICANT CUSTOMERS

The Company’s net foreign sales amounted to $9,621,433 during 2014 and $19,393,145 during 2013.

The Company’s sales by country were as follows:

	2014	2013
United States	$14,219,449	$16,371,434
Sweden	2,310,064	7,161,327
Canada	1,899,573	1,223,176
Cyprus	1,471,381	1,975,736
Czech Republic	1,305,239	1,309,697
Japan	751,912	758,550
United Kingdom	489,291	707,724
Malaysia	65,835	1,795,059
Russia	377,135	1,441,484
All other countries	951,003	3,020,392
Net sales	$23,840,882	$35,764,579

Sales during 2014 and 2013 to the Company's five largest customers, which are generally large national retailers or foreign distributors, represented approximately 37% and 44% of the Company's net sales, respectively. Included in these percentages were sales to a single United States customer which represented approximately 9% of the Company's net sales in both 2014 and 2013. Net sales to a single Scandinavian distributor represented approximately 10% and 20% of the Company's net sales during 2014 and 2013, respectively.

20. COMMITMENTS AND CONTINGENCIES

The Company leases its facility in Milwaukee, Wisconsin from Koss Holdings, LLC, which is wholly-owned by the Company's Chairman. On May 15, 2012, the lease was renewed for a period of five years, ending June 30, 2018, and is being accounted for as an operating lease. The lease extension maintained the rent at a fixed rate of $380,000 per year. The Company is responsible for all property maintenance, insurance, taxes and other normal expenses related to ownership. Total rent expense was $380,000 in both 2014 and 2013.

21. LEGAL MATTERS

As of June 30, 2014, the Company is party to the matters related to the unauthorized transactions and the termination of a vendor contract described below:

- On February 18, 2010, the Company filed an action against American Express Company, American Express Travel Related Services Company, Inc., AMEX Card Services Company, Decision Science, and Pamela S. Hopkins in Superior Court of Maricopa County, Arizona, case no. CV2010-006631. The claims alleged include aiding and abetting breach of fiduciary duty, aiding and abetting fraud, and conversion relating to the unauthorized transactions. The case is proceeding in the Superior Court with respect to those claims.

- On December 17, 2010, the Company filed an action against Park Bank in Circuit Court of Milwaukee County, Wisconsin alleging claims of negligence and breach of fiduciary duty relating to the unauthorized transactions. The Company voluntarily dismissed the negligence claim and the case is proceeding in the Circuit Court.

- On March 6, 2014, the Company filed a replevin action against Red Fusion Studios, Inc. ("Red Fusion") in Circuit Court of Milwaukee County, Wisconsin, Case No. 14CV001885, seeking the return of the Company's property and information following the termination of the agreement that the Company had with Red Fusion for the development of the Company's Striva Technology. Red Fusion filed counterclaims relating to fees that Red Fusion alleges it is owed as a result of the termination. The Company has since received most if not all of the property and information that it was seeking. The case is proceeding in the Circuit Court.

The ultimate resolution of these matters is not determinable unless otherwise noted.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KOSS CORPORATION

By:	/s/ Michael J. Koss Michael J. Koss Vice Chairman President Chief Executive Officer Chief Operating Officer	August 28, 2014
By:	/s/ David D. Smith David D. Smith Executive Vice President Chief Financial Officer Principal Accounting Officer Secretary	August 28, 2014

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on August 28, 2014.

/s/ John C. Koss John C. Koss, Director	/s/ Michael J. Koss Michael J. Koss, Director
/s/ Lawrence S. Mattson Lawrence S. Mattson, Director	/s/ John J. Stollenwerk John J. Stollenwerk, Director
/s/ Thomas L. Doerr Thomas L. Doerr, Director	/s/ Theodore H. Nixon Theodore H. Nixon, Director

EXHIBIT INDEX

Exhibit No.	Exhibit Description
3.1	Amended and Restated Certificate of Incorporation of Koss Corporation, as in effect on November 19, 2009. Filed as Exhibit 3.1 to the Company’s Quarterly Report on Form 10-Q for the period ended December 31, 2009 and incorporated herein by reference.
3.2	By-Laws of Koss Corporation. Filed as Exhibit 3.2 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1996 and incorporated herein by reference.
10.1	Death Benefit Agreement with John C. Koss. Filed as Exhibit 10.4 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1996 and incorporated herein by reference. *
10.2	Stock Purchase Agreement with John C. Koss. Filed as Exhibit 10.5 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1996 and incorporated herein by reference. *
10.3	Salary Continuation Resolution for John C. Koss. Filed as Exhibit 10.6 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1996 and incorporated herein by reference. *
10.4	1983 Incentive Stock Option Plan. Filed as Exhibit 10.7 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1996 and incorporated herein by reference. *
10.5	Assignment of Lease to John C. Koss. Filed as Exhibit 10.7 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1988 and incorporated herein by reference.
10.6	Addendum to Lease. Filed as Exhibit 10.8 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1988 and incorporated herein by reference.
10.7	Amendment to Lease. Filed as Exhibit 10.22 to the Company’s Annual Report on Form 10-K for the year ended June 30, 2000 and incorporated herein by reference.
10.8	Partial Assignment, Termination and Modification of Lease. Filed as Exhibit 10.25 to the Company’s Annual Report on Form 10-K for the year ended June 30, 2001 and incorporated herein by reference.
10.9	Restated Lease. Filed as Exhibit 10.26 to the Company’s Annual Report on Form 10-K for the year ended June 30, 2001 and incorporated herein by reference.
10.10	1990 Flexible Incentive Plan. Filed as Exhibit 25 to the Company’s Annual Report on Form 10-K for the year ended June 30, 1990 and incorporated herein by reference. *
10.11	Consent of Directors (Supplemental Executive Retirement Plan for Michael J. Koss dated March 7, 1997). Filed as Exhibit 10.2 to the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 1997 and incorporated herein by reference. *
10.12	Credit Agreement dated May 12, 2010, between Koss Corporation and JPMorgan Chase Bank, N.A. Filed as Exhibit 10.12 to the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 and incorporated by reference herein.

10.13	Pledge and Security Agreement dated May 12, 2010, between Koss Corporation and JPMorgan Chase Bank, N.A. Filed as Exhibit 10.13 to the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 and incorporated by reference herein.
10.14	Koss Corporation 2012 Omnibus Incentive Plan (Incorporated by reference to Appendix B to Koss Corporation's Definitive Proxy Statement on Schedule 14A filed on August 27, 2012). *

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10.15	Amendment No. 2 dated July 24, 2013 to Credit Agreement dated May 12, 2010, between Koss Corporation and JPMorgan Chase Bank, N.A. **
10.16	Amendment No. 3 dated July 23, 2014 to Credit Agreement dated May 12, 2010, between Koss Corporation and JPMorgan Chase Bank, N.A. **
14	Koss Corporation Code of Ethics. Filed as Exhibit 14 to the Company's Annual Report on Form 10-K for the year ended June 30, 2011 and incorporated by reference herein.
23.1	Consent of Baker Tilly Virchow Krause, LLP. **
31.1	Rule 13a -14(a)/15d-14(a) Certification of Chief Executive Officer. **
31.2	Rule 13a -14(a)/15d-14(a) Certification of Chief Financial Officer. **
32.1	Section 1350 Certification of Chief Executive Officer. ***
32.2	Section 1350 Certification of Chief Financial Officer. ***
101	The following financial information from Koss Corporation's Annual Report on Form 10-K for the year ended June 30, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Statements of Operations for the years ended June 30, 2014 and 2013, (ii) Consolidated Balance Sheets as of June 30, 2014 and 2013, (iii) Consolidated Statements of Cash Flows for the years ended June 30, 2014 and 2013, (iv) Consolidated Statements of Stockholders' Equity for the years ended June 30, 2014 and 2013 and (v) the Notes to Consolidated Financial Statements. **

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*	Denotes a management contract or compensatory plan or arrangement
**	Filed herewith
***	Furnished herewith

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