
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For The Fiscal Year Ended March 31, 2004

Commission File No. 1-15345

GALAXY NUTRITIONAL FOODS, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

25-1391475

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

2441 Viscount Row

Orlando, Florida

(Address of principal executive offices)

32809

(Zip Code)

Registrant's telephone number, including area code: **(407) 855-5500**

Securities registered under Section 12(b) of the Exchange Act: **None**

Securities registered under Section 12(g) of the Exchange Act:

Common Stock, par value \$.01 per share

(Title of Class)

American Stock Exchange

(Name of exchange on which registered)

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

Indicate by check mark if a disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting common equity held by non-affiliates as of September 30, 2003 (the last business day of the registrant's most recently completed second fiscal quarter) was \$18,284,935 based on the closing price of such common equity of \$2.90 per share on such date.

As of June 25, 2004, the number of shares outstanding of registrant's common stock, \$0.01 par value per share, was 15,724,073.

DOCUMENTS INCORPORATED BY REFERENCE: **None**

PART I

FORWARD LOOKING STATEMENTS

THIS FORM 10-K CONTAINS FORWARD-LOOKING STATEMENTS. THESE STATEMENTS RELATE TO FUTURE EVENTS OR THE COMPANY'S FUTURE FINANCIAL PERFORMANCE. THESE FORWARD-LOOKING STATEMENTS ARE BASED ON THE COMPANY'S CURRENT EXPECTATIONS, ESTIMATES AND PROJECTIONS ABOUT ITS INDUSTRY, MANAGEMENT'S BELIEFS AND CERTAIN ASSUMPTIONS MADE BY THE COMPANY. WORDS SUCH AS "ANTICIPATES," "EXPECTS," "INTENDS," "PLANS," "BELIEVES," "SEEKS," "ESTIMATES" AND VARIATIONS OF THESE WORDS OR SIMILAR EXPRESSIONS ARE INTENDED TO IDENTIFY FORWARD-LOOKING STATEMENTS. THESE STATEMENTS ARE NOT GUARANTEES OF FUTURE PERFORMANCE AND ARE SUBJECT TO CERTAIN RISKS, UNCERTAINTIES AND ASSUMPTIONS THAT ARE DIFFICULT TO PREDICT. THEREFORE, ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE EXPRESSED OR FORECASTED IN ANY FORWARD-LOOKING STATEMENTS AS A RESULT OF A VARIETY OF FACTORS, INCLUDING THOSE SET FORTH IN "RISK FACTORS" AND ELSEWHERE IN, OR INCORPORATED BY REFERENCE INTO, THIS FORM 10-K. THE COMPANY UNDERTAKES NO OBLIGATION TO UPDATE PUBLICLY ANY FORWARD-LOOKING STATEMENTS FOR ANY REASON, EVEN IF NEW INFORMATION BECOMES AVAILABLE OR OTHER EVENTS OCCUR IN THE FUTURE.

Item 1. BUSINESS.

GENERAL

Galaxy Nutritional Foods, Inc. (the "Company") is principally engaged in developing, manufacturing and marketing a variety of healthy cheese and dairy related products, as well as other cheese alternatives, and is a leading producer of dairy alternative products made with soy. The Company was founded by Angelo S. Morini in 1972 under the original name of Fiesta Foods & Galaxy Foods.

In June 1991, the Company relocated from New Castle, Pennsylvania to Orlando, Florida and began production and shipment of its products directly from its Orlando plant to customers in each of the Company's two principal markets--retail stores, such as supermarket chains and health food stores; and food service operations, such as restaurant chains, cafeterias, hospitals and schools.

The Company's sales effort is primarily directed to retailers, to take advantage of what it perceives to be an increased consumer emphasis on nutrition, by offering a diverse line of low and no fat, no saturated fat, no trans-fats, low and no cholesterol, no lactose cheese and dairy-related products. These include individually wrapped cheese slices, shredded cheeses, grated toppings, cheese crumbles, butter, milk, yogurt, smoothies, chunk cheeses, deli cheeses, string cheese and soft cheeses like sour cream, cream cheese and cheese sauces.

The Company also manufactures and markets non-branded and private label process and blended cheese products, as well as branded, organic soy-based, rice-based and non-dairy cheese products. Most of these products are made using the Company's formulas and processes, which are believed to be proprietary, and the Company's state-of-the-art manufacturing equipment.

The Company's strategy for the future is to continue its marketing efforts primarily in the retail market to capitalize on the continuing interest among consumers in eating more nutritious natural foods, which will help reduce their cholesterol levels and saturated fat intake. The Company believes that one of the leading contributors of cholesterol and saturated fat in the American diet is conventional cheese. By providing good

tasting cheese alternatives in diverse forms and flavors, the Company believes it will be able to attract an increasing number of worldwide consumers interested in improving their health and changing to more nutritious eating habits. The Company intends to broaden this strategy for the future by creating a more widely accepted and broader appealing line of great tasting, healthy dairy related products.

DEVELOPMENT OF BUSINESS

In the past eight years, the Company has developed several new marketing strategies and product lines for the retail and foodservice markets. In retail, the Company developed a unique marketing strategy for its complete product line of plant-based dairy alternatives, called Veggie™. While most companies sell dairy products through supermarket dairy cases, the Company adopted a marketing strategy whereby its Veggie™ plant-based dairy alternatives are sold mostly in produce cases of supermarkets nationwide. In produce, the products are sold next to other nutritious natural products, which allows targeted consumers to locate the products much more easily instead of being sold in the dairy cases of supermarkets where targeted consumers may not look.

In health food stores, the Company significantly expanded its existing product lines and introduced several new line extensions over the past few years. These product line extensions also are plant-based dairy alternatives and are made from either soy or rice. The Company believes its vegan (non-dairy) product line is the most extensive in the world. With the addition of natural food sections to most supermarkets, the Company also markets these products to the mass market. In the past, these products were only sold to the health food industry.

In the past few years, the Company began offering these plant-based dairy alternatives to the foodservice market so that consumers could also enjoy the taste and health benefits of these products while eating away from home. Prior to doing this, the Company primarily sold only conventional-type products to foodservice.

PRODUCTS AND SERVICES

The Company's healthy cheese and dairy related products, sold under the Company's brand names such as Veggie™, Veggie Nature's Alternative to Milk®, Veggie Slices®, Veggie Milk™, Soyco®, Soymage®, Wholesome Valley®, Rice Slice™, Veggy Singles®, Lite Bakery®, and Veggie Lite Bakery™, are low or no fat, low or no cholesterol, no saturated fat, and lactose (milk sugar) free, vitamin and mineral enriched, and contain one-third fewer calories and typically more calcium than conventional cheese. These healthy cheese and dairy related products mirror the flavor, appearance, aroma, texture, and melt of conventional cheeses and products that use conventional cheeses, and are nutritionally equal or superior to such cheeses and products. Some of the Company's cheese alternatives, which are marketed for their lower price points and not for their nutritious components, are not nutritionally equivalent or superior to conventional cheeses.

Veggie™ – Complete line of healthy dairy alternatives – The Company's flagship brand has a complete line of nutritious dairy alternative products made with soy. All Veggie™ products are reduced or low in fat, contain less calories, and are saturated fat, trans fat, cholesterol and lactose free. The Veggie™ product line includes Veggie Slices®, Veggie Chunks, Veggie Shreds, Veggie Cream Cheese, Veggie Sour Cream, Veggie Butter, Veggie Honey Butter, Veggie Grated Toppings, Veggie Milk, Veggie Milk Bars, Veggie Ice Cream, Veggie Yogurt, Veggie String Cheese, and Veggie Deli Products.

Dairy Free – Soymage® Vegan Dairy Alternatives – Soymage® products were developed for health food and specialty stores. These products are intended for consumers who are allergic to dairy products, such as milk protein, or who are practicing a Vegan lifestyle. The Soymage® Vegan line is completely dairy free, contains no animal fats and has no casein (skim milk protein). The Soymage® Vegan product line includes:

cheese slices, grated toppings, chunk cheeses, sour cream, cream cheese and cheese sauce alternatives. The Company believes that its Soymage® line is the largest and most comprehensive vegan line in the world.

Soy Free – Soy Free Dairy Alternatives made with Rice -- The Company has developed a dairy free alternative product line made with organic brown rice. This product is reduced or low in fat, cholesterol free, lactose free, soy free and is fortified with essential vitamins and minerals. Additionally, this product is formulated for people with soy allergy or who are just looking for alternatives for conventional dairy products. The Rice product line includes individual slices, shreds, chunks, grated toppings, cream cheese, sour cream, butter and yogurt.

Veggy™ – Soy Nutritious – Soy Dairy Alternatives – These Veggy™ products offer the taste of cheese, are available in many forms, and are made from soy. They are low in fat or fat free, and are lactose, cholesterol and saturated fat free. The Veggy product line comes in several flavors and is available in individual slices (Veggy Singles®), grated toppings and chunks. These products are distributed to natural foods stores and produced specifically to meet the discriminating taste and nutritional demands of the specialized nutritional foods market.

Wholesome Valley® Organic – Products made from organic milk - These products are processed cheese foods made from organic milk, contain up to 50% less fat than regular processed cheese food, contain no artificial ingredients, no rBST hormone or antibiotics and are an excellent source of calcium and protein. The farmland, cows and feed are free from pesticides, antibiotics, growth hormones and chemicals.

Processed Cheese Products – Galaxy Sandwich Slices™ and Toppings – These products are low in cholesterol and serve as an alternative to conventional dairy cheeses. They are not nutritionally equivalent or superior to conventional cheeses and may have more cholesterol than the Company's branded cheeses. These products include a variety of sandwich slices and shredded cheeses, including shredded taco and pizza toppings, and a cheddar cheese sauce. They are marketed as a lower cost alternative to conventional dairy cheeses.

Lite Bakery® - Veggie Lite Bakery® – The Company has developed a collection of over 50 recipes using the Company's soy based bakery ingredients. The Company's soy based bakery powder can be used to develop finished products or can be sold as an ingredient to be used in other foods. The Company's Lite Bakery® mix is fat free, low or reduced fat, cholesterol free and lactose free.

The Company's only branded product line, which accounts for more than 10% of the Company's gross sales for the fiscal year ended March 31, 2004, is the Veggie™ line of products. This line of products contributed approximately sixty percent (60%), sixty-one percent (61%), and fifty-six percent (56%) of gross sales for the fiscal years ended March 31, 2004, 2003 and 2002, respectively. The Company's non-branded imitation, private label and sandwich slice business contributed approximately twenty-four percent (24%), twenty-one percent (21%), and twenty-nine percent (29%) of gross sales for the fiscal years ended March 31, 2004, 2003 and 2002, respectively.

The characteristics of the Company's products vary according to the specific requirements of individual customers within each market. In the retail market, the Company's products are formulated to meet the health concerns of today's consumers. In the food service markets, the Company's products are made according to the customer's specifications as to color, texture, shred, melt, cohesiveness, stretch, browning, fat retention, protein, vitamin and mineral content, and cost parameters. The Company's products are manufactured in various forms, such as individual slices, grated, shredded, salad toppings, deli loaves, and multi-pound blocks and are available in several flavors, including, but not limited to mozzarella, pepper-jack, cheddar, American, parmesan and Swiss.

MARKETS

The Company's products are sold primarily to two commercial markets: retail (conventional grocery stores, mass merchandisers, natural foods and club stores) and food service (restaurants, cafeterias, hospitals and schools).

In the retail market, where the Company believes taste and nutrition generally outweighs price considerations, the Company markets its Veggie™ and Soyco® products at prices generally comparable to or higher than the prices of conventional cheeses. In this market, the Company sells directly to retail establishments, including national and regional supermarket chains, and to distributors that sell and deliver to retail establishments.

In the food service market, the Company markets its more expensive premium products to customers who place importance on taste and nutrition and its less expensive branded, non-branded and private label substitute and conventional-type cheese products to customers whose primary consideration is cost. The food service products are primarily sold to distributors who supply food to restaurants, cafeterias, hospitals, correctional institutions, and schools. The Company also markets its products directly to franchisees of large national restaurant chains.

The following chart sets forth the percentage of gross sales that the retail and food service markets represented for the fiscal years ended March 31, 2004, 2003 and 2002:

Percentage of Sales Fiscal Years Ended March 31,

Category	2004	2003	2002
Retail sales	88%	87%	83%
Food service sales	12%	13%	17%

DISTRIBUTION CHANNELS AND METHODS

The Company currently distributes all of its products by common carrier and customer pick-up. The Company ships all its products from its shipping, warehouse and cooler facilities in Orlando, Florida. In order to distribute to its Canadian customers quickly and efficiently, the Company stores and distributes products through a public storage facility in Canada. The Company maintains a certain stock level at this facility and pays the Canadian facility a processing fee for its services.

MANUFACTURING PROCESS

Most of the Company's products are made using the Company's formulas, processes and manufacturing equipment, from five principal ingredients: casein (a pure skim milk protein) instead of liquid milk which is used to make conventional cheeses; soybean and canola oils; water; soy proteins; and natural flavorings. The Company's Soymage® products are also made using the Company's formulas, processes and manufacturing equipment from these principal ingredients, except that Soymage® does not contain casein. All of these products are produced at a temperature above that required for pasteurization. The Company's original formulas and processes were designed and developed by the Company's Founder, Angelo S. Morini. Mr. Morini has assigned the rights to these formulas, processes and equipment to the Company. Unlike the conventional cheese manufacturing process, the production of the Company's products does not require the costly and time-consuming use of bacteria to curdle milk, nor does it require removal of whey or product curing.

QUALITY CONTROL

Throughout the production process, the Company subjects its products to stringent quality control inspections in order to satisfy federal and state regulations for good manufacturing procedures, meet customer specifications, and assure consistent product quality. A sample of each production run is tested for various characteristics including taste, color, acidity (Ph), melt, stretch, percentage fat, and microorganisms, such as pathogens, total bacterial count, yeast, mold, and coliform. Random samples are also regularly sent to an independent laboratory to test for bacteria and other microorganisms.

CAPITAL EXPENDITURES

During the fiscal years ended March 31, 2004, 2003 and 2002, the Company's capital expenditures, including capitalized leases, were approximately \$277,000, \$309,000, \$1,705,000, respectively. The substantial capital expenditures for the fiscal year ended March 31, 2002 were the result of the final installation costs on several new production lines at its manufacturing facility in Orlando, Florida. These new lines included two new slice lines, a new chunk cheese line, a cup line, a string cheese line and a shred line.

SALES AND MARKETING

In the retail market, the Company markets its healthy products to grocery stores, mass merchandisers, natural food stores and club stores. The Company believes its healthy products appeal to a wide range of consumers interested in lower fat, lower cholesterol, lactose free products and other health-promoting aspects of these products and that the retail market for its products will continue to expand. These products are sold through distributors and directly to customers by in-house and territory sales managers and a nationwide network of non-exclusive commission brokers. The Company uses conventional marketing and public relations techniques for market introductions such as promotional allowances, coupons, in-store consumer sampling, print advertising and television.

In the food service market, the Company promotes its healthy Veggie™ cheese products as well as lower cost cheese alternatives. In marketing its Veggie™ line of products to food service customers, the Company emphasizes that its products taste like conventional cheese and have no, low or reduced fat, low or no cholesterol, no lactose and typically more calcium than conventional cheeses. The Company also promotes its food service products on the basis of their considerably longer shelf life and microbiologically safer profile than conventional cheeses. The Company sells directly to food distributors and other customers in the food service market, as well as utilizing its in-house staff, territory managers and nationwide network of non-exclusive commission brokers to sell the Company's products.

PRODUCT DEVELOPMENT

The Company conducts ongoing research to improve product quality on key strategic product lines, develop new varieties of cheese, dessert products and dairy related products, in addition to developing new flavors and customized formulations for existing products. For the fiscal years ended March 31, 2004, 2003 and 2002, expenditures for product development were \$260,410, \$232,552, and \$261,972, respectively. None of the research and development costs are directly borne by any particular customer or group of customers, instead they are considered part of operating expenses.

In May 2001, the Company entered into a licensing arrangement with Tropicana® that enabled the Company to manufacture, distribute (in limited distribution channels and countries) and market its Ultra Smoothie™ product in a co-branding relationship and use Tropicana's logo "made with Tropicana® Juices" on the package. After review of actual sales related to its Ultra Smoothie™ product and in a mutual agreement with Tropicana®, the Company canceled the licensing agreement effective June 1, 2004. The Company noted a lack of sufficient sales revenue primarily resulting from agreement restrictions on distribution channels in

which the product could be sold and a packaging design (i.e. beverage in a yogurt cup) that was not optimal for the intended consumer usage occasion. The parties agreed that neither party should have any further obligation to the other with respect to the agreement. The Company plans to reformulate, redesign, and consider for re-introduction into more mainstream retail grocery distribution a new smoothie product at a future date.

SUPPLIERS

The Company purchases the ingredients used in its manufacturing operations, *i.e.*, casein, vegetable proteins and oils, enzymes and other ingredients, from several sources, and it believes that all of these ingredients are readily available from numerous suppliers. Due to more cost effective conditions in other countries, suppliers from such countries are often able to supply casein at prices lower than domestic suppliers. Accordingly, the Company currently purchases its major ingredient, casein, from foreign suppliers. Because casein purchased by the Company is imported, its availability is subject to a variety of factors, including federal import regulations. During the fiscal year ended March 31, 2002, casein prices were significantly higher as a result of “Mad Cow” and “foot and mouth” disease epidemics in Europe. The Company’s increased costs for casein throughout the fiscal year ended March 31, 2002 had an adverse impact on the Company’s results of operations for such fiscal year. In the fiscal year ended March 31, 2003, the cost of casein returned to levels comparable to those prior to the occurrence of the above events. The Company is anticipating substantial price increases during fiscal 2005 compared fiscal 2004 as further discussed in Item 7 under “*Cost of Goods Sold*”.

For the fiscal years ended March 31, 2004, 2003 and 2002, the Company purchased approximately \$6,133,967, \$7,911,000, \$8,975,000, respectively, of casein, the principal raw material used to manufacture the Company's products. The following table sets forth the name of each supplier along with the percentage they supplied of casein which either alone, or together with their affiliates, provided 5% or more casein to the Company, based on dollar volume purchased.

Type of Raw Material	Name of Supplier	Percent of Casein Purchases Fiscal Year Ended March 31,		
		2004	2003	2002
Casein	Lactalis f/n/a Besnier-Scerma U.S.A.	20%	24%	36%
	Glanbia f/n/a Avonmore Food Products	29%	36%	18%
	Irish Dairy Board	24%	22%	20%
	Eurial Poitouaine/Euro Proteins	20%	18%	10%
	Kerry Ingredients	7%	--	--
	JLS Foods International	--	--	7%

TRADEMARKS AND OTHER INTELLECTUAL PROPERTY

The Company owns several registered and unregistered trademarks, which are used in the marketing and sale of the Company’s products. Its material product trademarks are those mentioned above under Products and Services. The registrations of these trademarks in the United States and foreign jurisdictions are effective for varying periods of time, and may be renewed periodically, provided that the Company, as the registered owner of the trademarks, complies with all pertinent renewal requirements.

Trademarks include registered brand names, logos, symbols, or copyright used to identify the Company’s products or services. As such, this prevents other manufacturers from using any words or symbols for which the Company holds the trademark. This is important as it helps provide competitive insulation around the Company’s products in the marketplace and enables consumers to identify with one particular brand or

another. The Company will continue to market its trademarks in order to increase brand awareness for its products in order to improve demand and margin.

Although the Company believes that its formulas and processes are proprietary, the Company has not sought and does not intend to seek patent protection for such technology. In not seeking patent protection, the Company is instead relying on the complexity of its technology, on trade secrecy laws, and on employee confidentiality agreements. The Company believes that its technology has been independently developed and does not infringe on the patents or trade secrets of others.

INVENTORY SUPPLY

During the fiscal year ended March 31, 2002, the Company reduced the number of items it manufactures on a regular basis from 400 to 200. During the fiscal year ended March 31, 2003, the Company further reduced its core item base to 135 items that are in line with the Company's strategy of higher margin or higher volume products. As a result of this change in production policy and the desire to create more inventory turns during the year, the Company reduced its net inventory levels from \$5,748,652 at March 31, 2002 to \$5,294,500 at March 31, 2003 and then to \$4,632,843 at March 31, 2004. The Company anticipates that inventory will begin to increase in the future as sales volume and larger accounts increase.

CUSTOMERS

The Company sells to customers throughout the United States and direct to 16 other countries. Revenues derived from foreign countries were approximately \$2,500,000, \$3,800,000 and \$1,800,000 with sales to Canada and Puerto Rico accounting for approximately 75% of these sales for the fiscal years ended March 31, 2004, 2003 and 2002, respectively. Revenues are attributed to individual countries based on the customer address. The Company has no long-term assets located outside of the United States.

For the fiscal years ended March 31, 2004, 2003 and 2002, the Company had net sales of \$36,176,961, \$40,008,769, and \$42,927,104, respectively. The following table sets forth the name of each customer of the Company, which either alone, or together with its affiliates, accounted for 5% or more of the Company's gross sales for the fiscal years ended March 31, 2004, 2003, and 2002:

Customer Name	Percentage of Sales		
	Fiscal Year Ended March 31,		
	2004	2003	2002
DPI Food Products	8.2%	9.5%	6.1%
Kroger	5.6%	5.8%	5.9%
Publix	6.8%	6.6%	5.0%
United Natural Foods	9.2%	9.9%	5.7%

*Less than 5% of sales for the stated fiscal year.

The majority of the Company's customers are required to make payment on goods within 30 days of invoicing. The Company's credit department makes calls on payments that are 10 to 15 days past due and then puts accounts on credit hold if they have not made arrangements for those payments that are 30 to 45 days past due. After all efforts have been exhausted to contact the customer and collect the past due balances, the credit manager will provide authorization to write off the past due balance. The Company typically averages less than 1% of gross sales in credits related to bad debt.

The Company provides a guarantee of sale to many of its retail customers in natural food stores, conventional grocery stores and mass merchandising industry. If the product is not sold during its shelf life, the Company will allow a credit for the unsold merchandise. Since the shelf life of the Company's products

range from 6 months to one year, the Company historically averages less than 2% of gross sales in credits for unsold product.

COMPETITION

The food industry is highly competitive, and the Company faces substantial competition in the manufacturing, marketing and sale of its products. In the retail cheese market, the Company competes with conventional cheeses, including “Lite” and “low fat”, and low or no cholesterol or lactose products produced by manufacturers of conventional cheeses. “Lite” cheese generally has lower fat content than regular cheese but still contains cholesterol and lactose, unlike the Company’s Veggie™ and Soyco® brand product lines, which are soy nutritious, contain no cholesterol and are lactose free. In the food service markets, the Company’s substitute and imitation cheese products compete with other substitute and imitation cheese products, as well as with conventional cheeses.

The Company believes that its primary competition in its niche market are small companies such as Tree of Life, White Wave, Tofutti Brands, Inc. (“Tofutti”), Yves, a subsidiary of Hain Celestial Group, and Melissa’s. Tree of Life is a wholly owned subsidiary of Koninklijke Wessanen, NV, a multinational manufacturer of dairy, natural and specialty foods and cereals. Like the Company’s products, Tree of Life’s Soya Kaas, Yves and Melissa’s dairy alternatives are sold in mainstream supermarkets. White Wave is a private company that primarily markets soy milk to the retail markets (grocery and natural foods stores). Tofutti (AMEX:TOF) is a public company that offers a wide range of soy based products including alternative cheese slices, sour creams, cream cheese and frozen pizza made with alternative cheeses to the retail markets (primarily grocery). These parties are considered competitors as they offer similar product lines in terms of product form, consumer benefits, and are distributed or positioned in the same retail shelf space as the Company’s products.

The Company also competes with larger national and regional manufacturers of conventional and imitation cheeses, such as Kraft (which produces products under the Kraft Free® label), Borden’s, and ConAgra (which produces products under the Healthy Choice® label). Each of these competitors is well established and has substantially greater marketing, financial and human resources than the Company. However, management believes its products are nutritionally superior, strategically marketed, and positioned to a slightly different consumer base versus the healthy cheese items offered by larger cheese manufacturers.

The Company believes that it has the most complete line of alternative dairy products in the industry and that its competitors’ current products do not have all of the same healthy characteristics. Further, the Company’s branded products are fortified and possess soy-based ingredients, reduced, low and no fat, low or no cholesterol, no saturated fat, no transfat, no lactose, no artificial colorings or flavorings. The Company further believes that it is superior to the competition in its niche in the most important competitive factors, which are taste, nutritional value, product appearance, breadth and depth of product line, and overall consumer purchase interest.

The Company also believes that its vertically integrated operations provide it with a cost advantage over its smaller competitors because it has the ability to maintain quality and efficiency at every level, from purchasing to manufacturing to shipping to merchandising. Furthermore, the Company believes the breadth and depth of its product line has made it difficult for its smaller competitors to have a significant impact on the Company’s market share in the alternative cheese category.

GOVERNMENT REGULATION

As a manufacturer of food products for human consumption, the Company is subject to extensive regulation by federal, state and local governmental authorities regarding the quality, purity, manufacturing, distribution and labeling of food products.

The Company's United States product labels are subject to regulation by the United States Food and Drug Administration ("FDA"). Such regulation includes standards for product descriptions, nutritional claims, label format, minimum type sizes, content and location of nutritional information panels, nutritional comparisons, and ingredient content panels. The Company's labels, ingredients, and manufacturing techniques and facilities are subject to inspection by the FDA. Labeling regulations require specific details of ingredients and their components along with nutritional information on labels and also impose restrictions on product claims that can be included on labels. The Company believes the labeling regulations have enhanced the marketability of the Company's products and has resulted in increased sales of the Company's products because product labels make it easier for consumers to recognize the nutritional benefits of the Company's products compared to other products.

The Company's facility and manufacturing processes are subject to inspection by the Florida Department of Agriculture and Consumer Services. The Company received its Annual Food Permit from that bureau for 2004.

The Company has a team of individuals from its marketing, quality assurance, and research and development departments who review all new labels for compliance with Company standards and current laws and regulations. The Company believes that it is in material compliance with all applicable governmental regulations regarding its current products and has obtained the necessary government permits, licenses, qualifications, and approvals, which are required for its operations.

ENVIRONMENTAL REGULATION

The Company is required to comply with environmental regulations in connection with the development of its products and the operation of its business. At the present time, the Company believes that it is in material compliance with the federal, state and local environmental laws and regulations applicable to it. The Company believes that continued compliance with any current or reasonably foreseeable future environmental laws and regulations will not have a material adverse effect on the capital expenditures, earnings, financial condition or competitive position of the Company.

EMPLOYEES

As of June 25, 2004, the Company had a total of 141 full-time employees and 4 temporary employees. All personnel are employed directly by the Company. The Company is an affirmative action employer providing equal employment opportunity to all applicants. The Company considers its relations with employees to be satisfactory. No employee is a member of a trade union.

Item 2. PROPERTIES.

The Company occupies two facilities, close in proximity, approximating a total of 119,000 square feet of industrial property in Orlando, Florida. The Company's corporate headquarters occupies approximately 55,000 square feet and is comprised of approximately 8,500 square feet in office space, approximately 31,500 square feet of dock-height, air-conditioned manufacturing space and coolers of approximately 15,000 square feet, which are situated on 2.4 acres of a 5.2 acre site in an industrial park. The Company entered into a lease agreement for the corporate headquarters with Anco Company, a Florida general partnership, on

November 13, 1991. The lease was renewed for a 5-year period in November 1996 and again in November 2001. The lease expires in November 2006, unless renewed pursuant to terms mutually agreeable to the Company and the landlord. The Company has a right of first refusal to purchase or lease the remaining 2.8 acres upon 20 days notice to the landlord in the event that the landlord elects to sell or lease such remaining land. The lease is a “triple net” lease, which means that the Company is responsible for all taxes, insurance, maintenance and repair of the facilities, in addition to rental payments. The monthly base rent through the stated expiration of the lease is \$28,173.

The Company produces all of its products at its Orlando manufacturing facility. The Company maintains production equipment for mixing, blending, cooking and heating ingredients, and for production, shredding, dicing, slicing, chopping, grating, packaging and labeling of its products. The Company also maintains cold storage areas for cooling finished products and warehouse areas for storing supplies and finished goods.

The Company’s second facility includes additional office space, shipping and receiving, warehouse and cooler space totaling approximately 64,000 square feet. The Company entered into a lease agreement with Cabot Industrial Properties, a Florida limited partnership, on July 28, 1999 for this second facility. In May 2004, the Company renegotiated and renewed the lease from August 1, 2004 to July 31, 2009. The term of the lease is for five years and provides for escalating rental payments ranging from \$18,225 to \$22,942 per month through the end of the lease period. The lease is a “triple net lease”, which means the Company is responsible for all taxes, insurance, maintenance, and repair of the facility, in addition to rental payments.

Management believes that the Company’s properties are adequately covered by casualty insurance. The Company believes that its facilities and production equipment are adequate to meet current requirements and its anticipated growth through the end of fiscal 2006. The Company further believes that suitable additional space and equipment will be available as needed to accommodate any further physical expansion of its operations.

Item 3. LEGAL PROCEEDINGS.

On May 17, 2002, Schreiber Foods, Inc. of Green Bay, Wisconsin, filed a lawsuit against the Company in the federal district court for the Eastern District of Wisconsin (“Wisconsin lawsuit”), being Case No. 02-C-0498, alleging various acts of patent infringement. The Complaint alleged that the Company’s machines for wrapping of individual cheese slices, manufactured by Kustner Industries, S.A. of Switzerland, known as models KE and KD, and the Company’s machines for producing individually wrapped slices manufactured by Hart Design Mfg., Inc. of Green Bay, Wisconsin, infringe certain claims of U.S. Patents Nos. 5,112,632, 5,440,860, 5,701,724 and 6,085,680. Schreiber Foods was seeking a preliminary and permanent injunction prohibiting the Company from further infringing acts and was also seeking damages in the nature of either lost profits or reasonable royalties.

On May 6, 2004, Schreiber Foods and the Company executed a settlement agreement pursuant to which all claims in the patent infringement lawsuit were dismissed. Pursuant to this settlement agreement, the Company procured a worldwide, fully paid-up, nonexclusive license to own and use all of the Company’s individually wrapped slice equipment, which Schreiber alleged infringed on Schreiber’s patents. The Company was not obligated to make any cash payment in connection with the settlement of the lawsuit or the license granted in the settlement agreement. The settlement agreement restricts the Company from using the slicing equipment to co-pack product for certain specified manufacturers, however, the Company is not currently engaged in any co-packing business with any of the specified parties, and does not contemplate engaging in the future in any co-packing business with the specified parties.

Pursuant to the settlement agreement, if, during the term of the license, the Company receives an offer to purchase the Company or its business, the Company must notify Schreiber of the offer and Schreiber will

have the option to match the offer or make a better offer to purchase the Company or its business. Acceptance of the Schreiber offer is subject to the approval by the Company's Board of Directors, however, if the Board of Directors determines that the Schreiber offer is equal to or better than the other offer, the Board of Directors must take all permitted actions to accept the offer and recommend it to the Company's shareholders for approval.

The term of the license extends through the life of all patents named in the lawsuit (and all related patents) and is assignable by the Company in connection with the sale of its business. In the event the assignee uses the applicable equipment to manufacture private label product, and such private label product accounts for more than 50% of the total product manufactured on the applicable equipment, the assignee will be required to pay Schreiber a royalty in an amount to be agreed upon by Schreiber and the assignee, but in any event not more than \$.20 per pound of product for each pound of private label product manufactured by the assignee in any year that exceeds the amount of private label product manufactured by the Company in the year preceding the sale of the Company or its business. In the event that the parties cannot agree upon a royalty rate, the assignee retains the license rights but private label production must be maintained at a level less than 50% of the total product manufactured on the applicable equipment.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended March 31, 2004.

PART II

Item 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Market Information

Since August 1999, the Company's common stock, \$.01 par value per share, has been traded on the American Stock Exchange ("AMEX") under the symbol "GXY". There is no established public trading market for the Company's Series A Convertible Preferred Stock, \$0.01 par value per share. The following table sets forth the high and low closing sales prices for each quarter for the Company's common stock as reported on AMEX during the fiscal years ended March 31, 2004 and 2003:

<u>Period</u>	<u>High Closing Sales Price</u>	<u>Low Closing Sales Price</u>
2004 Fiscal Year, quarter ended:		
June 30, 2003	\$2.85	\$1.65
September 30, 2003	\$3.10	\$2.55
December 31, 2003	\$4.00	\$2.36
March 31, 2004	\$3.18	\$1.90
2003 Fiscal Year, quarter ended:		
June 30, 2002	\$5.48	\$4.74
September 30, 2002	\$4.70	\$2.90
December 31, 2002	\$2.90	\$1.50
March 31, 2003	\$2.15	\$1.55

Holdings

On June 25, 2004, there were 665 shareholders of the Company's common stock of record and 2 holders of the Company's Series A convertible preferred stock of record.

Dividends

The Company has not paid any dividends with respect to the Company's common stock and does not expect to pay dividends on its common stock in the foreseeable future. It is the present policy of the Company's Board of Directors to retain future earnings to finance the growth and development of the Company's business. Any future dividends will be declared at the discretion of the Board of Directors and will depend upon, among other things, the financial condition, capital requirements, earnings and liquidity of the Company. The Company's Restated Certificate of Incorporation provides that before any dividend is declared or paid, the Company must secure the consent of the holders of at least 60% of the then-outstanding shares of the Series A convertible preferred stock. Additionally, the Company's credit facilities with Textron Financial Corporation and SouthTrust Bank require the Company to obtain the approval of such financial institutions prior to declaring or paying any dividends. See Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of the Company's current capital position.

Securities Authorized for Issuance under Equity Compensation Plans

Please see the section titled "Equity Compensation Plan Information" in Item 12 in Part III of this Form 10-K.

Recent Sales of Unregistered Securities

There were no sales of unregistered securities in the quarter ended March 31, 2004.

Item 6. SELECTED FINANCIAL DATA.

	Fiscal Year Ended March 31,				
	2004	2003	2002	2001	2000
Net sales	\$36,176,961	\$40,008,769	\$42,927,104	\$ 45,085,937	\$ 41,911,295
Non-cash compensation (income)/expense (1)	651,273	(2,906,762)	2,373,662	1,116,444	18,583
Income (loss) before taxes	(2,962,173)	1,034,128	(15,499,152)	(5,939,334)	2,420,560
Income (loss) before cumulative effect of change in accounting policy	(2,962,173)	1,034,128	(17,059,152)	(5,699,334)	3,629,891
Net income (loss) available to common shareholders	(4,504,907)	(601,077)	(19,147,995)	(6,485,763)	3,629,891
Net income (loss) per common share before cumulative effect of change in accounting policy – basic	(0.30)	(0.05)	(1.81)	(0.61)	0.40
Net income (loss) per common share – basic	(0.30)	(0.05)	(1.81)	(0.69)	0.40
Net income (loss) per common share before cumulative effect of change in accounting policy – diluted	(0.30)	(0.05)	(1.81)	(0.61)	0.39
Net income (loss) per common share – diluted	(0.30)	(0.05)	(1.81)	(0.69)	0.39
Total assets	29,887,087	33,255,842	36,115,051	48,083,126	36,450,393
Long-term debt	8,446,952	10,170,195	12,511,461	14,720,875	7,261,706
Redeemable Convertible Preferred Stock	2,573,581	2,324,671	2,156,311	--	--

(1) Non-cash compensation is calculated based on fluctuations in the Company's stock price, which are outside the Company's control and typically do not reflect the Company's operations. Due to the volatility of the market price of its common stock, the Company is incapable of predicting whether this expense will increase or decrease in the future. Large swings in the Company's stock price could result in material changes to the Company's Financial Statements as demonstrated in prior years. See "Valuation of Non-Cash Compensation" in Item 7 below for further information.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION.

Statements other than historical information contained in this report are considered forward looking and involve a number of risks and uncertainties. Factors that could cause such statements not to be accurate include, but are not limited to, increased competition for the Company's products, improvements in alternative technologies, a lack of market acceptance for new products introduced by the Company and the failure of the Company to successfully market its products.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of income and expense during the reporting periods presented. The

Company's significant estimates include the allowance for doubtful accounts receivable, provision for obsolete inventory, and valuation of deferred taxes and warrants. Although the Company believes that these estimates are reasonable, actual results could differ from those estimates given a change in conditions or assumptions that have been consistently applied.

The critical accounting policies used by the Company, and the methodology for estimates and assumptions are as follows:

Valuation of Accounts Receivable and Chargebacks

The Company records revenue upon shipment of products to its customers and reasonable assurance of collection on the sale. It provides credit terms to customers usually based on net 30 days. The Company performs ongoing credit evaluations of its accounts receivable and makes reserves for anticipated future credits that will be issued to its customers for promotions, discounts, spoils, etc., based on historical experience. In addition, the Company evaluates the accounts for potential uncollectible amounts. The Company's accounts receivable reserve estimate is based on a specific identification and a general reserve methodology over the remaining items.

Based on the age of the receivable, cash collection history and past dilution in the receivables, the Company makes an estimate of its anticipated bad debt, anticipated future authorized deductions due to current period activity and anticipated collections on non-authorized amounts that customers have currently deducted on past invoices. Based on this analysis, the Company reserved \$633,000 and \$633,221 for known and anticipated future credits and doubtful accounts at March 31, 2004 and 2003, respectively. We believe that this estimate is reasonable, but there can be no assurance that the Company's estimate will not change given a change in economic conditions or business conditions within the food industry or the Company.

Inventory

Inventories are valued at the lower of cost or market. Cost is determined using a weighted average, first-in, first out method. The Company reviews its inventory valuation each month and writes down the inventory for potential obsolete and damaged inventory. In addition, the finished goods inventory value is reduced to market value when the known sales price is less than the cost of the inventory.

Deferred Taxes

Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities.

Valuation of Non-Cash Compensation

The Company accounts for its stock-based employee compensation plans under the accounting provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", furnishes the pro forma disclosures required under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation", and applies SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" on a prospective basis for options granted after March 31, 2003.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock Based Compensation—Transition and Disclosure—an Amendment to SFAS 123." SFAS 148 provides two additional transition methods for entities that adopt the preferable method of accounting for stock based compensation. Further, the statement requires disclosure of comparable information for all companies regardless of whether, when, or how an entity adopts the preferable, fair value based method of accounting. These disclosures are now required for interim periods in addition to the traditional annual disclosure. Effective April 1, 2003, the Company adopted the fair value method of recording compensation expense related to all stock options granted after March 31, 2003, in accordance with SFAS 123 and SFAS 148 (the prospective method, as defined by SFAS 148). Accordingly, the fair value of stock options as determined on the date of grant using

the Black-Scholes option-pricing model, will be expensed over the vesting period of the related stock options.

Several management estimates are needed to compute the fair value of the options including anticipated life of the options, risk free interest rates, and volatility of the Company's stock price. Currently, the Company estimates the life of all options granted assuming that the option will remain outstanding and not be exercised until the end of its term. This results in the highest possible value of the option. If the Company were to change its estimate of the option lives to something less than the maximum term, then the fair value expense per share would decrease by approximately \$.01 to \$.02 per month. If the Company changes its estimate of the volatility percentage, the fair value expense per share would change by approximately \$.02 per percentage change in the volatility. If the Company changes its estimate of the interest rate, the fair value expense per share would change by approximately \$.04 per percentage change in the interest rate.

Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "*Accounting for Stock Based Compensation*", requires the Company to provide pro-forma information regarding net income (loss) and earnings (loss) per share amounts as if compensation cost for the Company's employee and director stock options had been determined in accordance with the fair market value-based method prescribed in SFAS No. 123. The Company estimates the fair value of each stock option at the grant date by using a Black-Scholes option-pricing model. The following assumptions were used for options issued during the periods:

Year Ended	<u>March 31, 2004</u>	<u>March 31, 2003</u>	<u>March 31, 2002</u>
Dividend Yield	None	None	None
Volatility	41% to 45%	37% to 44%	38%
Risk Free Interest Rate	2.01% to 4.28%	1.71% to 5.03%	4.75%
Expected Lives in Months	36 to 120	60 to 120	120

In addition to non-cash compensation expense related to new option issuances, the Company also records non-cash compensation expense or income in accordance with the Financial Accounting Standards Board Interpretation No. 44 ("FIN 44"). FIN 44 states that when an option is repriced or there is an outstanding loan related to the exercise of an option, it is treated as a variable option and is marked to market each quarter. Accordingly, any increase in the market price of the Company's common stock over the exercise price of the option that was not previously recorded is recorded as compensation expense at each reporting period. If there is a decrease in the market price of the Company's common stock compared to the prior reporting period, the reduction is recorded as compensation income. Compensation income is limited to the original base exercise price (the "Floor") of the options. Each period the Company records non-cash compensation expense or income related to its analysis on approximately 6.8 million option shares. Assuming that the stock price exceeds the Floor on all the variable option shares, a \$0.01 increase or decrease in the Company's common stock price results in an expense or income, respectively, of \$68,000. Due to the volatility of the market price of its common stock, the Company is incapable of predicting whether this expense will increase or decrease in the future.

NEW ACCOUNTING PRONOUNCEMENTS

In May 2003, the FASB issued SFAS No. 150, "*Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*." The Statement establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. Many of such instruments were previously classified as equity. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatory redeemable financial instruments of nonpublic entities. On November 7, 2003, the FASB deferred the classification and

measurement provisions of SFAS No. 150 as they apply to certain mandatorily redeemable non-controlling interests. This deferral is expected to remain in effect while these provisions are further evaluated by the FASB. The application of the requirements of SFAS 150 did not have any impact on the Company's financial position or result of operations as the Company's Series A convertible preferred stock is not mandatorily redeemable.

In December 2003, the FASB issued a revised FASB Interpretation No. 46, "*Consolidation of Variable Interest Entities*" (FIN 46R), which clarifies how a business enterprise should evaluate whether it has a controlling interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, "*Consolidation of Variable Interest Entities*" which was issued in January 2003. The application of the requirements of FIN 46R did not have any impact on the Company's financial position or result of operations as the Company does not have any variable interests in variable interest entities.

MATERIAL FUTURE EVENTS

On April 6, 2005, the Series A Preferred Holders have the right to require the Company to redeem the outstanding shares of Series A convertible preferred stock. The redemption price is payable in cash at a price per preferred share equal to the greater of (a) 100% of the preference amount (\$48.18 plus accrued dividends) or (b) an amount equal to the aggregate market price on the date of redemption of the common stock that would be then issuable upon conversion of the Series A convertible preferred stock. The market price is based on a five-day average of the closing bid prices for the five trading days prior to the date of redemption.

As of June 25, 2004, there are 41,994 shares of Series A convertible preferred stock outstanding. Assuming that no further conversions were made and the conversion price remained at \$1.75, the redemption price of the outstanding Series A convertible preferred stock would be the greater of (a) \$2,711,116 (100% of the preference amount plus accrued dividends through April 6, 2005 - \$64.56 per share) or (b) the value of 1,549,209 shares of common stock multiplied by the market price on the date of redemption (currently estimated at \$3,364,882 using the average of the closing market price of the Company's common stock from June 21, 2004 - June 25, 2004).

The Company is considering a number of alternatives related to the redemption of the Series A convertible preferred stock which, individually or in combination, could resolve the Series A redemption obligations. These alternatives include procuring the necessary funds from operating activities and existing credit facilities, or from additional equity financing, or identifying one or more investors to buy out the Series A Preferred Holders directly and, in connection therewith, extending the date by which the Series A convertible preferred stock must be redeemed, or negotiating an extension of such date with the current Series A Preferred Holders. However, there are no assurances that any of such alternatives will be viable or available to the Company on terms that are acceptable to the Company, or that, even if viable, that the Company will be successful in implementing any of such alternatives. If the Company is required to redeem the outstanding Series A convertible preferred stock and does not have the funds to do so, the Company will be in default of its obligations and the Series A Preferred Holders will be entitled to pursue their remedies against the Company. In addition, any unpaid redemption amount owed to the Series A Preferred Holders shall bear interest at the rate of 3% per month until paid in full.

A default by the Company in its obligations to redeem the Series A convertible preferred stock will also result in a default by the Company under the Textron Loan, which, in turn, will result in a default by the Company under the SouthTrust Loan. In the cases of the Textron Loan and the SouthTrust Loan, the lenders thereunder could exercise their respective rights under their loan documents to, among other things, declare a default under the loans, accelerate the outstanding indebtedness such that it would become immediately due

and payable, and pursue foreclosure of the Company's assets which are pledged as collateral for such loans. In such event, it is unlikely that the Company would be able to continue as a going concern.

BUSINESS ENVIRONMENT

The Company is principally engaged in developing, manufacturing and marketing a variety of healthy cheese and dairy related products, as well as other cheese alternatives, and is a leading producer of dairy alternative products made with soy. For the year ended March 31, 2004 ("fiscal 2004"), 71% of the Company's sales were derived from sales of sliced cheese products. However, due to the change in consumers' eating habits toward low-carbohydrate meal preparation, the Company is in the process of diversifying, strengthening and balancing the Company's product segmentation between various forms of cheese such as slices, shreds, and chunks, and in its other non-cheese related products. This diversification will help the Company extend consumer usage occasions beyond lunchtime cheese slices for sandwich usage. For example, the Company may add new products that appeal to younger consumers and have portable functionality (that is, "on-the-go" users).

Management focuses on several items in order to measure the Company's performance. In the short term (1 to 3 years), management is working towards obtaining positive trends in the following areas:

- Operating cash flow
- Gross margin in dollars and % of gross sales
- Operating income excluding certain employment contract expenses and non-cash compensation related to options and warrants
- EBITDA excluding certain employment contract expenses and non-cash compensation related to options and warrants
- Liquidity
- Key financial ratios (AR/AP/Inventory turnover)
- Net sales trends (as it relates to consumer demand)

In the long term (over 3 years), management is striving to generate consistent and predictable net sales growth while incrementally enhancing net cash flow from operations.

The principal raw material used by the Company is casein, which accounts for approximately 41% of the Company's raw material purchases. As casein is a significant component of the Company's product formulation, the Company is vulnerable to changes in casein pricing over time, which, at times has been volatile. Management will pursue new business models that create less of a dependency on casein and trying to incorporate alternative sources of protein that maintain the integrity of the Company's product benefits, as well as the cost base of producing the Company's products.

Management believes that since the Company has procured a reasonable level of funding and has the working capital and production capacity required to meet consumer demand, it will be able to maintain and improve upon the operating cash flow performance demonstrated in the results during fiscal 2004. To accelerate top line growth and better utilize existing assets, the Company is again pursuing strategic co-pack, private label, and imitation cheese sales in addition to our branded sales focus. Although the Company's expansion of its private label and imitation business may result in a decrease in the Company's overall gross margin percentage, it should contribute incremental gross margin dollars through increased net sales. Management will balance the additional private label and imitation business growth by reinvesting the gross margin obtained from these sales into further developing its core brands. Management plans to build the business by leveraging a "superior" premium brand approach that begins with superior product quality over most of the direct alternative cheese competition. Improved quality versus conventional cheese competition leads to better than expected consumer experiences and thus better market share. This market share leads to an ability to charge premium prices for the Company's branded products and thus deliver enhanced margins.

The enhanced margins will be reinvested into the core brands and new products to produce additional earnings.

RESULTS OF OPERATIONS

As a result of the large cash outlays related to a large plant expansion, delays in new product shipment, and a sales mix skewed toward lower margin imitation and private label items in the fiscal year ended March 31, 2001 (“fiscal 2001”), the Company experienced shortfalls in cash that affected nearly every aspect of its operations in the fiscal year ended March 31, 2002 (“fiscal 2002”). This cash constraint on purchasing ingredients forced the Company to eliminate significant amounts of business at the key account level in order to achieve sustainable and adequate case fill and order fill levels. During the year ended March 31, 2003 (“fiscal 2003”), the Company achieved positive cash flow levels through efficiencies in production, purchase discounts, realignment of the sales mix toward branded items, reduction in overall number of items being sold and inventoried, improved customer fulfillment levels, new terms of sale, new customer invoice promotion settlement processes, new trade spending strategies and additional cost reductions through rigorous management. During fiscal 2004, the Company refinanced or paid in full all of its credit facilities, which improved the Company’s financial position and reduced interest expense over \$1.6 million during fiscal 2004. All excess cash has been used for working capital purposes to improve the Company’s operations and financial position.

FISCAL 2004 AS COMPARED TO FISCAL 2003

Net Sales were \$36,176,961 and \$40,008,769 during fiscal 2004 and fiscal 2003, respectively, a decrease of approximately \$3.8 million or 9.6 %.

The Company’s management has identified several market factors that it believes have had a negative affect on the Company’s business. First, consumers’ eating habits are changing with the publicly recognized trend toward low-carbohydrate meal preparation during all meals (breakfast, lunch, snack, and dinner). This has led to decreased consumption of items such as bread and the Company’s primary complementary product of cheese slices. Second, the number of consumers shopping in the retail grocery and natural food stores is down versus the prior year due to the further national emergence and presence of Wal*Mart superstores and other similar superstores which include extensive grocery operations. The Company’s product selection is growing but is still limited at Wal*Mart. Therefore, the Company’s sales growth with this account has not been able to fully counter the decline in retail grocery trends. In response to this change in consumer shopping, the Company is redesigning its products and packaging formats to specifically target growth opportunities in the superstore, warehouse club and mass merchandiser markets (such as Wal*Mart, Costco, Kmart, Target, and Sam’s Club). Third, the Veggie™ brand sales were down due to the Southern California retail grocery labor strike that occurred during fiscal 2004, but has since been resolved.

Management uses several internal and external reports to monitor sales by brand, segment, form and channel of sale to determine the outside factors affecting the sales levels. These reports provide management information on which brand, segments, forms and/or channel sales are increasing or decreasing both in units sold and price per unit. By reviewing these reports along with industry data from publications, syndicated retail consumption reports, and conversations with major retailers, other manufacturers in the food and beverage industry, and ingredient and service suppliers, management makes decisions on which brands to promote and analyzes trends in the consumer marketplace.

Through March 28, 2004, IRI (Information Resources Incorporated) scanner data, which measures retail grocery consumption, indicates that many of the major competitors in the conventional cheese slice, private label cheese slice and imitation cheese slice cheese segments have all experienced declining consumption versus the same period a year ago in terms of dollar sales. The range in declines is from 1% to 17%

depending on the brand and consumer support (that is, advertising, promotion, and brand building efforts). Consumption in dollars of Veggie slices, the Company's major product line, was down approximately 10% in fiscal 2004 compared to fiscal 2003. Alternatively, Veggie consumption in dollars increased approximately 2% in shred form and 5% in chunk form during fiscal 2004 compared fiscal 2003. Management believes this data demonstrates that pressure on Veggie slice consumption is a function of usage occasion and not a result of overall consumer dissatisfaction with the Company's brand.

Additionally, management regularly reviews statistics such as case fill rates and order fill rates. These rates show of every case/item ordered, what percentage was shipped complete and of every order placed, what percentage was shipped 100% complete, respectively. The case fill rate was 99.9% and 97.2% in fiscal 2004 and fiscal 2003, respectively, and the order fill rate was 98.7% and 74.1%, respectively. The high levels of completion on the fill rates indicate that the reduction in sales is a function of external consumer demand and behavior versus internal operational constraints.

Certain key initiatives and tactical actions implemented by the Company's management during the year have helped counter some of the market factors (noted above), which negatively impacted the business. Such key initiatives and tactical actions include but are not limited to:

- 1) Created and communicated a new more meaningful brand position for the Company's flagship Veggie™ Brand and new products. The recent focus is to highlight the good levels of carbohydrates and protein in the Company's products and to target a broader universe of consumers. The Company is attempting to attract incremental users by convincing prior users and light users of conventional cheese that the Veggie™ brand items can satisfy their needs with great tasting nutrition. This is a departure from the Company's past product positioning where physiological and medical requirements were a key driver in why consumers should buy the "healthy alternatives."
- 2) Added approximately 15,000 points of new distribution with a focus on slices, shreds, and chunk cheese. During fiscal 2004, it has proved much more difficult than expected to gain points of distribution on the three core items noted above; however, the Company achieved much greater success on new product distribution through crumbles and string cheese. It should be noted that, typically, crumbles and string cheese velocity (sales per point of distribution) is significantly lower than that of the slices, shreds, and chunks, and therefore the Company's new points of distribution were not as productive overall as was anticipated by the Company under its original plan.
- 3) Created and tested regionally a consumer driven marketing campaign that provided valuable insights into sales growth opportunities relative to its overall marketing strategy (trade/retailer incentives versus consumer advertising/promotion) going forward. These insights led to better consumer marketing, which helped stem consumer sales decline in the regions where testing was performed.
- 4) Improved gross margin through purchase savings, product mix, and efficiencies in price related promotions.
- 5) Improved product quality in terms of taste, color, aroma, and texture on the Company's Veggie™ and Rice slices product line.

The Company anticipates that the annual net sales for fiscal 2005 will increase compared to annual net sales for fiscal 2004 based on its plan to take on additional private label and imitation business, while simultaneously initiating marketing programs for the core brands.

In order to positively impact sales volume throughout fiscal 2005, the Company is focusing on three primary areas:

- The Company is shifting the emphasis and resource allocation of its marketing strategy from vendor promotions (retailer publications/flyers featuring price reductions and on-shelf temporary price reductions) to increase sales through consumer advertising (magazine, radio, event sponsorship, etc.) and consumer promotions (for example, on-pack "cents off" coupons, "cents off" coupons delivered via newspapers, in-store product sampling, product benefit communication at the point of purchase/shelf) while highlighting and communicating the benefits of the Company's products to

meet the consumer demand for low carbohydrate and high protein products. This is a significant strategy shift and is based upon retail consumption data purchased from IRI (Information Resources Incorporated) that indicates increased sales potential from consumer focused marketing efforts versus similar dollars being spent toward price related vendor advertising and promotions.

- The Company will also focus its efforts toward generating consumer awareness, conducting product trials, and generating more repeat purchases for its brands.
- Due to the completion of the financial restructuring in the first quarter of fiscal 2004, the Company has begun to pursue certain private label opportunities, which it previously turned away or did not pursue earlier due to cash constraints. This will enable the Company to better utilize some of its excess production capacity. These efforts should result in greater operating cash flow and a higher return on invested capital in future periods. As the Company adds certain private label business to its product mix, the Company's gross margin percentage may decrease. However, the overall gross margin dollars should increase due to higher net sales volume.

The Company does not believe that inflation or changing prices had a significant impact on its results of operations for the periods presented.

Cost of Goods Sold ("COGS") was \$24,864,289 (69% of net sales) and \$28,080,188 (70% of net sales) during fiscal 2004 and fiscal 2003, respectively, a decrease of approximately \$3.2 million or 11.5%. Approximately \$1.8 million of the decrease is the result of lower variable expenses such as direct materials, direct labor and direct overhead required as a function the decrease in sales as discussed above. Approximately \$1 million is the result of lower raw material costs due to a change in product mix and lower prices in the Company's key ingredients. The Company saw an 8% decrease in the price of casein, the Company's primary ingredient in a majority of its products, in fiscal 2004 compared to fiscal 2003, resulting in a savings in excess of \$500,000. Based on current pricing trends with its suppliers, management expects to see substantial increases in its casein prices in the first half of fiscal 2005. A 5% increase in casein prices would result in an annual cost increase of approximately \$307,000 assuming the same amount of pounds purchased as in fiscal 2004. Management is striving to offset these cost increases with efficiencies in production and cost savings in the purchase of other raw materials, along with substituting additional sources of protein into its products. Additionally, management plans to pass some of the cost increases down to the consumer through increases in the sales price of certain products. Management monitors its costs and production efficiencies through various ratios including pounds produced per hour and cost per pound sold and uses these ratios to make decisions in purchasing, production and setting sales prices. Due to certain production efficiencies gained during fiscal 2004, the Company reduced direct labor costs by nearly \$300,000.

Selling expense was \$4,981,996 (14% of net sales) and \$4,958,272 (12% of net sales) during fiscal 2004 and fiscal 2003, respectively, an increase of \$23,724 or 0.5%. The Company recorded an increase of approximately \$414,000 in advertising costs. These costs were limited in fiscal 2003 due to the prior financial constraints of the Company, but increased in fiscal 2004 with renewed emphasis on print, radio and television advertisement. The Company noted a decrease of approximately \$298,000 in brokerage costs and \$117,000 in promotional costs, which correspond to the decrease in sales in fiscal 2004. The Company expects that selling expenses should increase in fiscal 2005 as a function of the anticipated increase in net sales.

Delivery expense was \$1,877,682 (5% of net sales) and \$2,008,638 (5% of net sales) during fiscal 2004 and fiscal 2003, respectively, a decrease of \$130,956 or 6.5%. Since delivery expense is primarily a function of sales, nearly all of the decrease is a result of the decrease in sales as discussed above. Historically, delivery expenses approximate 5% of net sales each period. Unless offset by price savings from shipping larger loads, the Company anticipates that delivery costs will increase as a percentage of sales in the future periods due to higher fuel prices and rate changes in anticipation of the new laws regarding limitation of driver hours. The Company anticipates an increase from the current 5% to 6% of net sales.

Non-Cash Compensation Related to Options and Warrants

	Years Ended March 31,	
	2004	2003
Notes Receivable for Common Stock	\$ --	\$ (3,060,000)
Option and Warrant Repricing	8,001	--
Option and Warrant Issuances	643,272	153,238
Total Non-Cash Compensation		
(Income)/Expense	\$ 651,273	\$ (2,906,762)

The Company values the non-cash compensation related to its securities on three primary items:

a. Notes Receivable for Common Stock

The Financial Accounting Standards Board issued Interpretation No. 44 (“FIN 44”), which clarifies the application of APB Opinion 25 relating to the accounting consequences of various modifications to fixed stock options. FIN 44 covers specific events that occurred after December 15, 1998 and was effective as of July 2, 2000. FIN 44 clarified that when an option is repriced, it is treated as a variable option and is marked to market each quarter. Accordingly, any increase in the market price of the Company’s common stock over the exercise price of the options that was not previously recorded is recorded as compensation expense at each reporting period. If there is a decrease in the market price of the Company’s common stock compared to the prior reporting period, the reduction is recorded as compensation income. Compensation income is limited to the original base exercise price (the “Floor”) of the options. In accordance with FIN 44, the underlying shares related to the \$12,772,200 note receivable from the Company’s founder, Angelo S. Morini, are treated as variable due to the nature of the note being non-interest bearing and non-recourse. The Floor for the underlying shares is \$4.38 per share. There was no non-cash compensation expense or income related to these shares recorded during fiscal 2004 as the price of the Company’s common stock at the beginning and end of the period was below the Floor. The Company recorded non-cash compensation income of \$3,060,000 for fiscal 2003 based on the decrease in the market price of the Company’s common stock from \$5.43 at March 31, 2002 to \$1.87 at March 31, 2003. The Company did not record any further non-cash compensation income once the stock price fell below the Floor of \$4.38. Due to the volatility of the market price of its common stock, the Company is incapable of predicting whether this expense will increase or decrease in the future. If the Company’s stock price is above the Floor of \$4.38, a \$0.01 increase or decrease in the Company’s common stock price results in an expense or income, respectively, of \$29,143.

b. Option and Warrant Repricing

On October 11, 2002, the Company repriced all outstanding options granted to employees prior to October 11, 2002 (4,284,108 shares at former prices ranging from \$2.84 to \$10.28) to the market price of \$2.05 per share. In addition, the Company repriced the outstanding warrants held by current consultants as of October 11, 2002 (291,429 shares at former prices ranging from \$3.31 to \$5.50) to the market price of \$2.05 per share. This stock option repricing resulted in variable accounting treatment (as discussed under Notes Receivable for Common Stock above) for these stock options beginning with the quarter ended December 31, 2002 and such variable accounting treatment will continue until the related options have been cancelled, expired or exercised. On December 4, 2002, as a result of discussions and negotiations with certain major shareholders, the Company’s founder, Angelo S. Morini, agreed to reverse the repricing of his 3,692,035 options for the purpose of improving shareholder value and lessening potential financial statement expense. Although the exercise prices of the options were reversed back to their original amounts, the Company is still required to account for any outstanding options related to these reversed-repriced options in accordance with variable accounting standards each period.

The Company recorded non-cash compensation expense of \$8,001 related to these variable options and warrants for the year ended March 31, 2004. There was no compensation expense recorded for the year ended March 31, 2003, as the market price of the Company's stock was less than the \$2.05 Floor. The remaining outstanding variable options and warrants as of March 31, 2004 were 3,882,092. Assuming no further options or warrants are exercised or cancelled and all are vested and the Company's stock price is above the lowest Floor of \$2.05, a \$0.01 increase or decrease in the Company's common stock price results in an expense or income, respectively, up to \$38,821.

c. Option and Warrant Issuances

During fiscal 2004, 2003, and 2002, the Company recorded \$643,272, \$153,238, and \$413,662, respectively, as non-cash compensation expense related to stock, options and warrants that were issued to and vested by employees, officers, directors and consultants. This expense is included in non-cash compensation in the Company's Statements of Operations.

Employment Contract Expense – In October 2003, the Company and Angelo S. Morini created a Second Amended and Restated Employment Agreement, which agreement is described under Item 11 of Part III, "Executive Compensation". The Company accrued and expensed the five-year cost of this agreement in the quarter ended December 31, 2003. The total estimated costs expensed under this agreement are \$1,830,329 of which \$170,882 was paid during fiscal 2004 and \$1,659,447 remained unpaid but accrued (\$366,305 as short-term accrued liabilities and \$1,293,142 as long-term liabilities) as of March 31, 2004. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

General and administrative expenses were \$3,303,030 and \$3,570,889 during fiscal 2004 and fiscal 2003, respectively, a decrease of \$267,859 or 7.5%. During fiscal 2004, there was an increase of approximately \$132,000 in legal fees due to the Schreiber lawsuit, refinancing activities and additional reporting requirements during the fiscal 2004. Additionally, the Company had an increase of approximately \$183,000 in director and related insurance expenses due to the expanded Board of Directors and their activity in the fiscal 2004. These increases were offset by decreases of approximately \$115,000 in consulting fees, \$106,000 in personnel costs, \$67,000 in bad debt write-offs, \$50,000 in bank charges, \$44,000 in audit fees, and general allocation costs such as rent, depreciation and telephone charges of approximately \$200,000. Management is anticipating further declines in general and administrative expenses in fiscal 2005 due to continued reductions in general overhead costs for rent and depreciation along with a decrease in personnel expenses based on the amended employment agreement with Angelo S. Morini as described above. Additionally, management believes that legal fees should decrease significantly now that the Schreiber lawsuit has been fully resolved.

Research and development expenses were \$260,410 and \$232,552 during fiscal 2004 and fiscal 2003, respectively, an increase of \$27,858 or 12.0%. These increases are primarily the result of an increase in quality control testing as required by the Company and its customers in addition to salary and benefit cost increases. The Company anticipates minimal increases to research and development in future periods mainly related to increasing personnel costs.

Interest Expense was \$1,361,606 and \$2,923,215 during fiscal 2004 and fiscal 2003, respectively, a decrease of \$1,561,609 or 53.4%. During fiscal 2003, the Company amortized to interest expense \$614,230 related to debt discounts on its prior mezzanine loan from FINOVA Mezzanine Capital, Inc. ("FINOVA Mezzanine"). This non-cash amortization ended in September 2002 and did not occur during fiscal 2004. The Company also noted a decrease in loan costs of approximately \$413,722 in fiscal 2004 due to the lower fees charged under the Textron credit facility compared to the FINOVA credit facility. The remaining decrease in interest expense was the result of lower debt balances, and lower interest rates on the outstanding debt balances partly due to a reduction in the average prime rate during fiscal 2004 compared to fiscal 2003. See "Debt Financing" below for further detail on the Company's outstanding debts and interest rates thereon.

FISCAL 2003 AS COMPARED TO FISCAL 2002

Sales for fiscal 2003 decreased by 7% from fiscal 2002, reflecting the reduction of lower margin business during fiscal 2003. Sales in the fourth quarter of fiscal 2003 were \$10,213,005 reflecting a 3% increase over fourth quarter sales in fiscal 2002 and a 5% increase from the sales in the third quarter of fiscal 2003. While the Company has experienced positive cash flows in fiscal 2003, it has used this cash to improve the balance sheet by paying down debt and payables rather than increasing inventory for sale. As a result of the constraints put on ingredient, packaging and finished goods availability, the Company made a strategic decision to downsize sales volume in an effort to increase its margins. The product mix shift to focus on higher-margin brand name products under the Veggie™ and Soyco® brands, required the Company to turn away certain private label and other lower margin, non-branded business. While both the customer and consumer demand (as measured by IRI Scan Data for Grocery stores and SPINS Scan Data for Natural Food stores) for the Company's products and private label business remained strong, sales growth was maintained at lower levels so that the Company could improve margins on its core items and grow profitably. The Company does not believe that inflation or changing prices had a significant impact on its results of operations for the periods presented.

Cost of Goods Sold ("COGS") was \$28,080,188 representing 70% of net sales for fiscal 2003, compared with \$35,276,362 or 82% of net sales for fiscal 2002. There was an overall decrease in costs of \$7,196,174 in fiscal 2003 compared to fiscal 2002. This decrease in cost is primarily the result of several factors, including: (a) a 7% decrease in raw materials required for operations from the previous fiscal year (a decrease of \$3 million) due to the 7% decrease in sales described above; (b) the completed installation of the new equipment which resulted in a substantial decrease in the number of production personnel late in fiscal 2002 and caused labor-related expenses to decrease by approximately \$900,000 in fiscal 2003 as compared to fiscal 2002; (c) the non-recurrence of a \$600,000 inventory write-off which occurred in fiscal 2002 due to the Company's decision to decrease its product mix to 200 core items that constituted nearly 98% of sales; and (d) a decrease in raw material costs due to improved vendor relations, lower raw material costs and purchase discounts.

By fiscal 2003, the equipment was fully operational, the labor crews were trained, ingredient and packaging supply was consistent, and fewer number of core items were being produced, based on specific sales forecasting. Therefore, the Company experienced longer production runs, and improved run rates with more, high-quality product produced per hour. This resulted in the Company's gross margin increasing from 18% in fiscal 2002 to 30% in fiscal 2003.

Selling expenses decreased by \$3,615,685 (42%) for fiscal 2003 compared to fiscal 2002. The Company decreased advertising and promotional expenses by approximately \$155,000 and \$2,101,000, respectively, in fiscal 2003 as compared to fiscal 2002. In fiscal 2002, more effort was directed to provide incentives to our direct customers for brand item purchases, in addition to discounts offered to maintain current relationships with brokers and customers. The Company also experienced a decrease of approximately \$933,000 in brokerage and salary costs directly attributable to deployment of more focused, productive key account selling strategies and tactics and to the reduction in sales. The remainder of the decrease was caused by improved administrative efficiencies and a reduction in travel expenses.

Delivery expenses decreased 19% during fiscal 2003 compared to fiscal 2002. The decrease in delivery costs is due as result of the decrease in net sales and due to a diversification in shipping carriers resulting in lower prices per shipment.

Non-Cash Compensation Related to Options and Warrants

	Years Ended March 31,	
	2003	2002
Notes Receivable for Common Stock	\$ (3,060,000)	\$ 1,960,000
Option and Warrant Issuances	153,238	413,662
Total Non-Cash Compensation		
(Income)/Expense	\$ <u>(2,906,762)</u>	\$ <u>2,373,662</u>

Non-cash compensation related to options and warrants showed income of \$2,906,762 and an expense of \$2,373,662 for fiscal 2003 and 2002, respectively. The Financial Accounting Standards Board issued Interpretation No. 44 (“FIN 44”), which clarifies the application of APB Opinion 25 relating to the accounting consequences of various modifications to fixed stock options. FIN 44 states that when an option is repriced, it is treated as a variable option and is marked to market each quarter. Accordingly, any increase in the market price of the Company’s common stock over the exercise price of the options, that was not previously recorded, is recorded as compensation expense at each reporting period. If there is a decrease in the market price of the Company’s common stock compared to the prior reporting period, the reduction is recorded as compensation benefit. Compensation benefit is limited to the original base exercise price of the options. During fiscal 2003, the market price of the Company’s common stock decreased from \$5.43 at March 31, 2002 to \$1.87 at March 31, 2003. In accordance with FIN 44, the underlying shares related to the \$12,772,200 note receivable from Angelo S. Morini, the Company’s Founder, are treated as variable due to the nature of the note being non-interest bearing and non-recourse. Therefore, the Company recorded a \$3,060,000 decrease in the non-cash compensation based on the change in the market price of the Company’s common stock from \$5.43 to the floor of \$4.38 (the average base exercise price of the shares). The Company also recorded a \$153,238 expense related to the fair value of warrants issued for consulting services.

On October 11, 2002 through unanimous consent of the Board of Directors, the Company repriced all outstanding options granted to employees prior to this date (4,284,108 shares at former prices ranging from \$2.84 to \$10.28) to the market price of \$2.05 per share. In addition, the Company repriced the outstanding warrants held by current consultants prior to this date (291,429 shares at former prices ranging from \$3.31 to \$5.50) to the market price of \$2.05 per share. This stock option repricing resulted in variable accounting treatment for these stock options beginning with the quarter ended December 31, 2002 until the related options have been cancelled, expired or exercised. On December 4, 2002, as a result of discussions and negotiations with certain major shareholders, the Company’s Founder agreed to reverse the repricing of his 3,692,035 options for the purpose of improving shareholder value and lessening potential financial statement expense. Although the exercise prices of the options were reversed back to their original amounts, the Company is still required to account for any outstanding options related to these reversed-repriced options and any new options issued to the Company’s Founder prior to June 4, 2003 in accordance with variable accounting standards each quarter.

The remaining variable options and warrants as of March 31, 2003 were 3,612,770 of which none were vested and “in-the-money” based on the Company’s closing stock price of \$1.87 on March 31, 2003. Therefore, there is no non-cash compensation expense recorded in fiscal 2003 related to these variable options and warrants.

General and administrative expenses decreased \$1,777,624 (33%) during fiscal 2003, as compared to fiscal 2002. The decrease was due to a \$798,000 decrease in bad debt expense and a \$162,000 decrease in personnel costs along with a general reduction in standard administrative expenses due to cost cutting measures implemented at the end of fiscal 2002. Additionally, fiscal 2002 expenses were higher than fiscal

2003 due to \$547,000 in unused advertising trade credits that the Company wrote off in the fourth quarter of fiscal 2002.

Research and development expenses decreased 11% during fiscal 2003 compared to fiscal 2002. The decrease resulted primarily from a reduction in personnel costs during fiscal 2003.

Interest expense decreased \$670,876 (19%) from \$3,594,091 in fiscal 2002 to \$2,923,215 in fiscal 2003. On September 30, 1999, the Company entered into a \$4,000,000 subordinated note payable with FINOVA Mezzanine. During fiscal 2003, this debt bore interest at a rate of 15.5% and included an original issuance discount of \$786,900, which was amortized as interest expense over the term of the debt until September 30, 2002. In connection with FINOVA Mezzanine's warrant exercise and transfer of 815,000 shares of the Company's common stock, the Company agreed to guarantee the price at which the shares were sold to the public at \$4.41 per share. The actual price received by FINOVA Mezzanine was \$3.25 per share and the difference of \$945,400 was recorded as a debt discount and was amortized over the term until September 30, 2002. During the year ended March 31, 2003, interest expense decreased \$205,000 because the above debt discounts were fully amortized. Additionally, interest expense decreased approximately \$520,000 as a result of lower debt balances during fiscal 2003 compared to fiscal 2002. Loan fees amortized to interest expense increased approximately \$54,000 during the year ended March 31, 2003 due to additional loan costs and the shortened loan periods. See "Debt Financing" below for further detail on the Company's outstanding debts and interest rates thereon.

Income tax expense for the year ended March 31, 2002 was \$1,560,000 compared to zero income tax for fiscal 2003. At March 31, 2001, the Company had recorded a deferred tax asset of \$1,560,000, derived mainly from tax net operating losses incurred in prior years, which was expected to be realized in the future. This asset was written off during the fiscal year 2002 due to the uncertainty of the Company's ability to take advantage of the net operating loss carryforwards before they expire. As of March 31, 2003, the Company has approximately \$36 million of net operating loss carryforwards that it may be able to use to offset future taxable income.

LIQUIDITY AND CAPITAL RESOURCES

	Years Ended March 31,			
	2004	2003	Change	%
Cash provided by operating activities	2,236,350	1,175,875	1,060,475	90.2%
Cash used in investing activities	(231,778)	(100,026)	(131,752)	(131.7%)
Cash used in financing activities	(1,556,491)	(1,074,419)	(482,072)	(44.9%)

Operating Activities – During fiscal 2004, the Company received cash from operating activities of \$2,236,350, which is an increase in cash of \$1,060,475 over the previous fiscal year. The increase in cash from operations is primarily attributable to continued reductions in accounts receivable and inventory levels in fiscal 2004 compared to fiscal 2003. Management is continually reviewing its collection practices and inventory levels to maximize its cash flow from operations. The Company expects to maintain positive cash flows from operations during fiscal 2005.

Investing Activities – Net cash used in investing activities totaled \$231,778 for in fiscal 2004 compared to \$100,026 in fiscal 2003. The Company used cash of \$221,585 and \$214,003 to purchase equipment in fiscal 2004 and 2003, respectively. Additionally, the Company received \$113,977 in cash due to a decrease in its deposits and other assets during fiscal 2003. The Company does not anticipate any large capital expenditures during fiscal 2005 that would exceed the levels shown in fiscal 2004.

Financing Activities – Net cash flows used in financing activities were \$1,556,491 and \$1,074,419 for fiscal 2004 and 2003. During the first quarter of fiscal 2004, the Company raised \$3,850,000 through the issuance of common stock and \$2,000,000 from a new term loan with SouthTrust Bank, as described below. The Company used \$4,000,000 of these proceeds to pay in full the principal balance owed to FINOVA Mezzanine. The remaining proceeds were used to further reduce the Company’s book overdrafts, accounts payable and debt balances. Additionally, the Company obtained from Textron Financial Corporation a revolving credit facility that replaced the Company’s asset-based credit facility with FINOVA Capital on May 30, 2003, which had an outstanding principal balance of \$4,254,667 at the time of replacement, as further described below.

During the first quarter of fiscal 2003, the Company received loan proceeds from Excalibur Limited Partnership in the amount of \$500,000 in cash. The proceeds of which were used to pay down a portion of the Company’s outstanding debt under its term loan from SouthTrust Bank. In addition, the Company raised \$1,500,000 through the issuance of common stock to Stonestreet Limited Partnership (as further discussed below). These proceeds were used to pay off its term loan from Excalibur Limited Partnership and for working capital purposes. The Company used its cash from operating activities to reduce the balance of the Company’s outstanding debt under its line of credit from FINOVA Capital and to pay down its term debt with SouthTrust Bank.

Debt Financing

Effective May 30, 2003, the Company obtained from Textron Financial Corporation (“Textron”) a revolving credit facility (the “Textron Loan”) in the maximum principal amount of \$7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 (the “Loan Agreement”). The Textron Loan replaced the Company’s asset-based credit facility with FINOVA Capital on May 30, 2003, which had an outstanding principal balance of \$4,254,667 at the time of replacement. The Textron Loan is secured by the Company’s inventory, accounts receivable and all other assets. Generally, subject to the maximum principal amount which can be borrowed under the Textron Loan and certain reserves that must be maintained during the term of the Textron Loan, the amount available under the Textron Loan for borrowing by the Company from time to time is equal to the sum of (i) eighty-five percent (85%) of the net amount of its eligible accounts receivable plus (ii) sixty percent (60%) of the Company’s eligible inventory not to exceed \$3,500,000. Advances under the Textron Loan bear interest at a variable rate, adjusted on the first (1st) day of each month, equal to the prime rate plus one and three-quarter percent (1.75%) per annum (5.75% at March 31, 2004) calculated on the average cash borrowings for the preceding month. The Textron Loan matures and all amounts are due and payable in full on May 26, 2006. As of March 31, 2004, the outstanding principal balance on the Textron Loan was \$4,605,277.

The Textron Loan described above contains certain financial and operating covenants. In August 2003, the Company notified Textron that it had failed to comply with the fixed charge coverage ratio in June 2003. Pursuant to a certain Waiver Letter dated August 13, 2003, Textron agreed to waive the requirement to meet the fixed charge coverage ratio for each monthly period through September 30, 2003. Additionally, Textron agreed that after August 13, 2003, all of the financial covenants required of the Company under Section 7.6 of the Loan Agreement will be measured and tested on a quarterly rather than monthly basis. Due to the \$1.8 million charge to operations related to the Amended and Restated Employment Agreement for Angelo Morini, the Company fell below the requirement for the adjusted tangible net worth and the fixed charge coverage ratio covenants for the quarter ended December 31, 2003. Pursuant to a Second Amendment to the Loan Agreement dated June 25, 2004, which is effective as of December 31, 2003, Textron changed the definitions on the covenants to exclude accrued but unpaid costs related to the above mentioned Employment Agreement. Based on the revised definitions, the Company was in compliance with all covenants under the Loan Agreement for the quarter ended December 31, 2003 and the year ended March 31, 2004. The Company anticipates that it will be in compliance with these ratios, as amended, through the remainder of the loan period.

On September 30, 1999, the Company obtained a \$4 million subordinated loan from FINOVA Mezzanine to finance additional working capital and capital improvement needs. This loan was paid in full as of May 30, 2003 by the proceeds from a loan from SouthTrust Bank and from the equity proceeds raised in the private placements in May 2003, as discussed below. In accordance with a warrant agreement dated September 30, 1999, the exercise price on 200,000 warrants still held by FINOVA Mezzanine on May 30, 2003, was reduced from \$3.41 to \$1.80 per share based on the sales price of the Company's common stock in May 2003. FINOVA Mezzanine exercised these warrants to purchase 200,000 shares of the Company's common stock on June 2, 2003. The Company received net proceeds of \$119,000 after a deduction of \$241,000 due to FINOVA Capital Corporation for waiver fees pursuant to a certain Amendment and Limited Waiver to Security Agreement dated June 26, 2002.

Simultaneous with the closing of the Textron Loan in May 2003, SouthTrust Bank extended the Company a new term loan in the principal amount of \$2,000,000. This loan was consolidated with the Company's March 2000 term loan with SouthTrust Bank, which had a then outstanding principal balance of \$8,131,985 for a total term loan amount of \$10,131,985. The revised term loan bears interest at SouthTrust Bank's prime rate of interest plus 1% (5% at March 31, 2004), and is due in increasing principal installments by June 2009. Each month, the Company will pay the accrued interest on the loan plus principal amounts as follows: \$75,000 from May 2004 to June 2004, \$110,000 from July 2004 to June 2005, and \$166,250 from July 2005 until maturity in June 2009. This note is secured by all of the Company's equipment and certain related assets. The proceeds of the new term loan, together with the proceeds from certain sales of the Company's common stock conducted in May 2003, were used to repay the Company's \$4,000,000 mezzanine loan from FINOVA Mezzanine. The balance outstanding on this new term loan as of March 31, 2004 was \$9,381,985.

The SouthTrust term loan described above contains certain financial and operating covenants. Due to the \$1.8 million charge to operations related to the Amended and Restated Employment Agreement for Angelo Morini, the Company fell below the requirement for the tangible net worth covenant for the quarter ended December 31, 2003. Pursuant to a Loan Modification letter dated May 21, 2004, SouthTrust changed the definitions in its loan covenants to exclude accrued but unpaid costs related to the above mentioned Employment Agreement. Additionally, SouthTrust waived the Company's need to comply with the Maximum Funded Debt to EBITDA ratio for the year ended March 31, 2004. Based on the revised definitions and the waiver, the Company was in compliance with all covenants under the Loan Agreement for the quarter ended December 31, 2003 and the year ended March 31, 2004. The Company anticipates that it will be in compliance with these ratios, as amended, through the remainder of the loan period. Additionally, the Loan Modification letter dated May 21, 2004 established a pricing matrix which will tie the interest rate charged on the term loan to the Company's performance related to its funded debt to EBITDA ratio. Beginning October 1, 2004, the interest rate may be adjusted quarterly depending on the Company's ratio at the end of the prior quarter. Interest will be assessed in the range of prime to prime plus 1.25% according to the Company's performance. SouthTrust charged a fee of \$50,000 to make the all of the above modifications to the term loan. The Company's management believes that it will be able to offset a substantial portion of this fee in future periods by securing lower interest rates related to improved ratios. The fee is payable in four installments between June and December 2004.

In October 2000, the Company obtained a \$1.5 million bridge loan from SouthTrust Bank, which is guaranteed by Angelo S. Morini, the Company's founder, and secured by the pledge of one million shares of the Company's common stock owned by him. Interest on this note was at the prime rate. This loan was paid in full in February 2004 and the collateral shares were released by SouthTrust to the Company.

In connection with the consolidations and extensions of the SouthTrust Bank loans as described above, the Company issued a warrant to purchase 100,000 shares of the Company's common stock to SouthTrust Bank on May 29, 2003. The warrant is exercisable until June 1, 2009 at an exercise price of \$1.97 per share. In

accordance with SFAS 123, the fair value of this warrant was estimated at \$101,000 and will be amortized as non-cash compensation over 72 months beginning in May 2003.

In March 2002, Angelo S. Morini, the Company's founder, loaned \$330,000 to the Company in order for it to pay down certain notes payable that were coming due. This loan bore interest at the prime rate and was due on or before June 15, 2006. In connection with a Second Amended and Restated Employment Agreement effective October 13, 2003 between Mr. Morini and the Company, the Company offset \$167,603 of unreimbursed advances owed to it by Mr. Morini prior to June 2002 and certain family members against the balance of the loan and issued an aggregate of 55,087 shares of the Company's common stock (valued at approximately \$2.95 per share) as payment in full.

On August 15, 2002, the Company executed and delivered to Target Container, Inc. a \$347,475 promissory note in satisfaction of its accounts payable obligation to this vendor. This note bore interest at 7% per annum and was due in twelve equal monthly installments of \$30,066. This note was paid in full by September 30, 2003.

In January 2003, Ruggieri of Windermere Family Limited Partnership, an affiliate of Mr. John Ruggieri, the Company's former Vice President of Manufacturing, entered into a credit arrangement with the Company pursuant to which the partnership purchased for the Company raw materials approximating \$500,000. The amounts paid for the purchased materials, plus interest at the rate of 15% per annum on such amounts, was due and paid in full by May 31, 2003.

On April 10, 2003, the Company entered into a credit arrangement with Mr. Frederick Deluca, one of its greater than 5% shareholders, pursuant to which Mr. Deluca purchased raw materials for the Company in an aggregate amount that did not exceed \$500,000. The amounts paid for the purchased materials, plus interest at the rate of 15% per annum on such amounts, was due and payable in full on July 9, 2003. In consideration of the credit arrangement, the Company issued to Mr. Deluca a warrant to purchase 100,000 shares of the Company's common stock at an exercise price of \$1.70. In accordance with SFAS 123, the fair value of this warrant was estimated at \$63,000 and was recorded as non-cash compensation expense in the first quarter of fiscal 2004. All amounts owed under the credit arrangement were repaid in full and such credit arrangement was terminated on June 27, 2003.

Equity Financing

On April 6, 2001, in accordance with an exemption from registration under Regulation D promulgated under the Securities Act of 1933, as amended, the Company received from BH Capital Investments, L.P. and Excalibur Limited Partnership (the "Series A Preferred Holders") proceeds of approximately \$3,082,000 less costs of \$181,041 for the issuance of 72,646 shares of the Company's Series A convertible preferred stock with a face value of \$3,500,000 and warrants to purchase shares of the Company's common stock. The Series A Preferred Holders have the right to receive on any outstanding Series A convertible preferred stock a ten percent stock dividend on the shares, payable one year after the issuance of such preferred stock, and an eight percent stock dividend for the subsequent three years thereafter, payable in either cash or shares of preferred stock. The Series A convertible preferred stock is subject to certain designations, preferences and rights set forth in the Company's Restated Certificate of Incorporation, including the right to convert such shares into shares of common stock at any time, at a current conversion rate (subject to appropriate adjustment for stock splits, stock dividends, recapitalizations and other events) of the number of shares of common stock for each share of Series A convertible preferred stock equal to the quotient of:

\$48.18, plus all accrued dividends that are then unpaid for each share of the Series A convertible preferred stock then held by the holder,

divided by,

the lesser of (x) \$1.75 or (y) 95% of the average of the two lowest closing bid prices on the American Stock Exchange of the common stock out of the fifteen trading days immediately prior to conversion.

As of March 31, 2004, the Series A Preferred Holders had converted 28,752 shares of the Series A convertible preferred stock plus accrued dividends, into 1,084,844 shares of common stock. The conversion prices ranged from \$1.3633 to \$1.75 and were based on the lower of (a) 95% of the average of the two lowest closing bid prices on the AMEX for the fifteen trading days immediately prior to conversion or (b) \$1.75. From April 1, 2004 through June 25, 2004, the Series A Preferred Holders converted 1,900 shares of the Series A convertible preferred stock, plus accrued dividends, into 66,752 shares of common stock at a conversion price of \$1.75.

The Series A Preferred Holders have the right to require the Company to redeem their shares of Series A convertible preferred stock on April 6, 2005. The redemption price shall be paid in cash at a price per preferred share equal to the greater of (a) 100% of the preference amount (\$48.18 plus accrued dividends) or (b) an amount equal to the aggregate market price on the date of redemption of common stock that would be then issuable upon conversion of the Series A convertible preferred stock. The market price is based on a five-day average of the closing bid prices for the five trading days prior to the date of redemption. As of June 25, 2004, there are still 41,994 shares of the Series A convertible preferred stock outstanding. Assuming that no further conversions were made and the conversion price remained at \$1.75, the redemption price of the outstanding Series A convertible preferred stock would be the greater of (a) \$2,711,116 (100% of the preference amount plus accrued dividends through April 6, 2005 - \$64.56 per share) or (b) the value of 1,549,209 shares of common stock multiplied by the market price on the date of redemption (currently estimated at \$3,364,882 using the average of the closing market price of the Company's common stock from June 21, 2004 - June 25, 2004). Any unpaid amount after April 6, 2005 shall bear interest at the rate of 3% per month until paid in full.

On November 7, 2002, the Series A Preferred Holders exercised their right under the Series A Preferred Stock and Warrants Purchase Agreement the "Series A Purchase Agreement") to require the Company to solicit the approval of its shareholders for the Company's issuance of all of the shares of common stock potentially issuable upon conversion of the Series A convertible preferred stock in full and the exercise of their warrants. The Company was required to hold a shareholders meeting to solicit such approval on or before February 5, 2003. In accordance with the Stock Purchase Option Agreement described below, the Series A Preferred Holders agreed, among other things, to extend the deadline to September 30, 2003. On September 30, 2003, the Company's shareholders, by majority vote, approved the issuance by the Company of all required common stock in the event of a conversion of the Company's Series A convertible preferred stock and upon the exercise of certain warrants held by the Series A Preferred Holders.

On April 24, 2003, the Company and the Series A Preferred Holders entered into that certain Stock Purchase Option Agreement, whereby the Company was granted the option to purchase all of the shares of the Series A convertible preferred stock owned by such holders. The option expired on September 30, 2003. Pursuant to such agreement, the Series A Preferred Holders also agreed to extend the Company's required date to hold a shareholders meeting to September 30, 2003. In exchange for the option and the extension of the annual meeting date, the Company issued warrants to purchase 250,000 shares of the Company's common stock to each BH Capital Investments, L.P. and Excalibur Limited Partnership. These warrants are exercisable until July 15, 2006 at an exercise price equal to \$2.00 per share, which price was greater than the market value of the Company's common stock on April 24, 2003. These warrants were included on a Registration Statement on Form S-3, SEC File No. 333-109649, which was filed on October 10, 2003 and declared effective on November 18, 2003. In accordance with SFAS 123, the fair value of these warrants was estimated at \$230,000 and was recorded as non-cash compensation expense in the first quarter of fiscal 2004.

In accordance with an exemption from registration under Regulation D promulgated under the Securities Act of 1933, as amended, and pursuant to seven Securities Purchase Agreements dated May 21, 2003, the Company sold and issued a total of 2,138,891 shares of its common stock at a price per share equal to \$1.80 for aggregate gross proceeds to the Company of \$3,850,000. These securities were included on a Registration Statement on Form S-3, SEC File No. 333-109649, which was filed on October 10, 2003 and declared effective on November 18, 2003. Sales to related parties under the Securities Purchase Agreements include: 555,556 shares of common stock sold at an aggregate sales price of \$1,000,000 to Frederick DeLuca, a greater than 5% shareholder; 55,556 shares of common stock sold at an aggregate sales price of \$100,000 to David H. Lipka, a Director of the Company; 83,333 and 55,556 shares of common stock sold at an aggregate sales price of \$150,000 and \$100,000, respectively, to Ruggieri of Windermere Family Limited Partnership and Ruggieri Financial Pension Plan, respectively, each an affiliate of John Ruggieri, the Company's former Vice President of Manufacturing; 1,111,112 shares of common stock sold at an aggregate sales price of \$2,000,000 to Fromageries Bel S.A., a leading branded cheese company in Europe which signed a Master Distribution and Licensing Agreement effective May 22, 2003 with the Company. Sales to non-related parties under the Securities Purchase Agreements include: 138,889 shares of common stock sold at an aggregate sales price of \$250,000 Apollo Capital Management Group; and 138,889 shares of common stock sold at an aggregate sales price of \$250,000 Apollo MicroCap Partners, L.P.

The Company used \$2,000,000 of the proceeds generated from these May 2003 private placements to pay down the balance of the Company's mezzanine loan from FINOVA Mezzanine. The Company then applied the additional proceeds from the new loan from SouthTrust Bank, as discussed above, to pay the remaining \$2,000,000 on the FINOVA Mezzanine loan. The Company utilized the remainder of the private placement proceeds for working capital and general corporate purposes.

Management believes that with the proceeds received in connection with its revised credit facilities and equity financings together with cash flow from current operations, the Company will have enough cash to meet its current liquidity needs for general operations through March 31, 2005.

On April 6, 2005, the Series A Preferred Holders have the right to require the Company to redeem the outstanding shares of Series A convertible preferred stock for cash. Assuming that no further conversions of the Series A convertible preferred stock are made after the date hereof, the cost to the Company to redeem the outstanding Series A convertible preferred stock could be in excess of \$3,500,000.

The Company is considering a number of alternatives related to the redemption of the Series A convertible preferred stock which, individually or in combination, could resolve the Series A redemption obligations. These alternatives include procuring the necessary funds from operating activities and existing credit facilities, or from additional equity financing, or identifying one or more investors to buy out the Series A Preferred Holders directly and, in connection therewith, extending the date by which the Series A convertible preferred stock must be redeemed, or negotiating an extension of such date with the current Series A Preferred Holders.

If the Company is required to redeem the outstanding Series A convertible preferred stock and does not have the funds to do so, the Company will be in default of its obligations and the Series A Preferred Holders will be entitled to pursue their remedies against the Company. In addition, any unpaid redemption amount owed to the Series A Preferred Holders shall bear interest at the rate of 3% per month until paid in full.

A default by the Company in its obligations to redeem the Series A convertible preferred stock will also result in a default by the Company under the Textron Loan, which, in turn, will result in a default by the Company under the SouthTrust Loan. In the cases of the Textron Loan and the SouthTrust Loan, the lenders thereunder could exercise their respective rights under their loan documents to, among other things, declare a default under the loans, accelerate the outstanding indebtedness such that it would become immediately due and payable, and pursue foreclosure of the Company's assets which are pledged as collateral for such loans.

In such event, it is unlikely that the Company would be able to continue as a going concern. The issue related to the Series A convertible preferred stock is a key item on the agenda of the Company's Board of Directors and substantial attention is being focused on resolving this issue during fiscal 2005.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The Company leases its operating facilities and certain equipment under operating and capital leases, expiring at various dates through fiscal year 2010. In addition, the Company has several loan obligations as described in detail above. The table below summarizes the principal balances of the Company's obligations for indebtedness and lease obligations as of March 31, 2004 in accordance with their required payment terms:

Contractual Obligations	Payments due by period				
	Total	2005	2006-2007	2008-2009	Thereafter
Textron credit facility ⁽¹⁾	\$ 4,605,277	\$ 4,605,277	\$ --	\$ --	\$ --
SouthTrust Bank term loan	9,381,985	1,140,000	3,821,250	3,990,000	430,735
Series A convertible preferred stock ⁽²⁾	--	--	--	--	--
Capital Lease Obligations	436,399	231,432	183,893	21,074	--
Operating Lease Obligations	2,349,094	746,608	928,960	581,757	91,769
Total	<u>\$ 16,772,755</u>	<u>\$ 6,723,317</u>	<u>\$ 4,934,103</u>	<u>\$ 4,592,831</u>	<u>\$ 522,504</u>

(1) In accordance with EITF 95-22, "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that involve both a Subjective Acceleration Clause and a Lock-Box Arrangement," the \$4,605,277 balance owed to Textron is reflected as current on the balance sheet and in the above schedule. However, per the Textron Loan Agreement, the balance is not due until May 26, 2006.

(2) In fiscal 2006, the Company may be required to redeem the outstanding Series A convertible preferred stock on April 6, 2005 in accordance with the terms discussed above.

On May 22, 2003, the Company entered into a Master Distribution and Licensing Agreement with Fromageries Bel S.A., a leading branded cheese company in Europe who is a greater than 5% shareholder in the Company. The agreement became effective upon the closing of the Textron Loan, the new \$2 million loan from SouthTrust Bank and the private placements described above. Under the agreement, the Company has granted Fromageries Bel S.A. exclusive distribution rights for the Company's products in a territory comprised of the European Union States and to more than 21 other European countries and territories (the "Territory"). The Company has also granted Fromageries Bel S.A. the exclusive option during the term of the agreement to elect to manufacture the products designated by Fromageries Bel S.A. for distribution in the Territory. The term of the agreement is ten years, provided that either of the parties may elect to terminate the agreement by delivery of notice to the other between March 24, 2007 and May 22, 2007, which termination shall be effective as of first anniversary of the date of the notice of termination. Alternatively, the parties may mutually agree to continue operating under the agreement, to convert the agreement to a manufacturing and license agreement, or to terminate the agreement.

RISK FACTORS

In addition to the other information in this Form 10-K, the following factors should be considered carefully in evaluating the Company's business and prospects. If any of the following risks actually occur, they could seriously harm the Company's business, financial condition, results of operations or cash flows. This could cause the trading price of the Company's common stock to decline and you could lose all or part of your investment. For the purposes of this "RISK FACTORS" section, the terms "we," "us," "our" and similar terms refer to the Company.

We have an obligation to redeem our outstanding Series A Preferred Stock on April 6, 2005 and we may not have the funds to do so.

On April 6, 2005, the Series A Preferred Holders have the right to require that we redeem the outstanding shares of Series A convertible preferred stock. The redemption price is payable in cash at a price per preferred share equal to the greater of (a) 100% of the preference amount (\$48.18 plus accrued dividends) or (b) an amount equal to the aggregate market price on the date of redemption of the common stock that would be then issuable upon conversion of the Series A convertible preferred stock. The market price is based on a five-day average of the closing bid prices for the five trading days prior to the date of redemption.

As of June 25, 2004, there are 41,994 shares of Series A convertible preferred stock outstanding. Assuming that no further conversions were made and the conversion price remained at \$1.75, the redemption price of the outstanding Series A convertible preferred stock would be the greater of (a) \$2,711,116 (100% of the preference amount plus accrued dividends through April 6, 2005 - \$64.56 per share) or (b) the value of 1,549,209 shares of common stock multiplied by the market price on the date of redemption (currently estimated at \$3,364,882 using the average of the closing market price of our common stock from June 21, 2004 - June 25, 2004).

We are considering a number of alternatives related to the redemption of the Series A convertible preferred stock which, individually or in combination, could resolve the Series A redemption obligations. These alternatives include procuring the necessary funds from operating activities and existing credit facilities, or from additional equity financing, or identifying one or more investors to buy out the Series A Preferred Holders directly and, in connection therewith, extending the date by which the Series A convertible preferred stock must be redeemed, or negotiating an extension of such date with the current Series A Preferred Holders. However, there are no assurances that any of such alternatives will be viable or available to us on acceptable terms, or, even if a viable alternative is available, that we will be successful in implementing any such alternative. If we are required to redeem the outstanding Series A convertible preferred stock and do not have the funds to do so, we will be in default of our obligations and the Series A Preferred Holders will be entitled to pursue their remedies against us. In addition, any unpaid redemption amount owed to the Series A Preferred Holders shall bear interest at the rate of 3% per month until paid in full.

A default by us in our obligations to redeem the Series A convertible preferred stock will also result in our default under the Textron Loan, which, in turn, will result in a default under the SouthTrust Loan. In the cases of the Textron Loan and the SouthTrust Loan, the lenders thereunder could exercise their respective rights under their loan documents to, among other things, declare a default under the loans, accelerate the outstanding indebtedness such that it would become immediately due and payable, and pursue foreclosure of our assets, which are pledged as collateral for such loans. In such event, it is unlikely that we would be able to continue as a going concern.

We may issue securities with rights superior to those of the common stock, which could materially limit the ownership rights of existing stockholders.

We may offer debt or equity securities in private and/or public offerings in order to raise working capital and to refinance our debt. The board of directors has the right to determine the terms and rights of any debt securities and preferred stock without obtaining further approval of the stockholders. It is likely that any debt securities or preferred stock that we sell would have terms and rights superior to those of the common stock and may be convertible into common stock. Any sale of securities could adversely affect the interests or voting rights of the holders of common stock, result in substantial dilution to existing stockholders, or adversely affect the market price of our common stock.

We cannot control the timing or volume of sales of a substantial number of shares of our common stock.

As of June 25, 2004, approximately 7,000,000 shares of the 15,724,073 shares of our issued and outstanding common stock were freely tradable (unless acquired by one of our "affiliates") under the Securities Act of

1933. All of the shares which are not freely tradable are “restricted securities” within the meaning of Rule 144 promulgated by the Securities and Exchange Commission under the Securities Act, and may be sold in open market transactions after the holding period under Rule 144 with respect to such transaction has been met. As to shares subject to outstanding options and warrants, the one-year holding period generally will not begin until the shares underlying such options or warrants actually have been acquired. After the one-year holding period has been met, each holder generally may sell, every three months in brokerage transactions, an amount equal to the greater of one percent of our outstanding common stock or the amount of the average weekly trading volume during the four weeks preceding the sale. After two years, unless any such holder is one of our “affiliates,” such sales can be made without restriction.

As of June 25, 2004, 41,994 shares of our Series A convertible preferred stock were issued and outstanding. The Series A convertible preferred stock is subject to certain designations, preferences and rights set forth in our Restated Certificate of Incorporation, including the right to convert such shares into shares of common stock at any time. We registered 1,557,895 shares of our common stock to cover the number of shares required to be issued upon conversion of the Series A convertible preferred stock assuming the conversion price were to fall 50% below the conversion price on April 6, 2001.

Because the sales of registered common stock, including common stock underlying the Series A convertible preferred stock and the resale of any additional shares which may be attempted under Rule 144 may not be effected through an underwriter pursuant to a firm commitment agreement, there will be a substantial number of additional shares which may be available for sale on the market at one time without any control over the timing or volume of sales thereof by us or any third party. We cannot foresee the impact of such potential sales on the market, but it is possible that if a significant percentage of such available shares are attempted to be sold within a short period of time, the effect on the market may be negative. It is also unclear as to whether or not the market for our common stock could absorb a large number of attempted sales in a short period of time, regardless of the price at which the same might be offered. It is noted that even if a substantial number of sales does not occur within a short period of time, the mere existence of this “market overhang” could have a negative effect on the market for our common stock and our ability to raise additional capital or refinance our indebtedness.

Our Founder owns a large percentage of the outstanding shares, which could materially limit the ownership rights of existing stockholders.

As of June 25, 2004, Angelo S. Morini, our founder, beneficially owned approximately 22% of our current outstanding common stock and held options which, if exercised and assuming the exercise of no other outstanding options or warrants, would give him approximately 34% of our issued and outstanding common stock. Shareholders may be unable to elect any members of the board of directors or exercise significant control over us or our business as a result of Mr. Morini’s ownership.

Shareholders may experience further dilution.

We have a substantial number of outstanding options and warrants to acquire shares of common stock. A total of 5,985,057 shares have been reserved for issuance upon exercise of options and warrants that we have granted or may grant in the future. A total of 2,704,596 of these options and warrants are “in the money” and are currently exercisable as of June 25, 2004. “In the money” generally means that the current market price of the common stock is above the exercise price of the shares subject to the warrant or option. The issuance of common stock upon the exercise of these options and warrants could adversely affect the market price of the common stock or result in substantial dilution to our existing stockholders.

If we lose key foreign suppliers on whom we depend, we may be unable to obtain adequate supplies to manufacture our products.

Currently, we purchase our major ingredient, a milk protein called casein, from a limited number of foreign suppliers. We purchase casein from foreign suppliers because they have lower prices than domestic suppliers. However, their lower prices are generally the result of governmental export supports or subsidies.

We do not have any contractual arrangements with our principal suppliers, except for short-term agreements for periods of less than six months. Because we purchase casein from foreign suppliers, its availability is subject to a variety of factors, including federal import regulations. If the export supports or subsidies are reduced or eliminated or the United States takes retaliatory action or otherwise establishes trade barriers with any of the countries in which our casein suppliers are located, our business and results of operations would be negatively affected. Moreover, exchange rate fluctuations or the imposition of import quotas or tariffs could have an adverse effect on our business and our ability to compete with competitors that do not rely on foreign suppliers. We cannot assure you that we could obtain casein from U.S. sources if a foreign supply of casein were reduced or terminated. Even if we could obtain casein from U.S. sources, our production may be reduced during the period that it takes us to change suppliers and the prices for the casein would likely be significantly higher than we are paying now. Either event would negatively affect our business, results of operations and cash flows.

Based on current pricing trends with its suppliers, we expect to see substantial increases in our casein prices in the first half of fiscal 2005. A 5% increase in casein prices would result in an annual cost increase of approximately \$307,000 assuming the same amount of pounds purchased as in fiscal 2004. We are striving to offset these cost increases with efficiencies in production and cost savings in the purchase of other raw materials, along with substituting additional sources of protein into its products. Additionally, we plan to pass some of the cost increases down to the consumer through increases in the sales price of certain products.

Because we are dependent upon a single manufacturing facility, the loss of the facility would result in a work stoppage, which would negatively impact our business.

We manufacture all of our products at a single manufacturing facility in Orlando, Florida, and our revenues are dependent upon the continued operation of this facility. This facility is subject to a lease that expires in November 2006, unless renewed pursuant to terms mutually agreeable to our landlord and us. We do not have a backup facility or contractual arrangements with any other manufacturers in the event of a casualty to or destruction of the facility or if the facility ceases to be available to us for any other reason. If we are required to rebuild or relocate our manufacturing facility, a substantial investment in improvements and equipment would be necessary. Any rebuilding or relocation also would likely result in a significant delay or reduction in manufacturing and production capability which, in turn, could lead to substantially reduced sales and loss of market share.

Competition in our industry is intense.

Competition in our segment of the food industry is intense. We believe that as consumers become more interested in healthy food alternatives the competition in our markets will increase substantially. Our primary competition consists of equally sized companies such as Tree of Life, White Wave, Yves and Tofutti Brands that manufacture soy-based products, such as alternative cheese slices, sour creams, cream cheese and related products. In addition, we compete with major companies such as Kraft, which produces products under the Kraft Free® label, Borden's, and ConAgra, which produces products under the Healthy Choice® label. Each of these companies has substantially greater name recognition and greater research and development, marketing, financial and human resources than we have. These advantages have led to a substantially greater market penetration and product acceptance than we have developed. In addition, our competitors may succeed in developing new or enhanced products, which are better than our products. These companies may also prove to be more successful than us in marketing and selling these products. We cannot assure you that we will be able to compete successfully with any of these companies or achieve a greater market share than we currently possess. Increased competition as to any of our products or services could result in price reductions, reduced margins, and loss of market share, which could negatively affect our business, prospects, results of operations and financial condition.

Consumer eating habits and shopping trends may change and negatively impact demand for our products.

There could be downward pressure on demand for our products as consumers tastes, preferences, shopping behavior, and overall evaluation of health benefits change over time. This is demonstrated in the current year

9.6% decrease in sales which is due in part to a change in consumers' eating habits with the publicly recognized trend toward low-carbohydrate meal preparation during all meals (breakfast, lunch, snack, and dinner). This has led to decreased consumption of items such as bread and our primary complementary product of cheese slices. Additionally, the number of consumers shopping in the retail grocery and natural food stores is down due to the further national emergence and presence of Wal*Mart superstores and other similar superstores which include extensive grocery operations. Our product selection is growing but is still limited at Wal*Mart. Therefore, our sales growth with this account may not be able to fully counter the decline in retail grocery trends. In response to this change in consumer shopping, we are redesigning its products and packaging formats to specifically target growth opportunities in the superstore, warehouse club and mass merchandiser markets (such as Wal*Mart, Costco, Kmart, Target, and Sam's Club). With the growth in the aging population of U.S. consumers, there could be price pressure on our products due to the fixed income nature of this population segment.

Demand for our products could be hindered due to changing conditions within the distribution channels we sell products in.

Our sales could suffer based upon market place abnormalities such as retailer, distributor, and/or food service operator labor strikes. Further, consolidation within the industry could result in store closings, store layouts, and operating strategies that are incompatible with our product requirements.

We rely on the protection of our trademarks, and the loss of a trademark would negatively impact the products associated with the trademark, which could materially adversely affect our business.

We own several registered and unregistered trademarks, which are used in the marketing and sale of our products. We have invested a substantial amount of money in promoting our trademarked brands. However, the degree of protection that these trademarks afford us is unknown. Further, we may not have the money necessary to engage in actions to prevent infringement of our trademarks. A loss of a material trademark would negatively impact the products associated with it, and could negatively affect our business, prospects, results of operations, financial condition and cash flows.

We do not have patent protection for our formulas and processes, and a loss of ownership of any of our formulas and processes would negatively impact our business.

We believe that we own our formulas and processes. However, we have not sought, and do not intend to seek, patent protection for our formulas and processes. Instead, we rely on the complexity of our formulas and processes, trade secrecy laws, and employee confidentiality agreements. However, we cannot assure you that other companies will not acquire our confidential information or trade secrets or will not independently develop equivalent or superior products or technology and obtain patent or similar rights. Although we believe that our formulas and processes have been independently developed and do not infringe the patents or rights of others, a variety of components of our processes could infringe existing or future patents, in which event we may be required to modify our processes or obtain a license. We cannot assure you that we will be able to do so in a timely manner or upon acceptable terms and conditions and the failure to do either of the foregoing would negatively affect our business, results of operations, financial condition and cash flows.

Because we sell food products, we face the risk of exposure to product liability claims.

We, like any other seller of food, face the risk of exposure to product liability claims in the event that our quality control procedures fail and the consumption of our products causes injury or illness. With respect to product liability claims, our insurance may not continue to be available at a reasonable cost, or, if available, may not be adequate to cover liabilities. We generally seek contractual indemnification and insurance coverage from parties supplying us products, but this indemnification or insurance coverage is limited, as a practical matter, to the creditworthiness of the indemnifying party, and their carriers, if any, as well as the insured limits of any insurance provided by suppliers. If we do not have adequate insurance or contractual indemnification available, product liability claims relating to defective products could have a material adverse effect on our financial condition, results of operations and cash flows.

Government regulation could increase our costs of production and increase our legal and regulatory expenses.

We are subject to extensive regulation by federal, state, and local governmental authorities regarding the quality, purity, manufacturing, distribution, and labeling of food products. We cannot assure that you that we will be able to continue to comply with these regulations, or comply with future regulations, without inordinate cost or interruption of our operations. Failure to comply with applicable laws and regulations could subject us to civil remedies, including fines, injunctions, recalls or seizures, as well as possible criminal sanctions, which could have a material adverse effect on our business.

The low volume of trading of our shares may negatively impact the liquidity of our shares.

Although our shares are publicly traded on the American Stock Exchange, the trading market for our shares is limited. During the calendar quarter prior to June 25, 2004, the trading volume for our shares averaged 15,000 shares per trading day. We do not anticipate any material increase in the trading volume for our shares. The lack of an active trading market for our shares could negatively impact stockholders' ability to sell their shares when they desire and the price which could be obtained upon a sale of shares.

Rising interest rates could negatively affect our results of operations.

The interest rates of most of the Company's outstanding debts fluctuate based upon changes in our lenders' prime rate. Increases in the prime rate will result in an increase in our cost of funds, and could negatively affect our results of operations. The Company is anticipating future increases in interest rates during fiscal 2005. We have not entered into any derivative instruments such as interest rate swap or hedge agreements to manage our exposure to rising interest rates.

The market price of our stock could be subject to fluctuation.

The market price of our common stock could be subject to fluctuations in response to factors such as the following, some of which are beyond our control:

- quarterly variations in our operating results;
- operating results that vary from the expectations of securities analysts and investors;
- changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- announcements by us or our competitors of major business developments, such as new products, services or technologies or significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- announcements by third parties of significant claims or proceedings against us;
- future sales of our common stock;
- and general market conditions.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The Company's exposure to market risk results primarily from fluctuations in interest rates. The interest rates on the Company's outstanding debts to SouthTrust Bank and Textron are floating and based on the prevailing market interest rates. For market-based debt, interest rate changes generally do not affect the market value of the debt but do impact future interest expense and hence earnings and cash flows, assuming other factors remain unchanged. A theoretical 1% increase or decrease in market rates in effect on March 31, 2004 with respect to the Company's debt as of such date would increase or decrease interest expense and hence reduce or increase net income of the Company by approximately \$140,000 per year or \$35,000 per quarter.

The Company's sales which were denominated in a currency other than U.S. dollars during the fiscal years ended March 31, 2004, 2003 and 2002 were less than 2% of gross sales and no net assets were maintained in a functional currency other than U. S. dollars such fiscal years. Therefore, the effects of changes in foreign currency exchange rates have not historically been significant to the Company's operations or net assets.

Item 8. FINANCIAL STATEMENTS.

Report of Registered Public Accounting Firm

To the Board of Directors and Stockholders
Galaxy Nutritional Foods, Inc.
Orlando, Florida

We have audited the accompanying balance sheets of Galaxy Nutritional Foods, Inc. as of March 31, 2004 and 2003 and the related statements of operations, stockholders' equity and cash flows for each of the three years in the period ended March 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Galaxy Nutritional Foods, Inc. as of March 31, 2004 and 2003 and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO Seidman, LLP

Atlanta, Georgia
June 16, 2004

GALAXY NUTRITIONAL FOODS, INC.
Balance Sheets

	<u>Notes</u>	<u>MARCH 31, 2004</u>	<u>MARCH 31, 2003</u>
ASSETS			
CURRENT ASSETS:			
Cash		\$ 449,679	\$ 1,598
Trade receivables, net of allowance for doubtful accounts of \$633,000 and \$633,221	15	3,964,198	4,963,026
Inventories, net	2	4,632,843	5,294,500
Prepaid expenses and other	3	191,572	553,396
		<hr/>	<hr/>
Total current assets		9,238,292	10,812,520
PROPERTY AND EQUIPMENT, NET	4	20,232,089	22,168,404
OTHER ASSETS		416,706	274,918
		<hr/>	<hr/>
TOTAL		\$ 29,887,087	\$ 33,255,842
		<hr/> <hr/>	<hr/> <hr/>
LIABILITIES AND STOCKHOLDERS' EQUITY			
CURRENT LIABILITIES:			
Book overdrafts		\$ --	\$ 1,151,276
Line of credit	5	4,605,277	4,939,894
Accounts payable		1,191,617	2,622,996
Accrued liabilities		1,812,300	1,745,552
Current portion of accrued employment contract	6	366,305	--
Current portion of term notes payable	5	1,140,000	1,497,760
Current portion of subordinated note payable	5	--	2,000,000
Current portion of obligations under capital leases	6	231,432	363,152
		<hr/>	<hr/>
Total current liabilities		9,346,931	14,320,630
ACCRUED EMPLOYMENT CONTRACT , less current portion	6	1,293,142	--
TERM NOTES PAYABLE , less current portion	5	8,241,985	7,786,985
SUBORDINATED NOTE PAYABLE	5	--	2,000,000
OBLIGATIONS UNDER CAPITAL LEASES , less current portion	6	204,967	383,210
		<hr/>	<hr/>
Total liabilities		19,087,025	24,490,825
COMMITMENTS AND CONTINGENCIES	6	--	--
REDEEMABLE CONVERTIBLE PREFERRED STOCK	7	2,573,581	2,324,671
STOCKHOLDERS' EQUITY:			
Common stock, \$.01 par value, authorized 85,000,000 shares; 15,657,321 and 12,761,685 shares issued		156,573	127,617
Additional paid-in capital		64,520,084	59,800,732
Accumulated deficit		(43,557,515)	(40,595,342)
		<hr/>	<hr/>
		21,119,142	19,333,007
Less: Notes receivable arising from the exercise of stock options and sale of common stock		(12,772,200)	(12,772,200)
Treasury stock, 26,843 shares, at cost		(120,461)	(120,461)
		<hr/>	<hr/>
Total stockholders' equity		8,226,481	6,440,346
		<hr/>	<hr/>
TOTAL		\$ 29,887,087	\$ 33,255,842
		<hr/> <hr/>	<hr/> <hr/>

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
Statements of Operations

Years ended March 31,	<u>2004</u>	<u>2003</u>	<u>2002</u>
NET SALES	\$ 36,176,961	\$ 40,008,769	\$ 42,927,104
COST OF GOODS SOLD	<u>24,864,289</u>	<u>28,080,188</u>	<u>35,276,362</u>
Gross margin	<u>11,312,672</u>	<u>11,928,581</u>	<u>7,650,742</u>
OPERATING EXPENSES:			
Selling	4,981,996	4,958,272	8,573,957
Delivery	1,877,682	2,008,638	2,475,989
Non-cash compensation related to options & warrants (Note 7)	651,273	(2,906,762)	2,373,662
Employment contract expense (Note 6)	1,830,329	--	--
General and administrative	3,303,030	3,570,889	5,348,513
Research and development	260,410	232,552	261,972
Total operating expenses	<u>12,904,720</u>	<u>7,863,589</u>	<u>19,034,093</u>
INCOME (LOSS) FROM OPERATIONS	<u>(1,592,048)</u>	<u>4,064,992</u>	<u>(11,383,351)</u>
OTHER INCOME (EXPENSE):			
Interest expense	(1,361,606)	(2,923,215)	(3,594,091)
Loss on disposal of assets	(8,519)	(47,649)	(464,190)
Other expense	--	(60,000)	(57,520)
	<u>(1,370,125)</u>	<u>(3,030,864)</u>	<u>(4,115,801)</u>
INCOME (LOSS) BEFORE INCOME TAXES	(2,962,173)	1,034,128	(15,499,152)
INCOME TAX BENEFIT (EXPENSE) (Note 8)	<u>--</u>	<u>--</u>	<u>(1,560,000)</u>
NET INCOME (LOSS)	\$ (2,962,173)	\$ 1,034,128	\$ (17,059,152)
Preferred Stock Dividends (Note 7)	201,791	264,314	709,400
Preferred Stock Accretion to Redemption Value (Note 7)	<u>1,340,943</u>	<u>1,370,891</u>	<u>1,379,443</u>
NET LOSS AVAILABLE TO COMMON SHAREHOLDERS	<u>\$ (4,504,907)</u>	<u>\$ (601,077)</u>	<u>\$ (19,147,995)</u>
BASIC NET LOSS PER COMMON SHARE (Note 13)	<u>\$ (0.30)</u>	<u>\$ (0.05)</u>	<u>\$ (1.81)</u>
DILUTED NET LOSS PER COMMON SHARE (Note 13)	<u>\$ (0.30)</u>	<u>\$ (0.05)</u>	<u>\$ (1.81)</u>

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Notes Receivable for Common Stock	Treasury Stock	Total
	Shares	Par Value					
Balance at March 31, 2001	10,017,612	\$ 100,176	\$ 51,902,100	\$ (24,570,318)	\$ (12,772,200)	\$ (120,461)	\$ 14,539,297
Exercise of options	4,143	41	19,480	--	--	--	19,521
Exercise of warrants	753,625	7,537	2,252,549	--	--	--	2,260,086
Issuance of common stock under employee stock purchase plan	11,648	116	32,163	--	--	--	32,279
Issuance of common stock	753,013	7,530	3,801,282	--	--	--	3,808,812
Fair value of warrants issued	--	--	355,692	--	--	--	355,692
Non-cash compensation related to variable securities	--	--	1,960,000	--	--	--	1,960,000
Dividends on preferred stock	--	--	(350,000)	--	--	--	(350,000)
Discount on preferred stock	--	--	2,003,770	--	--	--	2,003,770
Accretion of discount on preferred stock	--	--	(1,259,122)	--	--	--	(1,259,122)
Net loss	--	--	--	(17,059,152)	--	--	(17,059,152)
Balance at March 31, 2002	11,540,041	\$ 115,400	\$ 60,717,914	\$ (41,629,470)	\$ (12,772,200)	\$ (120,461)	\$ 6,311,183
Exercise of options	1,000	10	4,240	--	--	--	4,250
Issuance of common stock under employee stock purchase plan	9,880	99	19,564	--	--	--	19,663
Issuance of common stock	585,828	5,859	2,295,269	--	--	--	2,301,128
Conversion of preferred stock	624,936	6,249	845,726	--	--	--	851,975
Fair value of warrants issued	--	--	146,000	--	--	--	146,000
Non-cash compensation related to variable securities	--	--	(3,060,000)	--	--	--	(3,060,000)
Dividends on preferred stock	--	--	(264,314)	--	--	--	(264,314)
Accretion of discount on preferred stock	--	--	(903,667)	--	--	--	(903,667)
Net income	--	--	--	1,034,128	--	--	1,034,128
Balance at March 31, 2003	12,761,685	127,617	59,800,732	(40,595,342)	(12,772,200)	(120,461)	6,440,346
Exercise of options	7,911	79	16,138	--	--	--	16,217
Exercise of warrants	200,000	2,000	358,000	--	--	--	360,000
Issuance of common stock under employee stock purchase plan	16,339	163	28,364	--	--	--	28,527
Issuance of common stock	2,211,478	22,115	3,929,242	--	--	--	3,951,357
Conversion of preferred stock	459,908	4,599	794,921	--	--	--	799,520
Fair value of warrants and employee options issued	--	--	685,308	--	--	--	685,308
Non-cash compensation related to variable securities	--	--	8,001	--	--	--	8,001
Dividends on preferred stock	--	--	(201,791)	--	--	--	(201,791)
Accretion of discount on preferred stock	--	--	(898,831)	--	--	--	(898,831)
Net income	--	--	--	(2,962,173)	--	--	(2,962,173)
Balance at March 31, 2004	15,657,321	\$ 156,573	\$ 64,520,084	\$ (43,557,515)	\$ (12,772,200)	\$ (120,461)	\$ 8,226,481

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
Statements of Cash Flows

Years Ended March 31,	2004	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES: (Note 12)			
Net Income (Loss)	\$ (2,962,173)	\$ 1,034,128	\$ (17,059,152)
Adjustments to reconcile net income (loss) to net cash from (used in) operating activities:			
Depreciation and amortization	2,205,053	2,273,349	2,362,900
Amortization of debt discount and financing costs	236,321	1,264,273	1,069,522
Deferred tax expense (benefit)	--	--	1,560,000
Provision for losses on trade receivables	(221)	(177,245)	1,058,335
Non-cash compensation related to options and warrants (Note 7)	651,273	(2,906,762)	2,373,662
Loss on disposal of assets	8,519	47,649	464,190
(Increase) decrease in:			
Trade receivables	999,049	364,907	1,844,538
Inventories	661,657	454,152	5,025,888
Prepaid expenses and other	194,248	2,124	1,260,490
Increase (decrease) in:			
Accounts payable	(1,431,379)	(1,589,514)	(4,056,922)
Accrued liabilities	1,674,003	408,814	368,060
NET CASH FROM (USED IN) OPERATING ACTIVITIES	2,236,350	1,175,875	(3,728,489)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of property and equipment	(221,585)	(214,003)	(140,277)
(Increase) decrease in other assets	(10,193)	113,977	1,801
NET CASH FROM (USED IN) INVESTING ACTIVITIES	(231,778)	(100,026)	(138,476)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Increase (decrease) in book overdrafts	(1,151,276)	(41,580)	746,027
Net borrowings (payments) on line of credit	(334,617)	(583,981)	(3,252,403)
Borrowings on term notes payable	2,000,000	500,000	330,000
Repayments on term notes payable	(1,572,760)	(1,763,265)	(1,409,964)
Repayments on subordinated note payable	(4,000,000)	--	(815,000)
Financing costs for long term debt	(288,230)	(239,539)	(25,000)
Principal payments on capital lease obligations	(365,635)	(431,937)	(539,399)
Proceeds from exercise of common stock options	16,217	4,250	19,521
Proceeds from exercise of common stock warrants, net of costs	360,000	--	2,070,801
Proceeds from issuance of common stock under employee stock purchase plan	28,527	19,663	32,279
Proceeds from issuance of common stock, net of offering costs	3,751,283	1,461,970	3,808,812
Proceeds from issuance of preferred stock, net of costs	--	--	2,900,959
NET CASH FROM (USED IN) FINANCING ACTIVITIES	(1,556,491)	(1,074,419)	3,866,633
NET INCREASE (DECREASE) IN CASH	448,081	1,430	(332)
CASH, BEGINNING OF YEAR	1,598	168	500
CASH, END OF YEAR	\$ 449,679	\$ 1,598	\$ 168

See accompanying notes to financial statements.

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS

(1) **Summary of Significant Accounting Policies**

Business

Galaxy Nutritional Foods, Inc. (the “Company”) is principally engaged in the development, manufacturing and marketing of a variety of healthy cheese and dairy related products, as well as other cheese alternatives. These healthy cheese and dairy related products include low, reduced or no fat, low or no cholesterol and lactose-free varieties. These products are sold throughout the United States and internationally to customers in the retail, food service and industrial markets. The Company’s headquarters and manufacturing facilities are located in Orlando, Florida.

Accounts Receivable

Accounts receivable are customer obligations due under normal trade terms. The Company evaluates the collectibility of its accounts receivable on a combination of factors. In circumstances where it is aware of a specific customer’s inability to meet its financial obligations, it records a specific allowance to reduce the amounts recorded to what it believes will be collected. In addition to reserving for potential uncollectible accounts, the Company uses its allowance for trade receivables account to estimate future credits that will be issued to customers for items such as rebates, sales promotions, coupons, and spoils that relate to current period sales. The Company also records these additional reserves for potential uncollectible amounts and future credits based on certain percentages, which are determined based on historical experience and its assessment of the general financial conditions affecting its customer base. After all attempts to collect a receivable have been exhausted and failed, the receivable is written off against the allowance.

Inventories

Inventories are valued at the lower of cost (weighted average, which approximates FIFO) or market.

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed over the estimated useful lives of the assets by the straight-line method for financial reporting and by accelerated methods for income tax purposes. Capital leases are recorded at the lower of fair market value or the present value of future minimum lease payments. Assets under capital leases are amortized by the straight-line method over their useful lives.

Revenue Recognition

Sales are recognized upon shipment of products to customers. The Company offers a right of return policy to certain retail customers in the conventional grocery stores and mass merchandising industry. If the product is not sold during its shelf life, the Company will allow a credit for the unsold merchandise. Since the shelf life of the Company’s products range from 6 months to one year, the Company historically averages less than 2% in credits for unsold product. The Company’s reserve on accounts receivable takes these potential future credits into consideration. Certain expenses such as slotting fees, rebates, coupons and other discounts are accounted for as a reduction to Revenues.

Shipping and Handling Costs

The Company accounts for certain shipping and handling costs related to the acquisition of goods from its vendors as Cost of Goods Sold. However, shipping and handling costs related to the shipment of goods to its customers is classified as Delivery expense.

Stock Based Compensation

The Company accounts for its stock-based employee compensation plans under the accounting provisions of Accounting Principles Board Opinion No. 25, “*Accounting for Stock Issued to Employees*”, furnishes the pro forma disclosures required under Statement of Financial Accounting Standards (“SFAS”) No. 123, “*Accounting for Stock-Based Compensation*”, and applies SFAS No. 148, “*Accounting for Stock-Based Compensation – Transition and Disclosure*” on a prospective basis for options granted after March 31, 2003.

In December 2002, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 148, “*Accounting for Stock Based Compensation—Transition and Disclosure—an Amendment to SFAS 123.*” SFAS 148 provides two

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
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additional transition methods for entities that adopt the preferable method of accounting for stock based compensation. Further, the statement requires disclosure of comparable information for all companies regardless of whether, when, or how an entity adopts the preferable, fair value based method of accounting. Effective April 1, 2003, the Company adopted the fair value method of recording compensation expense related to all stock options granted after March 31, 2003, in accordance with SFAS 123 and SFAS 148 (the prospective method, as defined by SFAS 148). Accordingly, the fair value of stock options as determined on the date of grant using the Black-Scholes option-pricing model, will be expensed over the vesting period of the related stock options. The negative impact on diluted earnings per share related to the issuance of employee stock options in fiscal 2004 was approximately \$0.03.

SFAS No. 123, "Accounting for Stock Based Compensation", requires the Company to provide pro-forma information regarding net income (loss) and earnings (loss) per share amounts as if compensation cost for the Company's employee and director stock options had been determined in accordance with the fair market value-based method prescribed in SFAS No. 123. The Company estimates the fair value of each stock option at the grant date by using a Black-Scholes option-pricing model. The following assumptions were used for options issued during the periods:

Year Ended	<u>March 31, 2004</u>	<u>March 31, 2003</u>	<u>March 31, 2002</u>
Dividend Yield	None	None	None
Volatility	41% to 45%	37% to 44%	38%
Risk Free Interest Rate	2.01% to 4.28%	1.71% to 5.03%	4.75%
Expected Lives in Months	36 to 120	60 to 120	120

Under the accounting provisions of SFAS No. 123, the Company's net income (loss) and net income (loss) per basic and diluted share would have been reduced to the pro forma amounts indicated below:

Year Ended	<u>March 31, 2004</u>	<u>March 31, 2003</u>	<u>March 31, 2002</u>
Net income (loss) available to common shareholders as reported	\$ (4,504,907)	\$ (601,077)	\$ (19,147,995)
Add: Stock-based compensation expense included in reported net income	651,273	(2,906,762)	2,373,662
Deduct: Stock-based compensation expense determined under fair value based method for all awards	<u>(1,070,997)</u>	<u>(3,728,592)</u>	<u>(2,918,802)</u>
Pro forma net income (loss) available to common shareholders	<u>\$ (4,924,631)</u>	<u>\$ (7,236,431)</u>	<u>\$ (19,693,135)</u>
Net income (loss) per common share:			
Basic – as reported	<u>\$ (0.30)</u>	<u>\$ (0.05)</u>	<u>\$ (1.81)</u>
Basic – pro forma	<u>\$ (0.33)</u>	<u>\$ (0.60)</u>	<u>\$ (1.87)</u>
Diluted – as reported	<u>\$ (0.30)</u>	<u>\$ (0.05)</u>	<u>\$ (1.81)</u>
Diluted – pro forma	<u>\$ (0.33)</u>	<u>\$ (0.60)</u>	<u>\$ (1.87)</u>

Income Taxes

Deferred income taxes are recognized for the tax consequences of temporary differences between the financial reporting bases and the tax bases of the Company's assets and liabilities in accordance with SFAS No. 109. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities.

Net Income (Loss) per Common Share

Net income (loss) per common share is computed by dividing net income or loss by the weighted average shares outstanding. Diluted income (loss) per common share is computed on the basis of weighted average shares

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
(Continued)

outstanding plus potential common shares which would arise from the exercise of stock options, warrants and conversion of the Series A convertible preferred stock.

Financial Instruments

Statement of Financial Accounting Standards No. 107, “*Disclosures about Fair Value of Financial Instruments*,” requires disclosure of fair value information about financial instruments. Fair value estimates discussed herein are based upon certain market assumptions and pertinent information available to management as of March 31, 2004.

The respective carrying value of certain on-balance-sheet financial instruments approximated their fair values. These financial instruments include cash, trade receivables, book overdrafts, accounts payable and accrued liabilities. Fair values were assumed to approximate carrying values for these financial instruments since they are short term in nature and their carrying amounts approximate fair values or they are receivable or payable on demand. The fair value of the Company’s long-term debt, subordinated debt, and capital leases is estimated based upon the quoted market prices for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities.

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 financial statements and reported amounts of revenues and expense during the reporting period. The Company’s significant estimates include the allowance for doubtful accounts receivable, which is made up of reserves for promotions, discounts and bad debts, provision for inventory obsolescence, valuation of deferred taxes, and valuation of stock options and warrants. Actual results could differ from those estimates.

Segment Information

The Company does not identify separate operating segments for management reporting purposes. The results of operations are the basis on which management evaluates operations and makes business decisions. The Company’s sales are generated primarily within the United States of America.

Reclassifications

Certain items in the financial statements of prior periods have been reclassified to conform to current period presentation.

Recent Accounting Pronouncements

In May 2003, the FASB issued SFAS No. 150, “*Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.” The Statement establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. Many of such instruments were previously classified as equity. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatory redeemable financial instruments of nonpublic entities. On November 7, 2003, the FASB deferred the classification and measurement provisions of SFAS No. 150 as they apply to certain mandatorily redeemable non-controlling interests. This deferral is expected to remain in effect while these provisions are further evaluated by the FASB. The application of the requirements of SFAS 150 did not have any impact on the Company’s financial position or result of operations as the Company’s Series A convertible preferred stock is not mandatorily redeemable.

In December 2003, the FASB issued a revised FASB Interpretation No. 46, “*Consolidation of Variable Interest Entities*”(FIN 46R), which clarifies how a business enterprise should evaluate whether it has a controlling interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN46R replaces FASB Interpretation No. 46, “*Consolidation of Variable Interest Entities*” which was issued in January

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
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2003. The application of the requirements of FIN 46R did not have any impact on the Company's financial position or result of operations as the Company does not have any variable interests in variable interest entities.

(2) **Inventories**

Inventories are summarized as follows:

	<u>March 31, 2004</u>	<u>March 31, 2003</u>
Raw materials	\$ 1,786,586	\$ 2,216,558
Finished goods	<u>2,846,257</u>	<u>3,077,942</u>
Total	<u>\$ 4,632,843</u>	<u>\$ 5,294,500</u>

(3) **Prepaid Expenses and Other**

Prepaid expenses are summarized as follows:

	<u>March 31, 2004</u>	<u>March 31, 2003</u>
Employee advances	\$ 10,195	\$ 231,918
Prepaid commissions	47,322	110,416
Prepaid insurance	49,786	70,888
Other	<u>84,269</u>	<u>140,174</u>
Total	<u>\$ 191,572</u>	<u>\$ 553,396</u>

The Company expenses the production costs of advertising the first time the advertising takes place. During fiscal 2001, the Company changed its accounting policy with regards to slotting fees and direct response advertising costs to expense these costs as incurred.

Advertising expense was approximately \$910,000, \$224,000, and \$762,000 during fiscal 2004, 2003, and 2002, respectively.

(4) **Property and Equipment**

Property and equipment are summarized as follows:

	<u>Useful Lives</u>	<u>March 31, 2004</u>	<u>March 31, 2003</u>
Leasehold improvements	10-25 years	\$ 3,215,596	\$ 3,187,596
Machinery and equipment	5-20 years	27,112,809	27,049,817
Equipment under capital leases	7-15 years	1,808,810	1,753,138
Construction in progress		<u>112,649</u>	<u>--</u>
		32,249,864	31,990,551
Less accumulated depreciation and amortization		<u>12,017,775</u>	<u>9,822,147</u>
Property and equipment, net		<u>\$20,232,089</u>	<u>\$22,168,404</u>

(5) **Line of Credit and Notes Payable**

Effective May 30, 2003, the Company obtained from Textron Financial Corporation ("Textron") a revolving credit facility (the "Textron Loan") in the maximum principal amount of \$7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 (the "Loan Agreement"). The Textron Loan replaced the Company's asset-based credit facility with FINOVA Capital Corporation on May 30, 2003, which had an outstanding principal balance of \$4,254,667 at the time of replacement. The Textron Loan is secured by the Company's inventory, accounts receivable and all other assets. Generally, subject to the maximum principal amount, which can be borrowed under the Textron Loan and certain reserves that must be maintained during the term of the Textron Loan, the amount available under the Textron Loan for borrowing by the Company from time to time is equal to the sum of (i) eighty-five percent (85%) of the net amount of its eligible accounts receivable

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
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plus (ii) sixty percent (60%) of the Company's eligible inventory not to exceed \$3,500,000. Advances under the Textron Loan bear interest at a variable rate, adjusted on the first (1st) day of each month, equal to the prime rate plus one and three-quarter percent (1.75%) per annum (5.75% at March 31, 2004) calculated on the average cash borrowings for the preceding month. The Textron Loan matures and all amounts are due and payable in full on May 26, 2006. However, in accordance with EITF 95-22, "*Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that involve both a Subjective Acceleration Clause and a Lock-Box Arrangement*," the balance is reflected as current on the balance sheet. As of March 31, 2004, the outstanding principal balance on the Textron Loan was \$4,605,277.

The Textron Loan described above contains certain financial and operating covenants. In August 2003, the Company notified Textron that it had failed to comply with the fixed charge coverage ratio in June 2003. Pursuant to a certain Waiver Letter dated August 13, 2003, Textron agreed to waive the requirement to meet the fixed charge coverage ratio for each monthly period through September 30, 2003. Additionally, Textron agreed that after August 13, 2003, all of the financial covenants required of the Company under Section 7.6 of the Loan Agreement would be measured and tested on a quarterly rather than monthly basis. Due to the \$1.8 million charge to operations related to the Amended and Restated Employment Agreement for Angelo Morini (See Note 6), the Company fell below the requirement for the adjusted tangible net worth and the fixed charge coverage ratio covenants for the quarter ended December 31, 2003. Pursuant to a Second Amendment to the Loan Agreement dated June 25, 2004, which is effective as of December 31, 2003, Textron changed the definitions on the covenants to exclude accrued but unpaid costs related to the above mentioned Employment Agreement. Based on the revised definitions, the Company was in compliance with all covenants under the Loan Agreement for the quarter ended December 31, 2003 and year ended March 31, 2004. The Company anticipates that it will be in compliance with these ratios, as amended, through the remainder of the loan period.

On September 30, 1999, the Company obtained a \$4 million subordinated loan from FINOVA Mezzanine to finance additional working capital and capital improvement needs. This loan was paid in full as of May 30, 2003 by the proceeds from a new loan from SouthTrust Bank, as discussed below, and from the equity proceeds raised in the private placements in May 2003, as discussed in Note 7. In accordance with a warrant agreement dated September 30, 1999, the exercise price on 200,000 warrants still held by FINOVA Mezzanine on May 30, 2003, was reduced from \$3.41 to \$1.80 per share based on the sales price of the Company's common stock in May 2003. FINOVA Mezzanine exercised these warrants to purchase 200,000 shares of the Company's common stock on June 2, 2003. The Company received net proceeds of \$119,000 after a deduction of \$241,000 due to FINOVA Capital Corporation for waiver fees pursuant to a certain Amendment and Limited Waiver to Security Agreement dated June 26, 2002.

Simultaneous with the closing of the Textron Loan in May 2003, SouthTrust Bank extended the Company a new term loan in the principal amount of \$2,000,000. This loan was consolidated with the Company's March 2000 term loan with SouthTrust Bank, which had a then outstanding principal balance of \$8,131,985 for a total term loan amount of \$10,131,985. The revised term loan bears interest at SouthTrust Bank's prime rate of interest plus 1% (5% at March 31, 2004), and is due in increasing principal installments by June 2009. Each month, the Company will pay the accrued interest on the loan plus principal amounts as follows: \$75,000 from May 2004 to June 2004, \$110,000 from July 2004 to June 2005, and \$166,250 from July 2005 until maturity in June 2009. This note is secured by all of the Company's equipment and certain related assets. The proceeds of the new term loan, together with the proceeds from certain sales of the Company's common stock conducted in May 2003 (as discussed in Note 7), were used to repay the Company's \$4,000,000 mezzanine loan from FINOVA Mezzanine. The balance outstanding on the new term loan as of March 31, 2004 was \$9,381,985.

The SouthTrust term loan described above contains certain financial and operating covenants. Due to the \$1.8 million charge to operations related to the Amended and Restated Employment Agreement for Angelo Morini, the Company fell below the requirement for the tangible net worth covenant for the quarter ended December 31, 2003. Pursuant to a Loan Modification letter dated May 21, 2004, SouthTrust changed the definitions in its loan covenants to exclude accrued but unpaid costs related to the above mentioned Employment Agreement. Additionally, SouthTrust waived the Company's need to comply with the Maximum Funded Debt to EBITDA ratio for the year ended March 31, 2004. Based on the revised definitions and the waiver, the Company was in

GALAXY NUTRITIONAL FOODS, INC.
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compliance with all covenants under the Loan Agreement for the quarter ended December 31, 2003 and the year ended March 31, 2004. The Company anticipates that it will be in compliance with these ratios, as amended, through the remainder of the loan period. Additionally, the Loan Modification letter dated May 21, 2004 established a pricing matrix which will tie the interest rate charged on the term loan to the Company's performance related to its funded debt to EBITDA ratio. Beginning October 1, 2004, the interest rate may be adjusted quarterly depending on the Company's ratio at the end of the prior quarter. Interest will be assessed in the range of prime to prime plus 1.25% according to the Company's performance. SouthTrust charged a fee of \$50,000 to make the all of the above modifications to the term loan. The Company's management believes that it will be able to offset a substantial portion of this fee in future periods by securing lower interest rates related to improved ratios. The fee is payable in four installments between June and December 2004.

In October 2000, the Company obtained a \$1.5 million bridge loan from SouthTrust Bank, which was guaranteed by Angelo S. Morini, the Company's founder, and secured by the pledge of one million shares of the Company's common stock owned by him. Interest on this note was at the prime rate. The loan was paid in full in February 2004 and the collateral shares were returned to the Company.

In March 2002, Angelo S. Morini, the Company's founder, loaned \$330,000 to the Company in order for it to pay down certain notes payable that were coming due. This loan bore interest at the prime rate and was due on or before June 15, 2006. In connection with a Second Amended and Restated Employment Agreement effective October 13, 2003 between Mr. Morini and the Company, the Company offset \$167,603 of unreimbursed advances owed to it by Mr. Morini and certain family members against the balance of the loan and issued an aggregate of 55,087 shares of the Company's common stock (valued at approximately \$2.95 per share) as payment in full.

On August 15, 2002, the Company executed and delivered to Target Container, Inc. a \$347,475 promissory note in satisfaction of its accounts payable obligation to this vendor. This note bore interest at 7% per annum and was due in twelve equal monthly installments of \$30,066. This note was paid in full by September 30, 2003.

On June 26, 2002, the Company signed a \$550,000 promissory note with Excalibur Limited Partnership, one of the holders of the Company's Series A convertible preferred stock. In consideration of the note, the Company issued Excalibur Limited Partnership a warrant to purchase 30,000 shares of the Company's common stock, which are exercisable until June 26, 2007 at a price equal to \$5.50 per share. This note was non-interest bearing assuming that it was repaid on or before July 26, 2002. This note was secured by 250,000 shares of the Company's common stock owned by the Angelo S. Morini, the Company's Founder. In consideration of his pledge, the Company granted Mr. Morini stock options to acquire 289,940 shares of common stock at an exercise price of \$5.17 (110% of market) per share. These options expire on July 1, 2007. On June 26, 2002, the Company received loan proceeds in the amount of \$500,000 in cash from Excalibur Limited Partnership. The additional \$50,000 was retained by Excalibur Limited Partnership as payment for consulting fees due to Excalibur Limited Partnership in accordance with a consulting agreement entered into on June 26, 2002, which expired December 31, 2002. This note was paid in full on June 28, 2002 from proceeds derived from the issuance of common stock to Stonestreet Limited Partnership as discussed in Note 7.

Aggregate maturities of the SouthTrust term loan payable over future years are as follows: 2005 - \$1,140,000; 2006 - \$1,826,250; 2007 - \$1,995,000; 2008 - \$1,995,000; 2009 - \$1,995,000; and 2010 - \$430,735

(6) **Commitments and Contingencies**

Leases

The Company leases its operating facilities and certain equipment under operating and capital leases, expiring at various dates through its fiscal year 2009. The following is a schedule by years as of March 31, 2004, of (1) future minimum lease payments under capital leases, together with the present value of the net minimum lease payments and (2) future minimum rental payments required under operating leases that have initial or remaining terms in excess of one year:

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	Capital Leases	Operating Leases
2005	\$ 239,772	\$ 746,608
2006	175,720	570,763
2007	12,211	358,197
2008	12,211	309,023
2009	9,646	272,734
2010	--	91,769
Total net minimum lease payments	449,560	\$2,349,094
Less amount representing interest	13,161	
Present value of the net minimum lease payments	436,399	
Less current portion	(231,432)	
Long-term obligations under capital leases	\$ 204,967	

The total capitalized cost for equipment under capital lease is \$1,808,810 with accumulated depreciation of \$634,383 as of March 31, 2004.

Rental expense was approximately, \$1,088,000 \$1,190,000, and \$1,102,000 for the fiscal years ended March 31, 2004, 2003, 2002, respectively.

Employment Agreements

In a Second Amended and Restated Employment Agreement effective October 13, 2003, Angelo S. Morini the Company's Founder, Vice-Chairman and President resigned from his positions with the Company as Vice Chairman and President and will no longer be involved in the daily operations of the Company. He will retain the title of Founder and has been named Chairman Emeritus. Mr. Morini will continue as an employee and as a member of the Company's Board of Directors. Additionally, he may carry out special assignments designated to him by the Chairman of the Board. The agreement is for a five-year period beginning October 13, 2003 and provides for an annual base salary of \$300,000 plus standard health insurance benefits, club dues and an auto allowance. Other material provisions of the agreement are as follows:

1. For the term of Mr. Morini's employment, the Company shall cause Mr. Morini to be nominated for election to the Company's Board of Directors as a member of the slate of directors proposed by the Company in its proxy statement for any meeting of the Company's stockholders whereby directors shall be elected. Notwithstanding the foregoing, in the event Mr. Morini is not elected to the Board of Directors by the stockholders at any meeting of the Company's stockholders for which the proxy statement indicates Mr. Morini is nominated for election as a member of the slate of directors proposed by the Company, such obligations shall immediately cease.
2. The Company will obtain, and maintain in effect during the term of Mr. Morini's employment, for the benefit of Mr. Morini (or reimburse Mr. Morini for the cost of) a Two Million Dollar (\$2,000,000) term life insurance policy insuring Mr. Morini's life, the beneficiaries of which shall be designated by Mr. Morini.
3. Mr. Morini and the Company agreed that Mr. Morini and certain family members received advances from the Company of which \$167,603 was unreimbursed as of October 13, 2003, and (ii) the Company owed \$330,000 to Mr. Morini pursuant to a loan on March 28, 2002 to the Company. Mr. Morini and the Company agreed to offset the unreimbursed advances against the amounts owed by the Company, and, in repayment of the remainder of the amounts owed by the Company, the Company issued an aggregate of 55,087 shares of the Company's common stock to Mr. Morini (valued at approximately \$2.95 per share based on the average of the closing prices for the five trading days preceding the effective date of the Agreement).

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4. Mr. Morini has agreed that during the term of his employment, and for a period of one (1) year following his termination of employment for any reason other than pursuant to termination without cause, a material breach of the agreement, or a change of control (as defined in the agreement) in the Company for which he did not vote, he will not, directly or indirectly, either as an employee, employer, consultant, agent, principal, partner, stockholder (other than owning fewer than one percent (1%) of the outstanding shares of a public corporation), corporate officer, director, or any other individual or representative capacity, engage or participate in any business that directly competes with the Company within those areas in the United States in which the Company is doing business as of the date of termination.

5. If the agreement is terminated by the Company without cause, Mr. Morini shall: (a) be entitled to continued payment of his annual compensation, health insurance benefits, club dues, auto allowance and life insurance benefits for the remainder of the term of the agreement, (b) become fully "vested" under the terms of any stock option agreements executed and delivered prior to, along with, or after the agreement and (c) be released from the terms of the \$12,772,200 Loan Agreement dated June 15, 1999 and all monies outstanding thereunder will be forgiven by the Company. The provisions of the agreement related to the forgiveness of the \$12,772,200 loan remain unchanged from the first Amended and Restated Employment Agreement. Mr. Morini acknowledges that his change in role does not constitute a termination of Mr. Morini by the Company, under the First Amended and Restated Employment Agreement.

6. If Mr. Morini terminates his employment in any manner other than in connection with a material breach of the agreement by the Company, he shall not be entitled to receive any further compensation or benefits, except that if he terminates his employment in connection with a change of control (as defined in the Agreement) in the Company for which he did not vote, he will be released from the terms of the \$12,772,200 Loan Agreement dated June 15, 1999 and all monies outstanding thereunder will be forgiven by the Company. The provisions of the Agreement related to the forgiveness of the \$12,772,200 loan remain unchanged from the first Amended and Restated Employment Agreement.

The Company accrued and expensed the five-year cost of this agreement in the quarter ended December 31, 2003. The total estimated costs expensed under this agreement are \$1,830,329 of which \$1,659,447 remained unpaid but accrued (\$366,305 as short-term liabilities and \$1,293,142 as long-term liabilities) as of March 31, 2004. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

The Company currently has employment agreements with several of its key employees that provide for up to five-year severance in the event they are terminated without cause.

Litigation

On May 17, 2002, Schreiber Foods, Inc. of Green Bay, Wisconsin, filed a lawsuit against the Company in the federal district court for the Eastern District of Wisconsin ("Wisconsin lawsuit"), being Case No. 02-C-0498, alleging various acts of patent infringement. The Complaint alleged that the Company's machines for wrapping of individual cheese slices, manufactured by Kustner Industries, S.A. of Switzerland, known as models KE and KD, and the Company's machines for producing individually wrapped slices manufactured by Hart Design Mfg., Inc. of Green Bay, Wisconsin, infringe certain claims of U.S. Patents Nos. 5,112,632, 5,440,860, 5,701,724 and 6,085,680. Schreiber Foods was seeking a preliminary and permanent injunction prohibiting the Company from further infringing acts and was also seeking damages in the nature of either lost profits or reasonable royalties.

On May 6, 2004, Schreiber Foods and the Company executed a settlement agreement pursuant to which all claims in the patent infringement lawsuit were dismissed. Pursuant to this settlement agreement, the Company procured a worldwide, fully paid-up, nonexclusive license to own and use all of the Company's individually wrapped slice equipment, which Schreiber alleged infringed on Schreiber's patents. The Company was not obligated to make any cash payment in connection with the settlement of the lawsuit or the license granted in the settlement agreement. The settlement agreement restricts the Company from using the slicing equipment to co-pack product for certain specified manufacturers, however, the Company is not currently engaged in any co-packing business with any of the specified parties, and does not contemplate engaging in the future in any co-packing business with the specified parties.

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Pursuant to the settlement agreement, if, during the term of the license, the Company receives an offer to purchase the Company or its business, the Company must notify Schreiber of the offer and Schreiber will have the option to match the offer or make a better offer to purchase the Company or its business. Acceptance of the Schreiber offer is subject to the approval by the Company's Board of Directors, however, if the Board of Directors determines that the Schreiber offer is equal to or better than the other offer, the Board of Directors must take all permitted actions to accept the offer and recommend it to the Company's shareholders for approval.

The term of the license extends through the life of all patents named in the lawsuit (and all related patents) and is assignable by the Company in connection with the sale of its business. In the event the assignee uses the applicable equipment to manufacture private label product, and such private label product accounts for more than 50% of the total product manufactured on the applicable equipment, the assignee will be required to pay Schreiber a royalty in an amount to be agreed upon by Schreiber and the assignee, but in any event not more than \$.20 per pound of product for each pound of private label product manufactured by the assignee in any year that exceeds the amount of private label product manufactured by the Company in the year preceding the sale of the Company or its business. In the event that the parties cannot agree upon a royalty rate, the assignee retains the license rights but private label production must be maintained at a level less than 50% of the total product manufactured on the applicable equipment.

(7) **Capital Stock**

Employee Stock Purchase Plan

In January 1992, the Company's stockholders approved the 1991 Employee Stock Purchase Plan (the "1991 Purchase Plan"). The 1991 Purchase Plan provides for the sale of up to an aggregate of 85,714 shares of common stock to eligible employees. Up to 500 shares may be purchased by each eligible employee at the lesser of 85% of the fair market value of the shares on the first or last business day of the six-month purchase periods ending August 31 and February 28. Substantially all full-time employees are eligible to participate in the plan. During the year ended March 31, 2004, 16,339 shares were issued under this plan at prices of \$1.49 and \$1.96 per share. During the year ended March 31, 2003, 9,880 shares were issued under this plan at prices of \$1.55 and \$2.80 per share. During the year ended March 31, 2002, 11,648 shares were issued under this plan at prices of \$4.63 and \$4.80 per share. The weighted average fair value of the shares issued were \$1.75, \$1.99, and \$4.78 per share for the fiscal years ended March 31, 2004, 2003 and 2002, respectively. As of March 31, 2004, there were 29,795 shares available for purchase under the Plan.

Stock Warrants

At March 31, 2004, the Company had common stock warrants outstanding, which were issued in connection with sales consulting, financial consulting, and financing arrangements. Information relating to these warrants is summarized as follows:

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Expiration Date	Number of Warrants	Exercise Price
September 2004	7,500	\$ 4.25
August 2005	7,143	2.05
December 2005	81,500	3.90
January 2006	33,571	2.05
April 2006	100,000	1.70
July 2006	500,000	2.00
July 2006	10,000	5.00
January 2007	42,592	5.74
June 2007	30,000	2.05
June 2007	122,549	5.52
May 2008	50,000	2.05
August 2008	1,429	2.05
January 2009	1,429	2.05
June 2009	100,000	1.97
June 2009	153,000	2.05
June 2012	2,143	2.05
	<u>1,242,856</u>	

On April 10, 2003, the Company entered into a credit arrangement with one of its greater than 5% shareholders pursuant to which the shareholder purchased raw materials for the Company in an aggregate amount that did not exceed \$500,000. In consideration of the credit arrangement, the Company issued to the shareholder a warrant to purchase 100,000 shares of the Company's common stock at an exercise price of \$1.70. This warrant is exercisable until April 10, 2006. The fair value of this warrant was estimated at \$63,000 and was recorded as non-cash compensation expense in the quarter ended June 30, 2003.

On April 24, 2003, the Company and the Series A Preferred Holders entered into a Stock Purchase Option Agreement, whereby the Company was granted the option to purchase all of the shares of the Series A convertible preferred stock owned by such holders. The option expired on September 30, 2003. Pursuant to such Agreement, the holders of the Series A convertible preferred stock also agreed to extend the Company's required date to hold a shareholders meeting, pursuant to an exercised right under the Series A Purchase Agreement as discussed under "Series A Convertible Preferred Stock" below, from February 5, 2003 to September 30, 2003. In exchange for the option and the extension of the annual meeting date, the Company issued warrants to purchase 250,000 shares of the Company's common stock to each BH Capital Investments, L.P. and Excalibur Limited Partnership. These warrants are exercisable until July 15, 2006 at an exercise price equal to \$2.00 per share. The fair value of these warrants was estimated at \$230,000 and was recorded as non-cash compensation expense in the quarter ended June 30, 2003.

In connection with the consolidations and extensions of the SouthTrust Bank loans as described in Note 5, the Company issued a warrant to purchase 100,000 shares of the Company's common stock to SouthTrust Bank on May 29, 2003. The warrant is exercisable until June 1, 2009 at an exercise price of \$1.97 per share. The fair value of this warrant was estimated at \$101,000 and will be amortized as non-cash compensation over 72 months beginning in May 2003.

Stock Options

At March 31, 2004, the Company has three employee stock option plans, which were adopted in 1987, 1991, and 1996 and has granted additional non-plan stock options. Under the Company's stock option plans, qualified and nonqualified stock options to purchase up to 200,500 shares of the Company's common stock may be granted to employees and members of the Board of Directors. The maximum and typical term of options granted under the plans is ten years. Generally, options vest from zero to three years.

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The following table summarizes information about plan stock option activity:

	Shares	Weighted-Average Exercise Price per Share	Weighted-Average Fair Value of Options Granted
Balance, March 31, 2001	133,684	\$ 4.60	--
Granted – at market	6,858	5.52	\$3.19
Exercised	(4,143)	4.71	--
Cancelled	(32,855)	5.00	--
Balance, March 31, 2002	103,544	4.54	--
Granted – at market	25,858	4.37	\$2.51
Exercised	(1,000)	4.25	--
Cancelled	(23,096)	2.43	--
Balance, March 31, 2003	105,306	2.66	--
Granted – at market	914	2.90	\$1.65
Exercised	(7,911)	2.05	--
Cancelled	(2,948)	4.96	--
Balance, March 31, 2004	95,361	\$ 2.64	--

At March 31, 2004, 2003 and 2002, a total of 82,027, 85,306, and 84,955 of the outstanding plan options were exercisable with a weighted-average exercise price of \$2.74, \$2.80, and \$4.69 per share, respectively.

The following table summarizes information about non-plan stock option activity:

	Shares	Weighted-Average Exercise Price per Share	Weighted-Average Fair Value of Options Granted
Balance, March 31, 2001	1,887,983	\$ 3.66	--
Granted – at market	830,000	4.54	\$2.63
Cancelled	(12,143)	6.59	--
Balance, March 31, 2002	2,705,840	3.93	--
Granted – at market	3,907,041	3.51	\$1.72
Cancelled	(2,066,041)	2.06	--
Balance, March 31, 2003	4,546,840	3.17	--
Granted – at market	400,000	2.73	\$0.77
Cancelled	(300,000)	2.24	--
Balance, March 31, 2004	4,646,840	\$ 3.19	--

At March 31, 2004, 2003, and 2002, a total of 4,452,006, 4,002,507, and 2,068,340 of the outstanding non-plan options were exercisable with a weighted-average exercise price of \$3.16, \$3.19, and \$3.73 per share, respectively.

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The following table summarizes information about plan and non-plan stock options outstanding and exercisable at March 31, 2004:

Range of Exercise Prices	Options Outstanding	Weighted- Average Remaining Life	Weighted- Average Exercise Price	Options Exercisable	Weighted- Average Remaining Life	Weighted- Average Exercise Price
\$1.60 – 1.99	132,143	8.7 years	\$ 1.79	132,143	8.7 years	\$ 1.79
2.00 – 2.99	1,676,726	4.7 years	2.11	1,618,558	4.5 years	2.11
3.00 – 3.99	1,921,198	5.4 years	3.41	1,921,198	5.4 years	3.41
4.00 – 4.99	576,716	5.9 years	4.29	426,716	5.5 years	4.25
5.00 – 5.99	432,797	3.3 years	5.20	432,797	3.3 years	5.20
6.00 – 19.25	2,621	3.6 years	10.17	2,621	3.6 years	10.17
	<u>4,742,201</u>			<u>4,534,033</u>		

Reserved

At March 31, 2004, the Company has reserved common stock for future issuance under all of the above arrangements totaling 5,985,057 shares.

Non-Cash Compensation Related to Options and Warrants

There Company calculates non-cash compensation related to its securities on three primary items:

a. Notes Receivable for Common Stock

The Financial Accounting Standards Board issued Interpretation No. 44 (“FIN 44”), which clarifies the application of APB Opinion 25 relating to the accounting consequences of various modifications to fixed stock options. FIN 44 covers specific events that occurred after December 15, 1998 and was effective as of July 2, 2000. FIN 44 clarified that when an option is repriced, it is treated as a variable option and is marked to market each quarter. Accordingly, any increase in the market price of the Company’s common stock over the exercise price of the options that was not previously recorded is recorded as compensation expense at each reporting period. If there is a decrease in the market price of the Company’s common stock compared to the prior reporting period, the reduction is recorded as compensation income. Compensation income is limited to the original base exercise price (the “Floor”) of the options. In accordance with FIN 44, the underlying shares related to the \$12,772,200 note receivable from the Company’s founder, Angelo S. Morini, as disclosed in Note 9, are treated as variable due to the nature of the note being non-interest bearing and non-recourse. The Floor for the underlying shares is \$4.38 per share. There was no non-cash compensation expense or income related to these shares recorded during the fiscal year ended March 31, 2004 as the price of the Company’s common stock at the beginning and end of the period was below the Floor. The Company recorded non-cash compensation income of \$3,060,000 for the year ended March 31, 2003 based on the decrease in the market price of the Company’s common stock from \$5.43 at March 31, 2002 to \$1.87 at March 31, 2003. The Company did not record any further non-cash compensation income once the stock price fell below the Floor of \$4.38. The Company recorded non-cash compensation expense of \$1,960,000 for the year ended March 31, 2002, based on the increase in the market price of the Company’s common stock from the Floor of \$4.38 to \$5.43 at March 31, 2002.

b. Option and Warrant Repricing

On October 11, 2002, the Company repriced all outstanding options granted to employees prior to October 11, 2002 (4,284,108 shares at former prices ranging from \$2.84 to \$10.28) to the market price of \$2.05 per share. In addition, the Company repriced the outstanding warrants held by current consultants as of October 11, 2002 (291,429 shares at former prices ranging from \$3.31 to \$5.50) to the market price of \$2.05 per share. This stock option repricing resulted in variable accounting treatment (as discussed under Notes Receivable for Common Stock above) for these stock options beginning with the quarter ended December 31, 2002 and such variable accounting treatment will continue until the related options have been cancelled, expired or exercised.

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On December 4, 2002, as a result of discussions and negotiations with certain major shareholders, the Company's founder, Angelo S. Morini, agreed to reverse the repricing of his 3,692,035 options for the purpose of improving shareholder value and lessening potential financial statement expense. Although the exercise prices of the options were reversed back to their original amounts, the Company is still required to account for any outstanding options related to these reversed-repriced options in accordance with variable accounting standards each period.

The Company recorded non-cash compensation expense of \$8,001 related to these variable options and warrants for the year ended March 31, 2004. There was no compensation expense recorded for the year ended March 31, 2003, as the market price of the Company's stock was less than the \$2.05 Floor. The remaining outstanding variable options and warrants as of March 31, 2004 were 3,882,092.

c. Option and Warrant Issuances

During the fiscal years ended March 31, 2004, 2003, and 2002, the Company recorded \$643,272, \$153,238, and \$413,662, respectively, as non-cash compensation expense related to stock, options and warrants that were issued to and vested by employees, officers, directors and consultants. This expense is included in non-cash compensation in the Company's Statements of Operations.

Series A Convertible Preferred Stock

On April 6, 2001, the Company received from BH Capital Investments, L.P. and Excalibur Limited Partnership (the "Series A Preferred Holders") proceeds of approximately \$3,082,000 less costs of \$181,041 for the issuance of 72,646 shares of the Company's Series A convertible preferred stock with a face value of \$3,500,000 and warrants to purchase shares of the Company's common stock. The shares are subject to certain designations, preferences and rights including the right to convert such shares into shares of common stock at any time. The per share conversion price is equal to the quotient of \$48.18, plus all accrued and unpaid dividends for each share of the Series A convertible preferred stock, (\$60.71 at March 31, 2004), divided by the lower of (x) \$1.75 or (y) 95% of the average of the two lowest closing bid prices of the Company's common stock on the American Stock Exchange ("AMEX") out of the fifteen trading days immediately prior to conversion.

The Series A Preferred Holders have the right to require the Company to redeem their shares of preferred stock on April 6, 2005 or upon occurrence of other events, as defined. The redemption price shall be paid in cash at a price per preferred share equal to the greater of (a) 100% of the preference amount (\$48.18 plus accrued dividends) or (b) an amount equal to the aggregate market price on the date of redemption of the common stock that would be then issuable upon conversion of the preferred stock and multiplied by the market price on the date of redemption. The market price is based on a five-day average of the closing bid prices for the five trading days prior to the date of redemption. Should there be no additional conversions on the Series A convertible preferred stock before April 6, 2005, the Company may be required to redeem the shares at a minimum price in excess of \$2.7 million.

The Series A Preferred Holders converted 13,490 and 15,262 shares of the Series A convertible preferred stock plus accrued dividends, into 459,908 and 624,936 shares of common stock, respectively, during the years ended March 31, 2004 and 2003, respectively. The conversion prices ranged from \$1.3633 to \$1.75 and were based on the lower of (a) 95% of the average of the two lowest closing bid prices on the AMEX for the fifteen trading days immediately prior to conversion or (b) \$1.75.

The Series A Preferred Holders have the right to receive on any outstanding Series A convertible preferred stock a ten percent dividend on the shares, payable one year after the issuance of such preferred stock, and an eight percent dividend for the subsequent three years thereafter, payable in either cash or shares of preferred stock. For the years ended March 31, 2004, 2003 and 2002, the Company recorded preferred dividends of \$201,791, \$264,314, and \$709,400, respectively, on the outstanding shares of the Series A convertible preferred stock.

On April 6, 2001, the Company recorded the initial carrying value of the preferred stock as \$521,848. Each quarter the Company calculates an estimated redemption value of the remaining preferred stock and then calculates the difference between the initial carrying value and this estimated redemption value. The difference is then accreted over the redemption period (48 months beginning April 2001) using the straight-line method, which

GALAXY NUTRITIONAL FOODS, INC.
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approximates the effective interest method. For the years ended March 31, 2004, 2003 and 2002, the Company recorded \$1,340,943, \$1,370,891, and \$1,379,443, respectively, related to the accretion of the redemption value of preferred stock and the beneficial conversion feature of accrued dividends. As of March 31, 2004, the value of the remaining 43,894 shares of redeemable convertible preferred stock is \$2,573,581.

On November 7, 2002, the Series A Preferred Holders exercised their right under the Series A Purchase Agreement to require the Company to solicit the approval of its shareholders for the Company's issuance of all of the shares of common stock potentially issuable upon conversion of the Series A convertible preferred stock and the exercise of their warrants. On September 30, 2003, the Company's shareholders, by majority vote, approved the issuance by the Company of all required common stock in the event of a conversion of the Company's Series A Convertible Preferred Stock and upon the exercise of certain warrants held by the Series A Preferred Holders.

Common Stock Issuances

In October 2003, pursuant to an employment contract, the Company issued 17,500 shares of its common stock with a total value of \$37,650 to a former employee for his services from January 2003 to July 2003.

In March 2002, Angelo S. Morini, the Company's founder, loaned \$330,000 to the Company in order for it to pay down certain notes payable that were coming due. This loan bore interest at the prime rate and was due on or before June 15, 2006. In connection with a Second Amended and Restated Employment Agreement effective October 13, 2003 between Mr. Morini and the Company, the Company offset \$167,603 of unreimbursed advances owed to it by Mr. Morini and certain family members against the balance of the loan and issued an aggregate of 55,087 shares of the Company's common stock (valued at approximately \$2.95 per share) as payment in full.

Pursuant to seven Securities Purchase Agreements dated May 21, 2003, the Company issued a total of 2,138,891 shares of its common stock at a price per share equal to \$1.80 for aggregate gross proceeds to the Company of \$3,850,000. Sales to related parties under the Securities Purchase Agreements include: 555,556 shares of common stock sold at an aggregate sales price of \$1,000,000 to Frederick DeLuca, a greater than 5% shareholder; 55,556 shares of common stock sold at an aggregate sales price of \$100,000 to David H. Lipka, a Director of the Company; 83,333 and 55,556 shares of common stock sold at an aggregate sales price of \$150,000 and \$100,000, respectively, to Ruggieri of Windermere Family Limited Partnership and Ruggieri Financial Pension Plan, respectively, each an affiliate of John Ruggieri, the Company's former Vice President of Manufacturing; 1,111,112 shares of common stock sold at an aggregate sales price of \$2,000,000 to Fromageries Bel S.A., a leading branded cheese company in Europe which signed a Master Distribution and Licensing Agreement effective May 22, 2003 with the Company. Sales to non-related parties under the Securities Purchase Agreements include: 138,889 shares of common stock sold at an aggregate sales price of \$250,000 Apollo Capital Management Group; and 138,889 shares of common stock sold at an aggregate sales price of \$250,000 Apollo MicroCap Partners, L.P.

The Company used \$2,000,000 of the proceeds generated from these May 2003 private placements to pay down the balance of the Company's mezzanine loan from FINOVA Mezzanine Capital, Inc. The Company then applied the additional proceeds from the new loan from SouthTrust Bank, as discussed in Note 5, to pay the remaining \$2,000,000 on the FINOVA Mezzanine loan. The Company utilized the remainder of the private placement proceeds for working capital and general corporate purposes.

In accordance with Section 4(2) of the Securities Act of 1933, as amended, and pursuant to a Securities Purchase Agreement dated August 27, 2002, the Company issued 65,404 shares of common stock for \$4.08 per share in settlement of an outstanding payable to Hart Design and Manufacturing, Inc. in the amount of \$266,848.

In accordance with Regulation D and pursuant to a certain common stock and Warrants Purchase Agreement dated June 28, 2002, the Company sold 367,647 shares of common stock on June 28, 2002 for \$4.08 (85% of an average market price) and issued warrants to purchase 122,549 shares of common stock at a price equal to \$5.52 per share to Stonestreet Limited Partnership. In connection with such sale, the Company issued 7,812 shares of common stock to Stonestreet Corporation and 4,687 shares of common stock to H&H Securities Limited in exchange for their services as finders. Per the terms of the agreement, the Company received net proceeds of \$930,000, after the

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
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repayment of a \$550,000 promissory note dated June 26, 2002 in favor of Excalibur Limited Partnership and payment of \$20,000 for Stonestreet Limited Partnership's costs and expenses related to the purchase of these shares of common stock.

In accordance with Section 4(2) of the Securities Act of 1933, as amended, and pursuant to a Food Service Brokerage Agreement dated June 25, 2002, the Company issued 140,273 shares of common stock for \$4.08 per share on September 9, 2002 to certain food brokers in consideration for prior services rendered valued at \$572,310.

(8) **Income Taxes**

The components of the net deferred tax assets consist of the following:

March 31,	2004	2003
Deferred tax assets:		
Net operating loss carry forwards	\$14,207,000	\$13,391,000
Non-deductible reserves	198,000	401,000
Investment, alternative minimum and general business tax credits	86,000	139,000
Accrued employment contract	596,000	--
Other	635,000	442,000
Gross deferred income tax assets	15,722,000	14,373,000
Valuation allowance	(11,816,000)	(11,029,000)
Total deferred income tax assets	3,906,000	3,344,000
Deferred income tax liabilities:		
Depreciation and amortization	(3,906,000)	(3,344,000)
Net deferred income tax assets	--	--
Less current portion	--	--
Long-term deferred income tax asset	--	--

The valuation allowance increased by \$787,000, \$1,037,000, and \$6,451,000 for the years ended March 31, 2004, 2003, and 2002, respectively. The Company has recorded a valuation allowance to state its deferred tax assets at estimated net realizable value due to the uncertainty related to realization of these assets through future taxable income.

Significant components of income tax (expense) benefit are as follows:

Years ended March 31,	2004		2003		2002	
Current:						
Federal	\$	--	\$	--	\$	--
State		--		--		--
Deferred:						
Federal		--		--		(1,353,900)
State		--		--		(206,100)
		--		--		(1,560,000)
	\$	--	\$	--	\$	(1,560,000)

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
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Tax expense for the year ended March 31, 2000 for the Company's liability for alternative minimum tax was \$110,669. The alternative minimum tax system limits the amount of alternative minimum NOL carry forward that can be applied against current year alternative minimum income, thus creating alternative minimum taxable income. Alternative minimum tax paid is carried forward as a tax credit to offset federal tax if incurred in the future. This credit does not expire.

The following summary reconciles differences from taxes at the federal statutory rate with the effective rate:

Years ended March 31,	2004	2003	2002
Federal income taxes at statutory rates	(34.0%)	(34.0%)	(34.0%)
Change in deferred tax asset valuation allowance	26.6%	(93.4%)	41.8%
Alternative minimum tax	--	--	--
Non deductible expenses:			
Non deductible compensation	--	93.7%	4.3%
Imputed interest on note receivable	7.0%	(18.8%)	1.5%
Other	0.4%	52.5%	(3.5%)
Utilization of net operating loss carry forward	--	--	--
Income taxes (benefit) at effective rates	--	--	10.1%

Unused net operating losses for income tax purposes, expiring in various amounts from 2008 through 2024, of approximately \$37,800,000 are available at March 31, 2004 for carry forward against future years' taxable income. Under Section 382 of the Internal Revenue Code, the annual utilization of this loss may be limited in the event there are changes in ownership.

(9) **Related Party Transactions**

Additional Morini Transactions

On October 24, 2002, the Company entered into a special services agreement with Angelo S. Morini, authorizing him to author and promote "Veggiesizing, the stealth/health diet" book, which promotes the Company's products. In consideration of these services and for his continued personal pledges, the Company granted him 900,000 shares at the market price of \$2.05 on October 24, 2002. On December 4, 2002, as a result of discussions and negotiations with certain major shareholders, Mr. Morini cancelled these options with the Company and accepted new options to acquire 510,060 shares of common stock – 200,000 options were granted at an exercise price of \$4.08 per share and 310,060 were granted at an exercise price of \$2.05 per share. These options expire on December 4, 2007. As a result of the cancellation and reissuance of options, the Company will account for these options in accordance with variable accounting standards.

On July 1, 2002, in consideration of his pledge of 250,000 shares of the Company's common stock to secure a \$550,000 promissory note by the Company in favor of Excalibur Limited Partnership (See Note 5), the Company granted Mr. Morini stock options to acquire 289,940 shares of common stock at an exercise price of \$5.17 (110% of market) per share. These options expire on July 1, 2007.

In June 1999, in connection with an amended and restated employment agreement for Angelo S. Morini, the Company's Founder, the Company consolidated two full recourse notes receivable (\$1,200,000 from November 1994 and \$11,572,200 from October 1995) related to the exercise of 2,914,286 shares of the Company's common stock into a single note receivable in the amount of \$12,772,200 that is due on June 15, 2006. This new consolidated note is non-interest bearing and non-recourse and is secured by the 2,914,286 shares of the Company's common stock. Per the June 1999 employment agreement and the October 2003 Second Amended and Restated Employment Agreement, this loan may be forgiven upon the occurrence of any of the following events: 1) Mr. Morini is terminated without cause; 2) there is a material breach in the terms of Mr. Morini's employment agreement; or 3) there is a change in control of the Company for which Mr. Morini did not vote "FOR" in his capacity as a director or a shareholder.

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
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In October 2000, the Company obtained a \$1.5 million bridge loan from SouthTrust Bank (as discussed in Note 5), which was guaranteed by Angelo S. Morini and secured by one million of his above mentioned 2,914,286 shares of the Company's common stock. These one million shares were returned to the Company when the loan was paid in full during February 2004.

Other Related Party Transactions

Beginning January 13, 2003, the Company entered into a vendor arrangement with one of its employees pursuant to which the employee purchased raw materials for the Company approximating \$500,000. The amounts paid for the purchased materials, plus interest at the rate of 15% per annum on such amounts, was due and paid in full by May 31, 2003.

On April 10, 2003, the Company entered into a credit arrangement with one of its greater than 5% shareholders pursuant to which the shareholder purchased raw materials for the Company in an aggregate amount that did not exceed \$500,000. The amounts paid for the purchased materials, plus interest at the rate of 15% per annum on such amounts, was due and payable in full on July 9, 2003. In consideration of the credit arrangement, the Company issued to the shareholder a warrant to purchase 100,000 shares of the Company's common stock at an exercise price of \$1.70. The fair value of this warrant was estimated at \$63,000 and was recorded as non-cash compensation expense in the quarter ended June 30, 2003. All amounts owed under the credit arrangement were repaid in full and such credit arrangement was terminated on June 27, 2003.

On May 22, 2003, the Company entered into a Master Distribution and Licensing Agreement with Fromageries Bel S.A. ("Bel"), a leading branded cheese company in Europe who is a greater than 5% shareholder in the Company. The agreement became effective upon the closing of the Textron Loan, the new \$2 million loan from SouthTrust Bank and the private placements described above. Under the agreement, the Company has granted Bel exclusive distribution rights for the Company's products in a territory comprised of the European Union States and to more than 21 other European countries and territories (the "Territory"). The Company has also granted Bel the exclusive option during the term of the agreement to elect to manufacture the products designated by Bel for distribution in the Territory. The term of the agreement is ten years, provided that either of the parties may elect to terminate the agreement by delivery of notice to the other between March 24, 2007 and May 22, 2007, which termination shall be effective as of first anniversary of the date of the notice of termination. Alternatively, the parties may mutually agree to continue operating under the agreement, to convert the agreement to a manufacturing and license agreement, or to terminate the agreement.

A director of the Company was paid consulting fees totaling \$32,300, \$77,520, and \$79,600 for introductions into several large foodservice companies during the fiscal years ended March 31, 2004, 2003, and 2002, respectively. Another director of the Company was paid \$59,000 for his consulting services on marketing issues.

(10) Economic Dependence

For the fiscal years ended March 31, 2004, 2003 and 2002, the Company did not have any customer that comprised more than 10% of net sales.

For the fiscal year ended March 31, 2004, the Company did not have any supplier that comprised more than 10% of raw material purchases. For the fiscal year ended March 31, 2003, the Company purchased approximately \$2,238,990 from one supplier totaling approximately 13% of raw material purchases for the fiscal year. For the fiscal year ended March 31, 2002, the Company purchased approximately \$3,374,000 from one supplier totaling approximately 19% of raw material purchases for the fiscal year.

(11) Employee Benefit Plan

The Company has a 401(k) defined contribution plan covering all employees meeting certain minimum age and service requirements. The Company's contributions to the plan are determined by the Board of Directors and are limited to a maximum of 50% of the employee's contribution and 6% of the employee's compensation. Company contributions to the plan amounted to \$35,807, \$21,820, and \$38,911 for the fiscal years ended March 31, 2004, 2003 and 2002, respectively.

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
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(12) **Supplemental Cash Flow Information**

Years ended March 31,	2004	2003	2002
Non-cash financing and investing activities:			
Purchase of equipment through capital lease obligations and term notes payable	\$ 55,672	\$ 94,763	\$1,564,355
Amortization of consulting and directors fees paid through issuance of common stock warrants	643,272	153,238	413,662
Reduction in accounts payable through issuance of notes payable	--	347,475	--
Reduction in accounts payable through issuance of common stock	37,650	839,158	--
Reduction in notes payable through issuance of common stock	162,424	--	--
Preferred dividends recorded for preferred shareholder waiver received in exchange for issuance of common stock	--	--	359,400
Accrued preferred stock dividends	201,791	264,314	350,000
Beneficial conversion feature related to preferred stock dividends	84,923	62,035	120,321
Accretion of discount on preferred stock	1,256,020	1,308,856	1,259,122
Discount related to preferred stock	--	--	2,003,770
Cash paid for:			
Interest (expensed and capitalized)	1,396,419	2,349,002	3,579,953
Income taxes	--	51,037	--

(13) **Earnings Per Share**

The following is a reconciliation of basic net earnings (loss) per share to diluted net earnings (loss) per share:

Years ended March 31,	2004	2003	2002
Net loss available to common shareholders	<u>\$ (4,504,907)</u>	<u>\$ (601,077)</u>	<u>\$ (19,147,995)</u>
Weighted average shares outstanding – basic	14,937,005	12,110,349	10,556,203
“In-the-money” shares under stock option agreements	--	--	--
“In-the-money” shares under stock warrant agreements	--	--	--
Less: Shares assumed repurchased under treasury stock method	--	--	--
Weighted average shares outstanding – diluted	<u>14,937,005</u>	<u>12,110,349</u>	<u>10,556,203</u>
Basic net loss per common share	<u>\$ (0.30)</u>	<u>\$ (0.05)</u>	<u>\$ (1.81)</u>
Diluted net loss per common share	<u>\$ (0.30)</u>	<u>\$ (0.05)</u>	<u>\$ (1.81)</u>

Potential conversion of the Series A convertible preferred stock for 1,522,658 shares, options for 4,742,201 shares and warrants for 1,242,856 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2004 as their effects were antidilutive. Potential conversion of the Series A convertible preferred stock for 2,013,831 shares, options for 4,652,146 shares and warrants for 742,856 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2003 as their effects were antidilutive. Potential conversion of the Series A convertible preferred

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NOTES TO FINANCIAL STATEMENTS
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stock for 769,034 shares, options for 2,809,384 shares and warrants for 490,878 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2002 as their effects were antidilutive.

(14) **Fourth Quarter Adjustments**

There were no significant or unusual adjustments in the fourth quarter of fiscal 2004 and 2003.

During the fourth quarter of fiscal 2002, the Company recorded the following adjustments:

Credits and reserves issued on accounts receivable	\$3,474,242
Deferred tax valuation reserve	1,560,000
Inventory write-offs	581,201
Write-off of unused advertising credits	547,386
Disposal of fixed assets	464,190

Due to the nature of the above adjustments, it is impractical to apply their effects to prior quarters.

(15) **Schedule of Valuation Account**

	Balance at Beginning of Year	Charged to Costs and Expenses	Write-Offs, Retirements and Collections	Balance at End of Year
<hr/>				
Year Ended March 31, 2002:				
Allowance for trade receivables	\$375,000	\$6,364,871	(\$5,929,405)	\$810,466
Year Ended March 31, 2003:				
Allowance for trade receivables	\$810,466	\$2,159,891	(\$2,337,136)	\$633,221
Year Ended March 31, 2004:				
Allowance for trade receivables	\$633,221	2,433,458	(\$2,433,679)	\$633,000

In addition to reserving for potential uncollectible accounts, the Company uses its allowance for trade receivables account to estimate future credits that will be issued to customers for items such as discounts, rebates, sales promotions, coupons, slotting fees and spoils that relate to current period sales. For the years ended March 31, 2004, 2003 and 2002, the Company recorded an expense of \$59,908, \$127,389 and \$925,836, respectively related to bad debt. For the years ended March 31, 2004 and 2003, this amounted to less than 0.5% of gross sales and for the year ended March 31, 2002 it was approximately 2% of gross sales.

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS
(Continued)

(16) **Quarterly Operating Results (Unaudited)**

Unaudited quarterly operating results are summarized as follows:

	Three Months Ended (Unaudited)			
<u>2004</u>	<u>March 31</u>	<u>December 31</u>	<u>September 30</u>	<u>June 30</u>
Net sales	\$ 8,512,702	\$ 9,638,571	\$ 9,329,907	\$ 8,695,781
Gross margin	2,745,256	2,922,821	2,999,930	2,644,665
Net income (loss)	614,430	(1,378,354)	(228,145)	(1,970,104)
Net income (loss) for common shareholders	906,277	(1,557,986)	(933,385)	(2,919,813)
Basic net income (loss) per common share	0.06	(0.10)	(0.06)	(0.21)
Diluted net income (loss) per common share	0.06	(0.10)	(0.06)	(0.21)
Stockholders' equity	8,226,481	7,497,656	8,404,579	9,191,983
	Three Months Ended (Unaudited)			
<u>2003</u>	<u>March 31</u>	<u>December 31</u>	<u>September 30</u>	<u>June 30</u>
Net sales	\$ 10,213,005	\$ 9,755,729	\$ 10,062,331	\$ 9,977,704
Gross margin	3,222,414	2,949,866	3,015,101	2,741,200
Net income (loss)	(241,059)	(476,568)	732,245	1,019,510
Net income (loss) for common shareholders	70,755	(1,823,610)	541,545	610,233
Basic net income (loss) per common share	0.01	(0.15)	0.05	0.05
Diluted net income (loss) per common share	0.01	(0.15)	0.04	0.05
Stockholders' equity	6,440,346	6,470,626	7,111,328	7,062,553

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

Not Applicable.

Item 9A. CONTROLS AND PROCEDURES.

As of March 31, 2004, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO"), and the Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures to insure that the Company records, processes, summarizes and reports in a timely and effective manner the information required to be disclosed in reports filed with or submitted to the Securities and Exchange Commission. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective in timely bringing to their attention material information related to the Company required to be included in the Company's periodic Securities and Exchange Commission filings. Since the date of this evaluation, there have been no significant changes in the Company's internal controls or in other factors that could significantly affect those controls.

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth the current directors and executive officers of the Company as of June 25, 2004, as well as their respective ages and positions with the Company:

Name	Age	Positions
David H. Lipka	74	Director, Chairman of the Board of Directors
Michael E. Broll ⁽¹⁾	55	Director
Thomas R. Dyckman ⁽¹⁾⁽²⁾	72	Director, Chairman of the Audit Committee
Charles L. Jarvie ⁽²⁾	67	Director, Chairman of the Compensation Committee
Joseph J. Juliano ⁽²⁾	53	Director
Angelo S. Morini	61	Director
Christopher J. New	43	Director and Chief Executive Officer
Patrice M.A. Videlier ⁽¹⁾	61	Director
Salvatore J. Furnari	39	Chief Financial Officer
John W. Jackson	46	Vice President of Sales
Christopher E. Morini	48	Vice President of New Business Development and Key Accounts
Thomas J. Perno	49	Vice President of Operations
Kulbir Sabharwal	61	Vice President of Technical Services

(1) Audit Committee Member

(2) Compensation Committee Member

The Board of Directors is currently comprised of the eight directors, including the Chairman of the Board, of which six are non-employee directors. The Chairman of the Board and the directors hold office until the next annual meeting of stockholders and until their successors have been duly elected and qualified. The executive officers of the Company are elected annually at the first Board of Directors meeting following the annual

meeting of shareholders, and hold office until their respective successors are duly elected and qualified, unless sooner displaced.

Directors

David H. Lipka spent forty years (1955-1995) with DCA Food Industries Inc., an international manufacturer of food ingredients and equipment with combined sales in excess of \$1 billion per annum, holding positions of president, chief executive officer, and chief operating officer. Since 2001, Mr. Lipka has served on the board of directors of Doctor's Associates Inc. (Subway Stores) and has served on numerous boards including Dunkin Donuts Inc. (1989-1994), Allied-Lyons Inc. (1988-1994), and Kerry Group PLC (1995-1996). Mr. Lipka has also been chairman and chief executive officer of Pennant Foods and Leons Baking Company. He obtained a B.S. degree from Brooklyn College and attended the Graduate School of Business at New York University. Mr. Lipka has agreed to serve as a director of the Company at the request of Frederick A. DeLuca, a beneficial owner of more than five percent (5%) of the Company's common stock. Both Messrs. Lipka and DeLuca are members of the Board of Directors of Doctor's Associates Inc.

Michael E. Broll is a private investor and consultant in the food industry, and most recently was President and CEO, from 1999 to 2002, of Chef Solutions Inc., a subsidiary of LSG Lufthansa, a business specializing in providing convenient baked foods and prepared meals to food service and retail segments of the food industry. Mr. Broll's career includes major executive assignments with Allied-Domecq Retailing as the head of its total supply chain for North America from 1997 to 1999, Nestle USA as the head of all supply chains for the chilled food group in North America from 1993 to 1995, and Pillsbury Company as its Vice President of Operations for the bakery group supply chain from 1991 to 1993. Mr. Broll received his BS in Economics from the University of Illinois in 1978.

Thomas R. Dyckman is currently the Ann Whitney Olin Professor of Accounting at the S.C. Johnson Graduate School of Management at Cornell University, Ithaca, New York, and has been a professor at Cornell University since 1964. Mr. Dyckman also served as Acting Vice President of the University for Information Technology (1998-1999) at Cornell University. He has conducted management executive programs for Goodyear, IBM, Gould Pump, New England Telephone, Ocean Spray, Columbia University, G.T.E. and Sylvania. Mr. Dyckman served as a consultant on research issues to the Financial Accounting Standards Board (FASB) from 1977 to 1988. During the mid 1990's he was acting dean of the S.C. Johnson Graduate School of Management at Cornell University. He is a member of the American Accounting Association and the Accounting Researchers International Association, and completed terms with the Financial Accounting Standards Advisory Committee (1984-1987) and the Financial Accounting Foundation (1989-1993). Mr. Dyckman has more than sixty published articles and is the author of ten books. He received his B.A., M.B.A. and Ph.D. from the University of Michigan.

Charles L. Jarvie, a partner with Beta Capital Group, LLC, has had an illustrious business career. After twenty years with the Procter and Gamble Company (1959-1979), he was president of Dr. Pepper Company (1980-1983), and Fidelity Investments Marketing Corp. (1983-1984), and Chief Executive Officer of Schenley Industries, Inc. (1984-1988). He has also served as a director of Guinness America, Inc. (1988-1992), chief executive officer of New Era Beverage Company (1990-1992), chairman of Universal Sports America (1995-2000), president of Host Communications, Inc. (1992-2000), chairman of Streetball Partners, Inc. (1990-2000) and chairman of J/P Management Associates, Inc. (1990-present). His accomplishments include the acquisition of Canada Dry Corporation, and the sale of Schenley Industries, Host Communications and New Era Beverage Company. Mr. Jarvie has helped generate and implement and still enforces strategic plans for many successful turnarounds. Mr. Jarvie has numerous civic and business associations serving as a director or member of many prestigious organizations and companies. He is a graduate of Cornell University where he received both his B.S. and M.B.A.

Joseph J. Juliano was elected to the Board of Directors on June 16, 1999. From 1973 to 1988, Mr. Juliano served in various management positions for Pepsi-Cola Company. In 1988, Mr. Juliano managed Pepsi Cola Company Bottling Operations where he achieved record sales and profits during his three-year tenure in this position. From 1991 to 1998, he served as Vice President of Prestige, Sports and Gaming for Pepsi Cola North America. In 1998, he was promoted to Vice President of Entertainment Sales, with expanded domestic and international account responsibilities encompassing movie theaters, theme parks, sports venues, golf management companies, theme restaurants, hotels, and casinos. Mr. Juliano currently serves on the board of Nevada Gold & Casinos, Inc, a developer of gaming properties. Mr. Juliano received his B.S. in marketing and Masters in Business Administration from St. John's University in New York City.

Angelo S. Morini was the Founder and inventor of the Company's healthier dairy alternative formula and was President of the Company since its inception until October 2003.. In December 2002, he was elected as the Vice-Chairman of the Board of Directors and President. On December 17, 2002, Mr. Morini resigned from his positions as Chief Executive Officer and Chairman of the Board. Effective October 13, 2003, Angelo S. Morini the Company's Founder, Vice-Chairman and President resigned from his positions with the Company as Vice-Chairman and President and will no longer be involved in the daily operations of the Company. He will retain the title of Founder and has been named Chairman Emeritus. From 1987 to December 2002, he served as Chairman of the Board of Directors, President, and Chief Executive Officer. Between 1972 and 1980, Mr. Morini was the general manager of Galaxy Cheese Company, which operated as a sole proprietorship until its incorporation in May 1980. Prior to 1974, he was associated with the Food Service Division of Pillsbury Company and the Post Division of General Foods Company. In addition, he worked in Morini Markets, his family-owned and operated chain of retail grocery stores in the New Castle, Pennsylvania area. Mr. Morini received a B.S. degree in Business Administration from Youngstown State University in 1968. Mr. Morini's brother, Christopher E. Morini, works for the Company as Vice President of New Business Development and Key Accounts. Prior to November 2003, Angelo S. Morini's wife, Julie Morini, was employed by the Company in the marketing and public relations departments. Mr. Morini's brother, Ronald Morini, worked for the Company until October 31, 2003 as an engineering consultant and was paid \$61,310 in consulting fees and benefits during the fiscal year ended March 31, 2004.

Christopher J. New was appointed the Company's Chief Marketing Officer and Vice President of Strategy on September 4, 2001. On December 14, 2001, the Board appointed Mr. New as Chief Operating Officer and on December 17, 2002 the Board appointed him as Chief Executive Officer. From 1993 through 2001, Mr. New was the Vice President of Commercial Strategies & Services for Tropicana Products of Bradenton, Florida. At Tropicana, Mr. New's responsibilities included direction and leadership of strategic planning, marketing, business development, sales planning, e-commerce, customer service and category management. Prior to his employment at Tropicana, Mr. New served as Senior Marketing Manager of Mott's USA, a division of Cadbury Schweppes, for four years. Mr. New received his M.S. in marketing and economics from Cornell University in 1986.

Patrice M.A. Videlier currently serves as Senior Vice President of Marketing - World for Fromageries Bel S.A. a company organized under the laws of France. Mr. Videlier has held numerous Sales and Marketing vice presidential positions over divisions such as the Natural Cheese Division, the European Division, and the International Worldwide Division; and he has served as a director for Fromageries Bel S.A. since 1990. From 1969 to 1989, Mr. Videlier was a senior marketing executive with Unilever Co. Mr. Videlier received his Masters in Business Administration from Indiana University. Mr. Videlier has agreed to serve as a director of the Company at the request of Fromageries Bel S.A., a beneficial owner of more than five percent (5%) of the Company's common stock. Mr. Videlier received his Masters in Business Administration from Indiana University in 1968.

Executive Officers

Salvatore J. Furnari, CPA was appointed the Company's Chief Financial Officer on July 8, 2002. From November 11, 2001 until July 8, 2002, Mr. Furnari served as the Company's Controller. Prior to joining the Company, Mr. Furnari was Corporate Controller and Treasurer of Pritchard Industries, Inc. From 1998 through 1999, he served as Chief Financial Officer and Vice President of Finance for Garage Management Corporation; and from 1993 until 1998, he was Chief Financial Officer of American Asset Corporation. Mr. Furnari received his B.S. in accounting from Queens College in New York City in May 1987.

John W. Jackson has been Vice President of Sales for the Company since 1993. From 1985 through 1992, Mr. Jackson was director of sales for H.J. Heinz Company. Mr. Jackson received his B.S. in business administration and accounting from Mars Hill College in 1980.

Christopher E. Morini has been the Vice President of New Business Development and Key Accounts since September 2001, having formerly served as Vice President of Marketing and International Sales for the Company since 1993. From 1986 through 1993, Mr. Morini was a Vice President of the Company, where he has been responsible for various sales and marketing divisions of the Company, including the Food Service, International Sales and Retail Sales divisions. Mr. Morini started with the Company as an area salesman in 1983 and became sales manager in 1984. Mr. Morini received a B.S. in economics from Slippery Rock University in 1978. Christopher E. Morini's brother, Angelo S. Morini, is the Founder of the Company.

Thomas J. Perno has worked for the Company since 1983. He began as a Shipping and Receiving Supervisor, then he was promoted to Plant Manager and then to Vice President of Operations. Mr. Perno received his M.S. in Electrical Engineering from Penn State University in 1976.

Kulbir Sabharwal has been Vice President of Technical Services for the Company since 1991. Dr. Sabharwal worked as the Director of Research and Quality Control for Gilardies Frozen Foods from 1987 to 1990 and for Fisher Cheese Company from 1972 to 1986. Dr. Sabharwal received his Ph.D. from the Ohio State University in 1972.

Section 16(A) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's executive officers and directors, and persons who own more than 10% of a registered class of the Company's equity securities, to file reports of ownership and changes in ownership with the Securities and Exchange Commission and the American Stock Exchange. Officers, directors and stockholders owning more than 10% of the Company's common stock are required by SEC regulations to provide the Company with copies of all the reports they file pursuant to Section 16(a).

Based solely upon the Company's review of those reports required by Section 16(a) and filed by or on behalf of the Company's officers, directors and stockholders owning greater than 10% of the Company's common stock, or written representations that no such reports were required which were submitted by such persons, the Company believes that during the fiscal year ended March 31, 2004, all of the officers and directors and stockholders owning greater than 10% of the Company's common stock complied with all applicable Section 16(a) filing requirements except for Michael E. Broll, Charles L. Jarvie and John W. Jackson. Each of the named individuals filed one report containing one transaction related to the acquisition of stock options after the required two or ten day reporting period, as applicable.

Other

The Company has adopted a code of ethics as defined in Item 406 of Regulation S-K, which code applies to all of its employees, including its principal executive officer, principal financial officer, principal accounting officer and persons performing similar functions. This code of ethics is available free of charge on the Company's website at www.galaxyfoods.com.

Additionally, the Company has adopted corporate governance guidelines and charters for its Audit and Compensation Committees and will adopt a code of business conduct and ethics that applies to the members of its Board of Directors. All of these materials may be acquired free of charge by requesting a copy by writing to: Corporate Secretary, Galaxy Nutritional Foods, Inc. 2441 Viscount Row, Orlando, FL 32809.

Audit Committee

The Company maintains a separately designated standing audit committee in accordance with Section 3(a)(14)(A) of the Securities Exchange Act of 1934, as amended. The audit committee members are Thomas R. Dyckman, Michael E. Broll and Patrice M.A. Videlier.

The Board of Directors has determined that all members of the audit committee are financially capable and that Thomas R. Dyckman, the audit committee chairman, is an "audit committee financial expert" within the meaning of the regulations of the Securities and Exchange Commission. Mr. Dyckman is considered an audit committee financial expert related to his significant and relevant accounting and financial experience disclosed above. The Company has determined that all audit committee members are "independent" as that term is defined in Item 7(d)(3)(iv) of Schedule MA promulgated under the Exchange Act. No member of the audit committee received any payments from the Company other than compensation received as a director of the Company. Mr. Dyckman has declined all cash compensation for his director services to the Company.

Nominating Committee

The Company does not have a standing nominating committee as of the date of this report, but the Board of Directors intends to establish a nominating committee prior to the filing of the Company's proxy statement for its next annual meeting.

Item 11. EXECUTIVE COMPENSATION

Summary Compensation Table

The following table sets forth the compensation during the fiscal years ended March 31, 2004, 2003 and 2002 paid to the following individuals (each, a "Named Executive Officer"): the Company's Chief Executive Officer and (i) its four other most highly compensated executive officers, and (ii) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year; provided, in the cases of (i) and (ii) above, that no disclosure is provided for any individual whose total annual salary and bonus does not exceed \$100,000:

Summary Compensation Table

(a) Names and Principal Position	Annual Compensation			(e) Other Annual Compensation (\$)	Long-Term Compensation		(h) LTIP Payouts (\$)	(i) All Other Compensation (\$) (34)
	(b) Fiscal Year	(c) Salary (\$)	(d) Bonus (\$)		(f) Awards Restricted Stock Award(s) (\$)	(g) Payouts Securities Underlying Options/SARs (#)		
Christopher J. New	2004	188,539	–	26,601 (2)	–	–	–	5,106
Chief Executive Officer (1)	2003	165,673	–	16,564 (3)	–	125,000(5)	–	2,855
	2002	89,693	–	7,583 (4)	–	100,000(6)	–	–
Salvatore J. Furnari	2004	134,577	–	25,600 (8)	–	–	–	5,106
Chief Financial Officer (7)	2003	116,923	–	(33)	–	30,000(9)	–	4,680
	2002	28,077	–	(33)	–	10,000(10)	–	700
John W. Jackson	2004	138,000	–	11,510 (12)	–	–	–	6,302
Vice President of Sales (11)	2003	138,000	–	10,250 (13)	–	96,429(15)	–	4,591
	2002	138,000	38,300	10,296 (14)	–	75,000(16)	–	1,200
Angelo S. Morini	2004	300,000	–	38,512 (19)	–	–	–	14,086
Founder and Director (17)	2003	300,000	53,706 (18)	33,349 (20)	–	800,000(22)	–	4,556
	2002	300,000	–	31,407 (21)	–	375,000(23)	–	3,450
Christopher E. Morini	2004	155,000	–	18,135 (25)	–	–	–	5,106
Vice President of Int'l	2003	155,000	–	17,626 (26)	–	97,143(28)	–	4,829
Sales (24)	2002	155,000	23,000	18,865 (27)	–	75,000(29)	–	3,450
Kulbir Sabharwal	2004	132,500	–	(33)	–	–	–	7,438
Vice President of Technical								
Services (30)	2003	130,000	–	(33)	–	63,143(31)	–	6,343
	2002	118,000	–	(33)	–	45,000(32)	–	3,450

- (1) On September 4, 2001, Christopher J. New was appointed Chief Marketing Officer and Vice President of Strategy. In December 2001, the Board appointed Mr. New as Chief Operating Officer and on December 17, 2002, the Board appointed Mr. New as Chief Executive Officer. Effective January 1, 2004, the Board approved an increase in his annual compensation from \$180,000 to \$210,000.
- (2) For the fiscal year ended March 31, 2004, the Company paid \$26,601 for an auto allowance for Mr. New.
- (3) For the fiscal year ended March 31, 2003, the Company paid \$14,835 for an auto allowance and \$1,729 for auto insurance for Mr. New.
- (4) For the fiscal year ended March 31, 2002, the Company paid \$7,583 to Mr. New for an auto allowance.
- (5) In December 2002, the Company granted options to acquire 25,000 shares of the Company's common stock at an exercise price equal to the market price on the date of grant of \$1.67 per share to Mr. New in consideration for his continued employment with the Company. Such options are fully exercisable and expire December 5, 2012. In October 2002, the Company repriced 100,000 options, which were previously granted (as described below in footnote 6) and therefore are included.
- (6) Under the terms of his employment agreement, Mr. New received an option to purchase up to 100,000 shares of the Company's common stock at an exercise price equal to the market price on the date of grant of \$4.98 per share. On October 11, 2002, the Company repriced the options to purchase 100,000 shares from \$4.98 per share to the then-market price of \$2.05 per share. One-third of such options shall become exercisable in September each year until all such options are exercisable. In the event of a change in control, all such options shall immediately become exercisable. Such options expire July 16, 2011.
- (7) On July 8, 2002, Salvatore Furnari was appointed Chief Financial Officer of the Company. From November 2002 to July 8, 2002, he worked as the Company's Controller. Effective January 1, 2004, the Board approved an increase in his annual compensation from \$130,000 to \$145,000.

- (8) For the fiscal year ended March 31, 2004, the Company paid \$25,600 for a car allowance for Mr. Furnari.
- (9) On July 8, 2002, the Company granted options to acquire 20,000 shares of the Company's common stock at an exercise price equal to the market price on the date of grant of \$4.55 per share to Mr. Furnari in consideration for his continued employment with the Company. On October 11, 2002, the Company repriced the options to purchase 20,000 shares from \$4.55 per share to the then-market price of \$2.05 per share. One-third of such options shall become exercisable each year in July 2003, 2004 and 2005 until all such options are exercisable. In the event of a change in control, all such options shall immediately become exercisable. Such options expire July 8, 2012. In October 2002, the Company repriced 10,000 options, which were previously granted (as described below in footnote 10) and therefore are included.
- (10) Under the terms of his employment agreement, Mr. Furnari received an option to purchase up to 10,000 shares of the Company's common stock at an exercise price equal to the market price on the date of grant of \$5.60 per share. On October 11, 2002, the Company repriced the options to purchase 10,000 shares from \$5.60 per share to the then-market price of \$2.05 per share. One-fourth of the options became exercisable February 12, 2002 and one-fourth shall become exercisable on each of the following December 12, 2002, 2003 and 2004. Such options expire November 12, 2011.
- (11) Effective April 1, 2004, Mr. Jackson's employment agreement provides for an annual base salary of \$144,900. Prior to this, the annual base salary was \$138,000. In March 2002, Mr. Jackson received \$38,300 in bonuses related to fiscal 2000.
- (12) For the fiscal year ended March 31, 2004, the Company paid \$10,943 in auto lease and auto allowance payments and \$567 for automobile insurance.
- (13) For the fiscal year ended March 31, 2003, the Company paid \$8,871 in auto lease payments and \$1,379 for automobile insurance.
- (14) For the fiscal year ended March 31, 2002, the Company paid \$8,917 in auto lease payments and \$1,379 for automobile insurance.
- (15) On October 11, 2002, the Company repriced all 96,429 outstanding options held by Mr. Jackson from their original exercise price to the then-market price of \$2.05 per share. The original exercise prices of the options were equal to the market price on the date of grant as follows: 14,286 options at \$2.84; 75,000 options (as further described below in footnote 16) at \$4.40 and 7,143 options at \$8.47.
- (16) In April 2001, Mr. Jackson was granted an incentive stock option to purchase up to 75,000 shares of common stock at an exercise price equal to the market price on the date of grant of \$4.40 per share. On October 11, 2002, the Company repriced the options to purchase 75,000 shares from \$4.40 per share to the then-market price of \$2.05 per share. One-third of such options shall become exercisable on each anniversary of the grant date until all such options are exercisable. Such options expire April 19, 2011.
- (17) In a Second Amended and Restated Employment Agreement effective October 13, 2003, Angelo S. Morini the Company's Founder, Vice-Chairman and President resigned from his positions with the Company as Vice-Chairman and President and will no longer be involved in the daily operations of the Company. He will retain the title of Founder and has been named Chairman Emeritus. Mr. Morini will continue as an employee and as a member of the Company's Board of Directors. Additionally, he may carry out special assignments designated to him by the Chairman of the Board. The Agreement is for a five-year period beginning October 13, 2003 and provides for an annual base salary of \$300,000 plus standard health insurance benefits, club dues and an auto allowance.
- (18) For the fiscal year ended March 31, 2003, the Company accrued bonuses of \$53,706 to Mr. Morini. These bonuses were used to pay down the employee advances due from Mr. Morini at the end of fiscal 2003.
- (19) For the fiscal year ended March 31, 2004, the Company paid \$24,584 in auto lease and auto allowance payments and \$13,928 for club dues for Mr. Morini.
- (20) For the fiscal year ended March 31, 2003, the Company paid \$21,081 in auto lease payments, \$1,670 for automobile insurance, and \$10,598 for club dues for Mr. Morini.
- (21) For the fiscal year ended March 31, 2002, the Company paid \$20,833 in auto lease payments, \$1,670 for automobile insurance, and \$8,904 in club dues for Mr. Morini.

- (22) On July 1, 2002, the Board of Directors granted Mr. Morini options to acquire 289,940 shares of common stock at an exercise price of \$5.17 per share (110% of market) in consideration of Mr. Morini's pledge of 250,000 shares of the Company's common stock to secure a \$550,000 bridge loan to the Company from Excalibur Limited Partnership. Such options are fully exercisable and shall expire on July 1, 2007. Effective as of December 4, 2002, the Board of Directors granted Mr. Morini options to acquire 510,060 shares of common stock in accordance with the terms of a special services agreement between the Company and Mr. Morini for writing a comprehensive diet and recipe book about the Company and its products and for the potential distribution of this book worldwide. Of these 510,060 options, 200,000 have an exercise price of \$4.08 per share and 310,060 have an exercise price of \$2.05 per share. Such options are fully exercisable and shall expire on December 4, 2007. The market price on the date of grant was \$1.67.
- (23) In April 2001, Angelo S. Morini was granted incentive stock options to acquire 375,000 shares of common stock at an exercise price equal to the market price on the date of grant of \$4.40 per share. One-fifth of such options shall become exercisable on each anniversary of the grant date until all such options are exercisable. Such options shall expire on April 19, 2011.
- (24) Mr. C. Morini's annual base salary was \$155,000. In March 2002, Mr. Morini received \$23,000 in bonuses related to fiscal 2000.
- (25) For the fiscal year ended March 31, 2004, the Company paid \$12,595 for auto lease payments, \$1,368 for automobile insurance, and \$4,172 for club dues for Mr. C. Morini.
- (26) For the fiscal year ended March 31, 2003, the Company paid \$12,595 for auto lease payments, \$1,368 for automobile insurance, and \$3,663 for club dues for Mr. C. Morini.
- (27) For the fiscal year ended March 31, 2002, the Company paid \$12,536 in auto lease payments, \$1,368 for automobile insurance, and \$4,961 for club dues for Mr. C. Morini.
- (28) On October 11, 2002, the Company repriced all 97,143 outstanding options held by Mr. C. Morini from their original exercise price to the then-market price of \$2.05 per share. The original exercise prices of the options were equal to the market price on the date of grant as follows: 14,286 options at \$2.84, 714 options at \$3.50; 75,000 options (as further described below in footnote 29) at \$4.40 and 7,43 options at \$8.47.
- (29) In April 2001, Mr. C. Morini was granted an incentive stock option to purchase up to 75,000 shares of common stock at an exercise price equal to the market price on the date of grant of \$4.40 per share. On October 11, 2002, the Company repriced the options to purchase 75,000 shares from \$4.40 per share to the then-market price of \$2.05 per share. One-third of such options shall become exercisable on each anniversary of the grant date until all such options are exercisable. Such options expire April 19, 2011.
- (30) Effective April 1, 2004, Mr. Sabharwal will receive an annual base salary of \$135,200. Prior to this, the annual base salary was \$130,000 during fiscal 2004 and \$118,000 during fiscal 2003.
- (31) On September 20, 2002, Mr. Sabharwal was granted an incentive stock option to purchase up to 11,000 shares of common stock at an exercise price equal to the market price on the date of grant of \$3.12 per share. Two thousand (2,000) such options shall become exercisable one year from the grant date and then 3,000 per year thereafter on each anniversary of the grant date until all such options are exercisable. Such options expire September 20, 2012. On October 11, 2002, the Company repriced all 63,143 outstanding options held by Mr. Sabharwal from their original exercise price to the then-market price of \$2.05 per share. The original exercise prices of the options were equal to the market price on the date of grant as follows: 7,143 options at \$8.47, 45,000 options (as further described below in footnote 32) at \$4.40 and 11,000 options at \$3.12.
- (32) In April 2001, Mr. Sabharwal was granted an incentive stock option to purchase up to 45,000 shares of common stock at an exercise price equal to the market price on the date of grant of \$4.40 per share. On October 11, 2002, the Company repriced the options to purchase 75,000 shares from \$4.40 per share to the then-market price of \$2.05 per share. One-third of such options shall become exercisable on each anniversary of the grant date until all such options are exercisable. Such options expire April 19, 2011.
- (33) Other than the options described in the footnotes above, there were no other annual compensation, perquisites or other personal benefits, securities or property equal to the lesser of \$50,000 or 10% of the total annual salary and bonus reported for such Named Executive Officer.
- (34) "All Other Compensation" represents the health insurance premiums and employer matching 401k contributions paid by the Company on behalf of the indicated Named Executive Officer.

Aggregate Option Exercises and Fiscal Year-End Option Value Table

The following table summarizes for each Named Executive Officer each exercise of stock options during the fiscal year ended March 31, 2004 and the fiscal year-end value of unexercised options. The value of unexercised in-the-money options at March 31, 2004 is based on a value of \$1.93 per share, the closing price of the Company's common stock on the American Stock Exchange on March 31, 2004:

Aggregate Option Exercises in Last Fiscal Year and Year-End Option Values

Name	Shares Acquired on Exercise (#)	Value Realized (\$)	Number of Securities Underlying Unexercised Options/SARS at Fiscal Year-End (#)		Value of Unexercised In-the-Money Options/SARS at Fiscal Year-End (\$)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Christopher J. New	--	--	92,984	33,334	\$6,500	--
Salvatore J. Furnari	--	--	14,166	15,834	--	--
John W. Jackson	--	--	96,429	--	--	--
Angelo S. Morini	--	--	2,888,447	150,000	--	--
Christopher E. Morini	--	--	96,429	--	--	--
Kulbir Sabharwal	--	--	55,393	9,000	--	--

Compensation of Directors

Standard Arrangements. Each non-employee director who served on the Board of Directors during the fiscal year ended March 31, 2004 was entitled to receive a fee of \$2,500 plus expenses for each Board of Directors meeting in which they attended in person on or before September 30, 2003. After September 30, 2003, the Board agreed to reduce this fee to \$1,500 per meeting. Additionally, each non-employee director of the Company is entitled to receive, on October 1 of each year, options to purchase a number of shares of common stock equal to (i) 286 shares, if such director served for a full year prior to the October 1 anniversary date, or (ii) a pro rated amount equal to 24 shares for each full month served during the year prior to such anniversary date, if such director did not serve for a full year prior to the anniversary date. Such options are granted pursuant to the Company's 1991 Non-Employee Director Stock Option Plan, which was adopted by the Board of Directors on October 1, 1991, and approved by the shareholders of the Company on January 31, 1992, as the same was amended by that certain 1996 Amendment and Restatement of the 1991 Non-Employee Director Stock Option Plan (as amended, the "Director Plan").

Other Arrangements. During each of the fiscal years ended March 31, 2004, 2003 and 2002, Joseph J. Juliano, a director of the Company, received cash or benefits totaling \$32,300, \$77,520, and \$79,600, respectively, in return for developing and maintaining business relationships with prospective and existing customers and suppliers on behalf of the Company. During the fiscal year ended March 31, 2004, C. Anthony Wainwright was granted options to acquire 200,000 shares of common stock at an exercise price of \$2.17 per share (123% of the closing price of the common stock as reported by AMEX) in consideration of his acceptance of the position as a member of the Board of Directors. On December 17, 2003, Michael E. Broll, was granted options to acquire 200,000 shares of common stock at an exercise price of \$3.29 per share (130% of the closing price of the

common stock as reported by AMEX) in consideration of his acceptance of position as a member of the Board of Directors. During the fiscal year ended March 31, 2004, Charles L. Jarvie received total compensation of \$59,000 for his services as Chairman of the Board prior to August 22, 2003 and for his consulting services to the Company. David H. Lipka received \$34,417 for his services as Chairman of the Board from September 22, 2003 to March 31, 2004.

Employment Agreements

Angelo S. Morini. In a Second Amended and Restated Employment Agreement effective October 13, 2003, Angelo S. Morini the Company's Founder, Vice-Chairman and President resigned from his positions with the Company as Vice-Chairman and President and will no longer be involved in the daily operations of the Company. He will retain the title of Founder and has been named Chairman Emeritus. Mr. Morini will continue as an employee and as a member of the Company's Board of Directors. Additionally, he may carry out special assignments designated to him by the Chairman of the Board. The agreement is for a five-year period beginning October 13, 2003 and provides for an annual base salary of \$300,000 plus standard health insurance benefits, club dues and an auto allowance. Other material provisions of the Agreement are as follows:

1. For the term of Mr. Morini's employment, the Company shall cause Mr. Morini to be nominated for election to the Company's Board of Directors as a member of the slate of directors proposed by the Company in its proxy statement for any meeting of the Company's stockholders whereby directors shall be elected. Notwithstanding the foregoing, in the event Mr. Morini is not elected to the Board of Directors by the stockholders at any meeting of the Company's stockholders for which the proxy statement indicates Mr. Morini is nominated for election as a member of the slate of directors proposed by the Company, such obligations shall immediately cease.
2. The Company will obtain, and maintain in effect during the term of Mr. Morini's employment, for the benefit of Mr. Morini (or reimburse Mr. Morini for the cost of) a Two Million Dollar (\$2,000,000) term life insurance policy insuring Mr. Morini's life, the beneficiaries of which shall be designated by Mr. Morini.
3. Mr. Morini and the Company agreed that Mr. Morini and certain family members received advances from the Company of which \$167,603 was unreimbursed as of October 13, 2003, and (ii) the Company owed \$330,000 to Mr. Morini pursuant to a loan on March 28, 2002 to the Company. Mr. Morini and the Company agreed to offset the unreimbursed advances against the amounts owed by the Company, and, in repayment of the remainder of the amounts owed by the Company, the Company issued an aggregate of 55,087 shares of the Company's common stock to Mr. Morini (valued at approximately \$2.95 per share based on the average of the closing prices for the five trading days preceding the effective date of the agreement).
4. Mr. Morini has agreed that during the term of his employment, and for a period of one (1) year following his termination of employment for any reason other than pursuant to termination without cause, a material breach of the agreement, or a change of control (as defined in the agreement) in the Company for which he did not vote, he will not, directly or indirectly, either as an employee, employer, consultant, agent, principal, partner, stockholder (other than owning fewer than one percent (1%) of the outstanding shares of a public corporation), corporate officer, director, or any other individual or representative capacity, engage or participate in any business that directly competes with the Company within those areas in the United States in which the Company is doing business as of the date of termination.

5. If the agreement is terminated by the Company without cause, Mr. Morini shall: (a) be entitled to continued payment of his annual compensation, health insurance benefits, club dues, auto allowance and life insurance benefits for the remainder of the term of the Agreement, (b) become fully "vested" under the terms of any stock option agreements executed and delivered prior to, along with, or after the agreement and (c) be released from the terms of the \$12,772,200 Loan Agreement dated June 15, 1999 and all monies outstanding thereunder will be forgiven by the Company. The provisions of the agreement related to the forgiveness of the \$12,772,200 loan remain unchanged from the first Amended and Restated Employment Agreement. Mr. Morini acknowledges that his change in role does not constitute a termination of Mr. Morini by the Company, under the First Amended and Restated Employment Agreement.
6. If Mr. Morini terminates his employment in any manner other than in connection with a material breach of the agreement by the Company, he shall not be entitled to receive any further compensation or benefits, except that if he terminates his employment in connection with a change of control (as defined in the agreement) in the Company for which he did not vote, he will be released from the terms of the \$12,772,200 Loan Agreement dated June 15, 1999 and all monies outstanding thereunder will be forgiven by the Company. The provisions of the agreement related to the forgiveness of the \$12,772,200 loan remain unchanged from the first Amended and Restated Employment Agreement.

The Company accrued and expensed the five-year cost of this agreement in the quarter ended December 31, 2003. The total estimated costs expensed under this agreement are \$1,830,329 of which \$1,659,447 remained unpaid but accrued (\$366,305 as short-term liabilities and \$1,293,142 as long-term liabilities) as of March 31, 2004. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

Christopher J. New. On September 4, 2001, Christopher J. New was appointed Chief Marketing Officer and Vice President of Strategy. In December 2001, the Board appointed him to Chief Operating Officer and in December 2002, the Board appointed him to Chief Executive Officer. Mr. New's current employment agreement provides for a base salary of \$210,000. Mr. New will also be entitled to receive a bonus of up to 40% of his base salary at fiscal year end with the qualification of such bonus to be determined by the Board of Directors. The agreement also provides for an automobile allowance up to \$2,700 per month. In the event of a change in ownership of the Company which results in his termination, Mr. New will be entitled to receive three years of his base salary as severance. In the event Mr. New's employment is terminated after September 4, 2003, but prior to September 4, 2004, he will be entitled to receive two years of his base salary as severance. In the event Mr. New's employment is terminated after September 4, 2004, he will be entitled to receive three years of his base salary as severance. In the event of a change in control of the majority ownership of the Company or he is terminated without cause, all prior granted but unvested stock options will immediately vest.

Salvatore J. Furnari. On November 11, 2001, Mr. Furnari was appointed as Controller and on July 8, 2002, he was appointed as the Company's Chief Financial Officer. Under the terms of his current employment agreement, he will receive an annual base salary of \$145,000. In the event of a change in control of the majority ownership of the Company or he is terminated without cause, all prior granted but unvested stock options will immediately vest. In the event Mr. Furnari's employment is terminated, he will be entitled to receive one year of his base salary, auto allowance and health benefits as severance.

John W. Jackson. In August of 1993, Mr. Jackson was appointed as Vice President of Sales. Mr. Jackson's current employment agreement provides for a base salary of \$144,900 and an auto allowance of \$1,000 per month. Mr. Jackson will also be entitled to a bonus that shall not exceed 40% of his base salary based on certain personal and Company goals as established by the Company's Chief Executive Officer. In the event of a change in ownership of the Company which results in his termination, Mr. Jackson will be entitled to receive three years of his base salary as severance. In the event Mr. Jackson's employment is otherwise terminated, he is entitled to receive one year of his base salary as severance, the payment of which shall be made at the Company's discretion.

Christopher E. Morini. Angelo S. Morini's brother, Christopher E. Morini, works for the Company as Vice President of New Business Development and Key Accounts. From February of 1993 until October 2001, Mr. C. Morini served as Vice President of Marketing. Mr. C. Morini's current employment agreement provides for a base salary of \$155,000 per year, an automobile lease with insurance, which together shall not exceed \$1,100 per month, and monthly country club dues. Mr. C. Morini will also be entitled to a bonus that shall not exceed 40% of his base salary based on certain personal and Company goals as established by the Company's Chief Executive Officer. In the event Mr. C. Morini's employment is terminated, Mr. C. Morini will be entitled to receive five years of his base salary as severance.

Additional Information with Respect to Insider Participation in Compensation Committee

From April 1, 2003 until August 22, 2003, the committee members consisted of David H. Lipka (chairman), Thomas R. Dyckman, Joseph J. Juliano and C. Anthony Wainwright. On August 22, 2003, Charles L. Jarvie replaced Mr. Lipka as the Chairman and in October 2003, upon the death of Mr. Wainwright, the committee was reduced to three members.

None of the current or former members of the Compensation Committee is or has been an officer or employee of the Company. All current members are independent within the meaning of the listing standards of the AMEX except for Mr. Juliano who, prior to September 2003, received compensation for his services in developing and maintaining business relationships with prospective and existing customers and suppliers on behalf of the Company. During each of the fiscal years ended March 31, 2004, 2003 and 2002, Mr. Juliano, received cash or benefits totaling \$32,300, \$77,520, \$79,600, respectively. From April 2002 to August 31, 2003, the Company leased an apartment in New York from 400 East 84th Street Associates, LP at \$6,460 per month and allowed Mr. Juliano use of this apartment in lieu of direct cash payments for his services.

Board Report on Executive Compensation

The following report describes the compensation policies applicable to the Company's executive officers' compensation for the fiscal year ended March 31, 2004:

Role of the Compensation Committee

In accordance with the charter of the Compensation Committee (the "Committee"), the Committee is appointed by the Board to oversee the overall Company compensation policies and their specific application to executive officers elected by the Board and to members of the Board.

In order to carry out this purpose, the Committee has the following duties and responsibilities with respect to setting the compensation of the Chief Executive Officer and other executive officers of the Company who are elected by the Board:

- To periodically review compensation policies and strategies that apply generally to all or groups of Company employees;
- To regularly review and evaluate compensation of executive officers of the Company;
- To approve compensation of executive officers of the Company as designated by the Board or for which it cannot be delegated to the Company's Chief Executive Officer;
- To review and approve corporate goals and objectives relevant to the compensation of the Company's Chief Executive Officer and President;
- To evaluate the performance of the Chief Executive Officer and President in light of the approved corporate goals and objectives;
- To set the base salary and short-term incentive compensation of the Chief Executive Officer and President based on the Committee's evaluation of competitive compensation practices and their performance in achieving the corporate goals established for the position as set by the Committee;

- To set the long-term incentive compensation of the Chief Executive Officer and President considering the Company's performance and relative shareholder return, along with the value of incentive awards to chief executives at other companies;
- To make recommendations to the Board with respect to incentive compensation plans and equity based plans;
- To regularly review and evaluate the compensation program for Directors and, as appropriate, recommend changes to the Board;
- To administer and otherwise exercise the various authorities prescribed for the Committee by the Company's Stock Plans including the Non-Employee Directors Stock Plan

The Committee has the authority to retain a compensation consultant to assist in the evaluation of Director, CEO or principal officer compensation, as well as such other experts as the Committee deems necessary in the performance of its duties.

Compensation of Executive Officers

In reviewing and approving the base salaries of executive officers, other than the Chief Executive Officer and President as discussed below, the Committee considered the terms of any existing employment contract with the executive, the recommendation of the Chief Executive Officer, responsibility levels and the salary norms for other individuals in comparable positions. The salaries for the most highly compensated executive officers of the Company are disclosed in the Executive Compensation Summary Table.

For salary increases to its Chief Financial Officer during fiscal 2004 and for salary increases that became effective on the first day of fiscal 2005 for other Named Executive Officers, the Committee approved them based on the above stated factors.

Compensation of the Company's Founder (formerly its President)

During fiscal 2004, the Committee along with the Board of Directors entered into a Second Amended and Restated Employment Agreement effective October 13, 2003 with Angelo S. Morini, the Company's Founder. In accordance with the agreement, which is more fully disclosed above under "Employment Agreements – Angelo S. Morini," Mr. Morini resigned from his positions with the Company as Vice-Chairman and President and will no longer be involved in the daily operations of the Company. He will retain the title of Founder and has been named Chairman Emeritus. Mr. Morini will continue as an employee and as a member of the Company's Board of Directors. Additionally, he may carry out special assignments designated to him by the Chairman of the Board. The agreement is for a five-year period beginning October 13, 2003 and provides for an annual base salary of \$300,000 plus standard health insurance benefits, club dues and an auto allowance.

Compensation of the Company's Chief Executive Officer

During the year ended March 31, 2004, the Committee recommended and it was approved by the Board of Directors to increase the base salary for Christopher J. New, the Company's Chief Executive Officer from \$180,000 to \$210,000 effective January 1, 2004, based on his performance in completing the corporate restructuring and refinancing in May 2003 and to increase him to a salary level more comparable to other executives in this role.

Bonus, Stock Awards and Performance-Based Compensation

There were no bonuses, stock awards, or performance based compensation paid to any Named Executive Officer during the year ended March 31, 2004 as the Compensation Committee is in the process of developing a more formal plan and evaluation criteria against which to measure the performance of the executive officers.

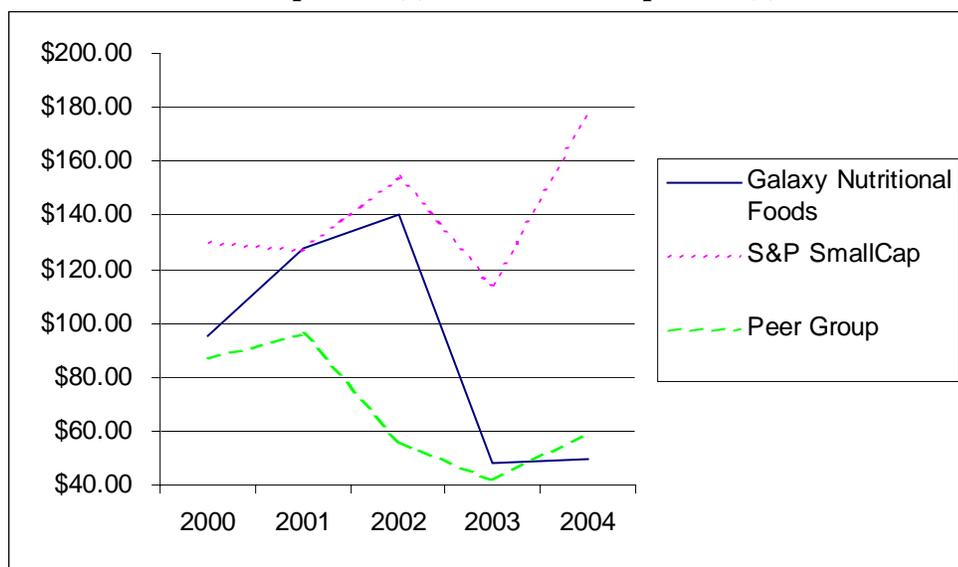
Respectively submitted by the Compensation Committee:

Charles L. Jarvie
 Thomas R. Dyckman
 Joseph J. Juliano

Stock Performance Graph

The following graph provides a comparison of the Company's cumulative total shareholder return on the Company's common stock with the cumulative total return of the Standard & Poor's SmallCap Index and a peer group index for the five-year period beginning April 1, 1999:

**Comparative of Five Year (1) Cumulative Total Returns of (2)
Galaxy Nutritional Foods Common Stock, the S&P
SmallCap Index (3) and a Peer Group Index (4)**



**Comparative of Five Year (1) Cumulative Total Returns of (2)
Galaxy Nutritional Foods Common Stock, the S&P
SmallCap Index (3) and a Peer Group Index (4)**

	2000	2001	2002	2003	2004
Galaxy Nutritional Foods	\$ 95.17	\$ 127.48	\$ 140.13	\$ 48.26	\$ 49.81
S&P Small Cap	\$ 129.73	\$ 127.14	\$ 153.92	\$ 114.72	\$ 177.97
Peer Group	\$ 87.49	\$ 70.04	\$ 71.28	\$ 52.87	\$ 40.49

- (1) Compares fiscal years ending on or about March 31st of the years indicated.
- (2) The comparison of total return on investment assumes \$100 invested on April 1, 1999 in Galaxy Nutritional Foods common stock and in each S&P Small Cap Index and the Peer Group.
- (3) The S&P Small Cap Index is composed of public companies with market capitalizations between zero and \$1 billion. As of June 25, 2004, the Company had a market capitalization of approximately \$37 million.
- (4) Companies in the Peer Group Index are food manufacturing and distribution companies within the S&P Food Group Indexes. The companies included are Hain Celestial Group, Conagra Foods, International Multifoods, Lance, and Tofutti Brands.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Equity Compensation Plan Information

The following table describes the Company's compensation plans under which the Company's common stock are authorized for issuance as of March 31, 2004:

Equity Compensation Plan Information Table

Plan Category	(a) Number of Securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	4,370,772	\$ 3.11	107,932
Equity compensation plans not approved by security holders (1)	371,429	\$ 3.95	N/A
Total	4,742,201	\$ 3.18	

(1) These securities were issued pursuant to individual compensation arrangements prior to July 2, 1997 or after September 30, 2003 and have not been approved by security holders.

Security Ownership of Certain Beneficial Owners

The following tables describe the beneficial ownership of the Company's common stock and the Company's Series A convertible preferred stock by each person or entity known to the Company to be the beneficial owner of more than 5% of the outstanding shares of the Company's capital stock outstanding as of June 25, 2004. The tables show beneficial ownership in accordance with the rules of the Securities and Exchange Commission to include securities that a named person or entity has the right to acquire within 60 days.

Common Stock Ownership of 5% or More Stockholders

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership (1)	Percent of Class (2)
Angelo S. Morini 2441 Viscount Row Orlando, Florida 32809	6,387,806 (3)	34.3%

John Hancock Advisors, Inc. 101 Huntington Avenue Boston, Massachusetts 02117	1,451,348 (4)	9.2%
BH Capital Investments, L.P. 175 Bloor Street East South Tower, 7 th Floor Toronto, Ontario, Canada M4W 3R8	981,413 (5)	5.6%
Excalibur Limited Partnership 33 Prince Arthur Avenue Toronto, Ontario, Canada M5R IB2	1,051,314 (6)	6.0%
Royce & Associates LLC 1414 Avenue of the Americas New York, NY 10019	1,227,000 (7)	7.8%
Frederick A. DeLuca c/o Doctor's Associates, Inc. 325 Bic Drive Milford, Connecticut 06460	1,269,842	8.1%
Fromageries Bel S.A. 16, Bd Malesherbes 75008 Paris, France	1,111,112 (8)	7.1%

- (1) The inclusion herein of any shares deemed beneficially owned does not constitute an admission of beneficial ownership of these shares.
- (2) The total number of shares outstanding as of June 25, 2004 is 15,724,073. The percentages are calculated on the basis of the amount of shares outstanding plus shares which may be acquired through the exercise of options, warrants, rights or conversion privileges by such holder within sixty (60) days of June 25, 2004.
- (3) Includes options to acquire 2,888,197 shares of the Company's common stock, which are currently exercisable at prices ranging from \$2.05 to \$5.25 per share. Options expire as to 13,072 shares on October 1, 2006, as to 432,797 on July 1, 2007, as to 517,203 shares on December 4, 2007, as to 1,357,000 shares on June 15, 2009, as to 343,125 on December 15, 2010, and as to 225,000 on April 19, 2011. Also includes a warrant to purchase 250 shares at an exercise price of \$5.744 per share, which expires on January 17, 2007. With the exception of the options, 10,500 shares held in a nominee name, 286 shares held in joint tenancy and 714 shares held individually, all of Mr. Morini's shares and warrant are held by Morini Investments Limited Partnership, a Delaware limited liability partnership, of which Angelo Morini is the sole Limited Partner and Morini Investments LLC is the sole General Partner. Mr. Morini is the sole member of Morini Investments LLC.
- (4) The information is based solely on a Schedule 13G filed with the SEC on February 6, 2004 by each of the reporting persons listed below. John Hancock Advisors, LLC has direct beneficial ownership of, and sole voting power and sole dispositive power to, the reported shares pursuant to Advisory Agreements for the following: John Hancock Small Cap Value Fund, John Hancock Small Cap Equity Fund, John Hancock Small Cap Value Fund, John Hancock Focused Relative Value Fund, and John Hancock Small Cap Value Fund. Each of The Berkeley Financial Group, LLC, John Hancock Subsidiaries, LLC, John Hancock Life Insurance Company, and John Hancock Financial Services, Inc. report that they do not beneficially own any of the reported shares except through their indirect, wholly owned subsidiary, John Hancock Advisors, LLC.
- (5) Includes a warrant to purchase 250,000 shares of the Company's common stock, which is exercisable until July 15, 2006 at \$2.00 per share. BH Capital Investments, L.P. ("BH Capital) informed the Company that it owned 12,597 shares of the Company's common stock as of June 25, 2004. Additionally, BH Capital still holds 20,430 shares of the Series A convertible preferred stock, which are presently convertible with accrued dividends into

718,816 shares of common stock. Combined BH Capital has potential beneficial ownership in 981,413 shares of the Company's common stock.

However, BH Capital, together with its affiliates (which includes Excalibur Limited Partnership), may not convert the Series A convertible preferred stock into an amount that, upon giving effect to such conversion, would cause the aggregate number of shares of common stock beneficially owned by BH Capital and its affiliates to exceed 9.99% of the outstanding shares of the Company's common stock following such conversion. BH Capital has the right to waive such restriction upon not less than 61 days prior notice to the Company. As of June 25, 2004, the Company has not received any such notice.

Because BH Capital and Excalibur Limited Partnership cannot collectively own more than 1,742,382 common shares (9.99% of the Company's outstanding shares excluding 25,196 shares currently owned by the Series A Preferred Holders), BH Capital may only convert its Series A convertible preferred stock into 428,471 shares of common stock as of June 25, 2004 on the assumption that Excalibur Limited Partnership will convert all of its outstanding warrants and Series A preferred stock into a total ownership of 1,051,314 common shares.

The information is based solely on a Schedule 13G, filed with the SEC on February 10, 2004: Each of the following reporting persons are deemed to beneficially own a pro rata share of the maximum 9.9% of the Company's common stock beneficially owned by the group, which pro rata share does not exceed 4.99% of the class: BH Capital Investments, L.P., HB and Co., Inc., Henry Brachfeld, Excalibur Limited Partnership, Excalibur Capital Management, Inc. and William S. Hechter. Lillian Brachfeld is the sole stockholder of HB and Co, Inc. and the wife of Henry Brachfeld. Lillian Brachfeld has disclaimed pursuant to Rule 13d-4 of the Securities Exchange Act of 1934, as amended, beneficial ownership of all shares she may be deemed to beneficially own by reason of such status. The address of the principal business office of BH Capital Investments, L.P., HB and Co., Inc., Henry Brachfeld and Lillian Brachfeld is 175 Bloor Street East, South Tower, Suite 705, Ontario Canada M4W 3R8. The address of the principal business office of Excalibur Limited Partnership, Excalibur Capital Management, Inc. and William S. Hechter is 33 Prince Arthur Avenue, Toronto, Ontario, Canada M5R 1B2.

- (6) Includes a warrant to purchase 250,000 shares of the Company's common stock, which is exercisable until July 15, 2006 at \$2.00 per share, and a warrant to purchase 30,000 shares of the Company's common stock, which is exercisable until June 26, 2007 at \$2.05 per share. Excalibur Limited Partnership ("Excalibur") informed the Company that it owned 12,599 shares of the Company's common stock as of June 25, 2004. Additionally, Excalibur still holds 21,564 shares of the Series A convertible preferred stock, which are presently convertible with accrued dividends into 758,715 shares of common stock. Combined Excalibur has potential beneficial ownership 1,051,314 shares of the Company's common stock.

However, Excalibur, together with its affiliates (which includes BH Capital), may not convert the Series A convertible preferred stock into an amount that, upon giving effect to such conversion, would cause the aggregate number of shares of common stock beneficially owned by Excalibur and its affiliates to exceed 9.99% of the outstanding shares of the Company's common stock following such conversion. Excalibur has the right to waive such restriction upon not less than 61 days prior notice to the Company. As of June 25, 2004, the Company has not received any such notice.

Because BH Capital and Excalibur cannot collectively own more than 1,742,382 common shares (9.99% of the Company's outstanding shares excluding 25,196 shares currently owned by the Series A Preferred Holders), Excalibur may only convert its Series A convertible preferred stock into 468,370 shares of common stock as of June 25, 2004 on the assumption that BH Capital will convert all of its outstanding warrants and Series A preferred stock into a total ownership of 981,413 common shares.

The information is based solely on a Schedule 13G filed with the SEC on February 10, 2004: Each of the following reporting persons are deemed to beneficially own a pro rata share of the maximum 9.9% of the Company's common stock beneficially owned by the group, which pro rata share does not exceed 4.99% of the class: BH Capital Investments, L.P., HB and Co., Inc., Henry Brachfeld, Excalibur Limited Partnership, Excalibur Capital Management, Inc. and William S. Hechter. Lillian Brachfeld is the sole stockholder of HB and Co, Inc. and the wife of Henry Brachfeld. Lillian Brachfeld has disclaimed pursuant to Rule 13d-4 of the Securities Exchange Act of 1934, as amended, beneficial ownership of all shares she may be deemed to beneficially own by reason of such status. The address of the principal business office of BH Capital Investments, L.P., HB and Co., Inc., Henry Brachfeld and Lillian Brachfeld is 175 Bloor Street East, South Tower, Suite 705, Ontario Canada M4W 3R8. The address of the principal business office of Excalibur Limited Partnership, Excalibur Capital Management, Inc. and William S. Hechter is 33 Prince Arthur Avenue, Toronto, Ontario, Canada M5R 1B2.

- (7) The information is based solely on a Schedule 13G filed with the SEC on February 3, 2004 by Royce and Associates, LLC. Royce and Associates, LLC has the sole voting power and sole dispositive power of all of the shares reported.
- (8) The information is based solely on a Schedule 13D filed with the SEC on June 9, 2003, by Fromageries Bel S.A. Fromageries Bel S.A. owns directly and beneficially all of the reported shares. Unibel, a French limited partnership, is deemed to beneficially own the reported shares by reason of the provisions of Rule 13d-3 of the Securities Exchange Act of 1934, as amended. Each of Fromageries Bel S.A. and Unibel, a French limited partnership, has shared voting power and shared dispositive power of all of the reported shares of the Company's common stock. The address of the principal office of Fromageries Bel S.A. and Unibel is 4 rue d Anjou 75008, Paris, France.

Series A Convertible Preferred Stock Ownership of 5% or More Stockholders

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership (1)	Percent of Class
BH Capital Investments, L.P. (2) 175 Bloor Street East South Tower, 7 th Floor Toronto, Ontario, Canada M4W 3R8	20,430 Series A	48.6%
Excalibur Limited Partnership (2) 33 Prince Arthur Avenue Toronto, Ontario, Canada M5R 1B2	21,564 Series A	51.4%

- (1) The inclusion herein of any shares deemed beneficially owned does not constitute an admission of beneficial ownership of these shares.
- (2) Pursuant to a certain Series A Preferred Stock and Warrants Purchase Agreement dated as of April 6, 2001, BH Capital Investments, L.P. and Excalibur Limited Partnership each purchased 36,323 shares of the Company's Series A convertible preferred stock and warrants to purchase 60,000 shares of common stock, at an aggregate sales price of approximately \$3,082,000. BH Capital Investments, L.P. and Excalibur Limited Partnership exercised their warrants and the Company has been informed that they have sold all of the shares received upon the exercise of the warrants. From April 2001 through June 25, 2004, the Series A Preferred Shareholders have converted a total of 30,652 Series A preferred shares into 1,151,596 shares of common stock. As of June 25, 2004, the holders of the Series A convertible preferred stock were each entitled to an additional \$13.39 per outstanding preferred share, or 11,674 total additional shares of the Series A convertible preferred stock, for dividends accrued on their initial purchase of the Series A convertible preferred stock. This dividend is payable in cash or shares of the Series A convertible preferred stock at the Company's discretion. However, in accordance with the terms of the asset-based loan from Textron Financial Corporation, the Company is prohibited from paying dividends in cash without Textron's consent.

Security Ownership of Management

The following table describes the beneficial ownership of the Company's common stock by (i) each Named Executive Officer, (ii) each director, and (iii) all of the Company's directors and executive officers as a group, outstanding as of June 25, 2004. The tables show beneficial ownership in accordance with the rules of the Securities and Exchange Commission to include securities that a named person or entity has the right to acquire within 60 days:

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership (1)	Percent of Class (2)
David H. Lipka	255,781 (3)	1.6%
Michael E. Broll	200,000 (4)	1.3%
Thomas R. Dyckman	200,225 (3)	1.3%
Charles L. Jarvie	200,225 (3)	1.3%
Joseph J. Juliano	185,283 (5)	1.2%
Angelo S. Morini	6,387,806 (6)	34.3%
Christopher J. New	98,254 (7)	*
Patrice M.A. Videlier	96 (8)	*
Salvatore J. Furnari	22,832 (9)	*
Christopher E. Morini	96,429 (10)	*
John W. Jackson	100,631 (10)	*
<u>Kulbir Sabharwal</u>	<u>55,393 (11)</u>	*
All executive officers and directors as a group	<u>7,802,955</u>	<u>39.1%</u>

* Less than 1%.

- (1) The inclusion herein of any shares deemed beneficially owned does not constitute an admission of beneficial ownership of these shares.
- (2) The total number of shares outstanding as of June 25, 2004 is 15,724,073. The percentages are calculated on the basis of the amount of shares outstanding plus shares which may be acquired through the exercise of options, warrants, rights or conversion privileges by such holder within sixty (60) days of June 25, 2004.
- (3) Includes currently exercisable options to acquire 200,000 shares of the Company's common stock at \$2.17 per share, which expire on December 17, 2007. Also, includes currently exercisable options to acquire 225 shares of the Company's common stock at \$2.90 per share, which expire on October 1, 2013.
- (4) Includes currently exercisable options to acquire 200,000 shares of the Company's common stock at \$3.29 per share, which expire on December 17, 2008.
- (5) Mr. Juliano, a current member of the Company's Board of Directors, is the beneficial owner of 33,571 shares of common stock issuable upon the exercise of warrants held by JCII Corporation, of which Catherine Juliano, Mr. Juliano's wife, is the sole shareholder. Additionally, there is a warrant for 143,000 shares of common stock issuable to V&R corporation, which is owned by Mr. Juliano's parents. The exercise price of the warrants is \$2.05 per share and they expire on January 31, 2006 and June 15, 2009, respectively. These warrants had an original exercise price of \$4.81 and \$3.31 per share, respectively, but were repriced to \$2.05 on October 11, 2002. These warrants were granted as compensation for introductions of key accounts to the Company. Mr. Juliano also beneficially owns 7,143 shares of

common stock, held of record by JCII Corporation. Additionally, Mr. Juliano was granted an option to acquire 2,143 shares of the Company's common stock. This option was issued at the closing bid price as quoted on the American Stock Exchange on the date of the grant, is currently exercisable at \$2.05 per share and expires on May 27, 2009. All of JCII Corporation's, V&R Corporation's and Mr. Juliano's options and warrants currently are exercisable.

- (6) Includes options to acquire 2,888,197 shares of the Company's common stock, which are currently exercisable at prices ranging from \$2.05 to \$5.25 per share. Options expire as to 13,072 shares on October 1, 2006, as to 432,797 on July 1, 2007, as to 517,203 shares on December 4, 2007, as to 1,357,000 shares on June 15, 2009, as to 343,125 on December 15, 2010, as to 225,000 on April 19, 2011. Also includes a warrant to purchase 250 shares at an exercise price of \$5.744 per share, which expires on January 17, 2007. With the exception of the options, 10,500 shares held in a nominee name, 286 shares held in joint tenancy and 714 shares held individually, all of Mr. Morini's shares and warrant are held by Morini Investments Limited Partnership, a Delaware limited liability partnership, of which Angelo Morini is the sole Limited Partner and Morini Investments LLC is the sole General Partner. Mr. Morini is the sole member of Morini Investments LLC.
- (7) Includes currently exercisable options to acquire 66,666 shares of the Company's common stock at \$2.05 per share, which expire on July 16, 2011. These options had an original exercise price of \$4.98 per share, but were repriced to \$2.05 on October 11, 2002. Also, includes currently exercisable options to acquire 25,000 shares of the Company's common stock at \$1.67 per share, which expire on December 5, 2012. Includes a warrant to purchase 1,318 shares of the Company's common stock at an exercise price of \$5.744 per share, which expires on January 17, 2007.
- (8) Includes currently exercisable options to acquire 96 shares of the Company's common stock at \$2.90 per share, which expire on October 1, 2013.
- (9) Includes currently exercisable options to acquire 7,500 and 13,332 shares of the Company's common stock at \$2.05 per share, which expire on November 12, 2011 and July 8, 2012, respectively. These options had an original exercise price of \$5.60 and \$4.55 per share, respectively, but were repriced to \$2.05 on October 11, 2002.
- (10) Includes currently exercisable options to acquire 96,429 shares of the Company's common stock at \$2.05 per share. These options had an original exercise prices ranging from \$2.84 to \$8.47 per share, but were repriced to \$2.05 on October 11, 2002. Options expire as to 7,143 shares on May 16, 2006, as to 14,286 shares on September 24, 2008, and as to 75,000 shares on April 19, 2011.
- (11) Includes currently exercisable options to acquire 54,143 shares of the Company's common stock at \$2.05 per share. These options had an original exercise prices ranging from \$3.12 to \$8.47 per share, but were repriced to \$2.05 on October 11, 2002. Options expire as to 7,143 shares on May 16, 2006, as to 45,000 shares on April 19, 2011, and as to 2,000 on September 20, 2012. Also includes a warrant to purchase 1,250 shares at an exercise price of \$5.744 per share, which expires on January 17, 2007.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Transactions with Management and Others

Employment Agreements

Please see "ITEM 11. EXECUTIVE COMPENSATION – Employment Agreements."

Other Transactions

Angelo S. Morini, Founder

In a Second Amended and Restated Employment Agreement effective October 13, 2003, Angelo S. Morini the Company's Founder, Vice-Chairman and President resigned from his positions with the Company as Vice-Chairman and President and will no longer be involved in the daily operations of the Company. He will retain the title of Founder and has been named Chairman Emeritus. Mr. Morini will continue as an employee and as a

member of the Company's Board of Directors. Additionally, he may carry out special assignments designated to him by the Chairman of the Board. The agreement is for a five-year period beginning October 13, 2003 and provides for an annual base salary of \$300,000 plus standard health insurance benefits, club dues and an auto allowance.

In March 2002, Angelo S. Morini, the Company's founder, loaned \$330,000 to the Company in order for it to pay down certain notes payable that were coming due. This loan bore interest at the prime rate and was due on or before June 15, 2006. In connection with the Second Amended and Restated Employment Agreement above, the Company offset \$167,603 of unreimbursed advances owed to it by Mr. Morini and certain family members against the balance of the loan and issued an aggregate of 55,087 shares of the Company's common stock (valued at approximately \$2.95 per share) as payment in full.

In June 1999, in connection with an amended and restated employment agreement for Angelo S. Morini, the Company's Founder, the Company consolidated two full recourse notes receivable (\$1,200,000 from November 1994 and \$11,572,200 from October 1995) related to the exercise of 2,914,286 shares of the Company's common stock into a single note receivable in the amount of \$12,772,200 that is due on June 15, 2006. This new consolidated note is non-interest bearing and non-recourse and is secured by the 2,914,286 shares of the Company's common stock. Per the June 1999 employment agreement and continued in the October 2003 Second Amended and Restated Employment Agreement, this loan may be forgiven upon the occurrence of any of the following events: 1) Mr. Morini is terminated without cause; 2) there is a material breach in the terms of Mr. Morini's employment agreement; or 3) there is a change in control of the Company for which Mr. Morini did not vote "FOR" in his capacity as a director or a shareholder.

Mr. Morini's brother, Christopher E. Morini, is employed by the Company as Vice President of New Business Development and Key Accounts and received total compensation of \$178,241 during the fiscal year ended March 31, 2004 (which includes salary, bonuses, 401k employer contributions, auto allowance and health benefits). Mr. Morini's brother-in-law, Robert Peterson, is employed by the Company as a sales representative. Mr. Peterson's total compensation for the fiscal year ended March 31, 2004 was \$111,292 (which includes salary, bonuses, 401k employer contributions, auto allowance and health benefits). Mr. Morini's brother, Ronald Morini, worked for the Company until October 31, 2003 as an engineering consultant and was paid \$61,310 in consulting fees and benefits during the fiscal year ended March 31, 2004.

Patrice M.A. Videlier, Director

Effective May 22, 2003, the Company entered into a Master Distribution and Licensing Agreement with Fromageries Bel S.A., a leading branded cheese company in Europe, of which Mr. Videlier is the Senior Vice President of Marketing - World. Under the agreement, the Company has granted Fromageries Bel S.A. exclusive distribution rights for the Company's products in a territory comprised of the European Union States and to more than 21 other European countries and territories, as well as the exclusive option during the term of the agreement to elect to manufacture the products designated by Fromageries Bel S.A. for distribution in the territory. Fromageries Bel S.A. also purchased 1,111,112 the Company's common stock at a purchase price of \$1.80 per share for a total investment of \$2,000,000 pursuant to a Securities Purchase Agreement dated as of May 21, 2003 between the Company and Fromageries Bel S.A. These shares were included on a Registration Statement on Form S-3, SEC File No. 333-109649, which was filed on October 10, 2003 and declared effective on November 18, 2003.

BH Capital Investments, L.P., and Excalibur Limited Partnership, the Series A Preferred Stockholders

On April 6, 2001, in accordance with an exemption from registration under Regulation D promulgated under the Securities Act of 1933, as amended, the Company received from BH Capital Investments, L.P. and Excalibur Limited Partnership (the "Series A Preferred Holders") proceeds of approximately \$3,082,000 less costs of \$181,041 for the issuance of 72,646 shares of the Company's Series A convertible preferred stock with a face

value of \$3,500,000 and warrants to purchase shares of the Company's common stock. As of June 25, 2004, the Series A Preferred Holders had converted 30,652 shares of the Series A convertible preferred stock plus accrued dividends, into 1,151,596 shares of common stock. The conversion prices ranged from \$1.3633 to \$1.75 and were based on the lower of (a) 95% of the average of the two lowest closing bid prices on the AMEX for the fifteen trading days immediately prior to conversion or (b) \$1.75.

On November 7, 2002, the Series A Preferred Holders exercised their right under the Series A Purchase Agreement to require the Company to solicit the approval of its shareholders for the Company's issuance of all of the shares of common stock potentially issuable upon conversion of the Series A convertible preferred stock in full and the exercise of their warrants. The Company was required to hold a shareholders meeting to solicit such approval on or before February 5, 2003. Pursuant to the Stock Purchase Option Agreement described below, the Series A Preferred Holders agreed, among other things, to extend the deadline to September 30, 2003. On September 30, 2003, the Company's shareholders, by majority vote, approved the issuance by the Company of all required common stock in the event of a conversion of the Company's Series A convertible preferred stock and upon the exercise of certain warrants held by the Series A Preferred Holders.

On April 24, 2003, the Company and the Series A Preferred Holders entered into that certain Stock Purchase Option Agreement, whereby the Company was granted the option to purchase all of the shares of the Series A convertible preferred stock owned by such holders. The option expired on September 30, 2003. Pursuant to such agreement, the Series A Preferred Holders also agreed to extend the Company's required date to hold a shareholders meeting to September 30, 2003. In exchange for the option and the extension of the annual meeting date, the Company issued warrants to purchase 250,000 shares of the Company's common stock to each BH Capital Investments, L.P. and Excalibur Limited Partnership. These warrants are exercisable until July 15, 2006 at an exercise price equal to \$2.00 per share, which price was greater than the market value of the Company's common stock on April 24, 2003. These warrants were included on a Registration Statement on Form S-3, SEC File No. 333-109649, which was filed on October 10, 2003 and declared effective on November 18, 2003. In accordance with SFAS 123, the fair value of these warrants was estimated at \$230,000 and was recorded as non-cash compensation expense in the first quarter of fiscal 2004.

Frederick A. DeLuca, 5% Common Stockholder

On April 10, 2003, Mr. DeLuca entered into a credit arrangement with the Company pursuant to which Mr. DeLuca would purchase for the Company raw materials in an aggregate amount not to exceed \$500,000. The amounts paid for the purchased materials, plus interest at the rate of 15% per annum on such amounts, were paid in full and the credit arrangement terminated as of June 27, 2003. In consideration of the credit arrangement, the Company issued to Mr. DeLuca a warrant to purchase 100,000 shares of the Company's common stock at an exercise price of \$1.70. In accordance with SFAS 123, the fair value of this warrant was estimated at \$63,000 and was recorded as non-cash compensation expense in the first quarter of fiscal 2004.

Pursuant to a Securities Purchase Agreement dated as of May 21, 2003, Mr. DeLuca purchased 555,556 shares of common stock, respectively, at an aggregate sales price of \$1,000,000. These shares were included on a Registration Statement on Form S-3, SEC File No. 333-109649, which was filed on October 10, 2003 and declared effective on November 18, 2003.

David H. Lipka, Director

Pursuant to a Securities Purchase Agreement dated as of May 21, 2003, David H. Lipka purchased 55,556 shares of common stock, respectively, at an aggregate sales price of \$100,000. These shares were included on a Registration Statement on Form S-3, SEC File No. 333-109649, which was filed on October 10, 2003 and declared effective on November 18, 2003.

Indebtedness of Management and Others

On June 15, 1999, in conjunction with the entry into a new employment agreement, the Company agreed to a consolidation of Mr. Morini's two existing promissory notes in favor of the Company into a single note payable in the amount of \$12,772,200 due and payable on June 15, 2006. This note is non-interest bearing, non-recourse to Mr. Morini, and is secured by 2,914,286 shares of the Company's common stock beneficially owned by Mr. Morini. In the event of certain circumstances, the loan may be forgiven in full. The Company has a security interest in the pledged shares. The current outstanding balance of the obligation is \$12,772,200.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Audit Fees

With respect to the fiscal years ended March 31, 2004 and 2003, the aggregate fees (including expenses) charged the Company by BDO Seidman, LLP for auditing the annual financial statements and reviewing interim financial statements were \$138,458 and \$144,961, respectively. Audit fees consist of those fees incurred in connection with statutory and regulatory filings or engagements; fees necessary to perform an audit or review in accordance with GAAS; and services that generally only an independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission.

Approximately 74% and 75% of the total hours spent by the auditors in carrying out the audit of the Company's financial statements for the year ended March 31, 2004 and 2003, respectively were spent by members of the BDO Alliance network of firms. Such members are not full-time, permanent employees of BDO Seidman, LLP.

Audit-Related Fees

During the fiscal year ended March 31, 2004 and 2003, BDO Seidman, LLP charged the Company \$16,805 and \$32,577 for audit-related fees. These fees related to accounting research and audit committee meeting attendance.

Tax Fees

BDO Seidman, LLP did not render any tax services during the fiscal years ended March 31, 2004 and 2003.

All Other Fees

There were no fees for other services charged to the Company by BDO Seidman, LLP during the fiscal years ended March 31, 2004 and 2003. The Audit Committee has considered and determined that BDO Seidman, LLP's provision of non-audit services to the Company during the fiscal years ended March 31, 2004 and 2003 is compatible with maintaining their independence.

Audit Committee Pre-Approval Policies and Procedures.

The Audit Committee's pre-approval policy is as follows:

- The Audit Committee will review and pre-approve on an annual basis any known audit, audit-related, tax and all other services, along with acceptable cost levels, to be performed by any audit firm. The Audit Committee may revise the pre-approved services during the period based on subsequent determinations. Pre-approved services typically include: statutory audits, quarterly reviews, regulatory filing requirements, consultation on new accounting and disclosure standards, employee benefit plan audits, reviews and reporting on management's internal controls and specified tax matters.
- Any proposed service that is not pre-approved on the annual basis requires a specific pre-approval by the Audit Committee, including cost level approval.

- The Audit Committee may delegate pre-approval authority to the Audit Committee chairman. The chairman must report to the Audit Committee, at the next Audit Committee meeting, any pre-approval decisions made.

The Audit Committee is responsible for approving all engagements to perform audit or non-audit services prior to Company engaging BDO Seidman, LLP or Gallogly, Fernandez and Riley, LLP, a member of the BDO Alliance network of firms. All of the services under the headings Audit Fees, Audit-Related Fees, Tax Fees, and All Other Fees were 100% approved by the Audit Committee pursuant to Rule 2-01 paragraph (c)(7)(i)(C) of Regulation S-X of the Exchange Act.

PART IV

Item 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.

Financial Statements

Balance Sheets at March 31, 2004 and 2003
Statements of Operations for the years ended March 31, 2004, 2003 and 2002
Statement of Stockholders' Equity for the years ended March 31, 2004, 2003 and 2002
Statements of Cash Flows for the years ended March 31, 2004, 2003 and 2002
Notes to Financial Statements

Exhibits

The following Exhibits are filed as part of this Form 10-K.

Exhibit No Exhibit Description

- * 3.1 Restated Certificate of Incorporation of the Company as filed with the Secretary of State of the State of Delaware on December 23, 2002 (Filed as Exhibit 3.2 on Form 10-Q for the fiscal quarter ended December 31, 2002.)
- * 3.2 By-laws of the Company, as amended (Filed as Exhibit 3.2 to Registration Statement on Form S-18, No. 33-15893-NY.)
- * 4.1 Stock Purchase Option Agreement and Stock Purchase Warrant by and between Excalibur Limited Partnership and BH Capital Investments, L.P. and Galaxy Nutritional Foods dated as of April 24, 2003 (Filed as Exhibit 10.52 on Form 10-Q for the fiscal quarter ended June 30, 2003.)
- * 4.2 Warrant to Purchase Securities of Galaxy Nutritional Foods, Inc. dated as of May 29, 2003 in favor of SouthTrust Bank (Filed as Exhibit 10.7 on Form 8-K filed June 2, 2003.)
- * 4.3 Securities Purchase Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Fromageries Bel S.A. (Filed as Exhibit 10.8 on Form 8-K filed June 2, 2003.)
- * 4.4 Registration Rights Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Fromageries Bel S.A. (Filed as Exhibit 10.9 on Form 8-K filed June 2, 2003.)
- * 4.5 Securities Purchase Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Frederick A. DeLuca (Filed as Exhibit 10.10 on Form 8-K filed June 2, 2003.)
- * 4.6 Registration Rights Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Frederick A. DeLuca (Filed as Exhibit 10.11 on Form 8-K filed June 2, 2003.)
- * 4.7 Securities Purchase Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Apollo Capital Management Group, L.P. (Filed as Exhibit 10.12 on Form 8-K filed June 2, 2003.)
- * 4.8 Registration Rights Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Apollo Capital Management Group, L.P. (Filed as Exhibit 10.13 on Form 8-K filed June 2, 2003.)
- * 4.9 Securities Purchase Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Apollo MicroCap Partners, L.P. (Filed as Exhibit 10.14 on Form 8-K filed June 2, 2003.)

- * 4.10 Registration Rights Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Apollo MicroCap Partners, L.P. (Filed as Exhibit 10.15 on Form 8-K filed June 2, 2003.)
- * 4.11 Securities Purchase Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Ruggieri of Windermere Family Limited Partnership (Filed as Exhibit 10.16 on Form 8-K filed June 2, 2003.)
- * 4.12 Registration Rights Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Ruggieri of Windermere Family Limited Partnership (Filed as Exhibit 10.17 on Form 8-K filed June 2, 2003.)
- * 4.13 Securities Purchase Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Ruggieri Financial Pension Plan (Filed as Exhibit 10.18 on Form 8-K filed June 2, 2003.)
- * 4.14 Registration Rights Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and Ruggieri Financial Pension Plan (Filed as Exhibit 10.19 on Form 8-K filed June 2, 2003.)
- * 4.15 Securities Purchase Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and David Lipka (Filed as Exhibit 10.20 on Form 8-K filed June 2, 2003.)
- * 4.16 Registration Rights Agreement dated as of May 21, 2003 between Galaxy Nutritional Foods, Inc. and David Lipka (Filed as Exhibit 10.21 on Form 8-K filed June 2, 2003.)
- * 4.17 Stockholder Agreement dated as of October 13, 2003 between Galaxy Nutritional Foods, Inc. and Angelo S. Morini (Filed as Exhibit 10.55 on Form 10-Q for the fiscal quarter ended September 30, 2003.)
- * 10.1 Master Distribution and License Agreement dated as of May 22, 2003 between Galaxy Nutritional Foods, Inc. and Fromageries Bel S.A. (Filed as Exhibit 10.22 on Form 8-K filed June 2, 2003.)
- * 10.2 Loan and Security Agreement dated as of May 27, 2003 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (Filed as Exhibit 10.1 on Form 8-K filed June 2, 2003.)
- * 10.3 Patent, Copyright and Trademark Collateral Security Agreement dated as of May 27, 2003 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (Filed as Exhibit 10.2 on Form 8-K filed June 2, 2003.)
- * 10.4 Renewal Promissory Note in the principal amount of \$10,131,984.85 dated as of May 28, 2003 by Galaxy Nutritional Foods, Inc. in favor of SouthTrust Bank (Filed as Exhibit 10.3 on Form 8-K filed June 2, 2003.)
- * 10.5 Renewal Promissory Note in the principal amount of \$501,000.00 dated as of May 28, 2003 by Galaxy Nutritional Foods, Inc. in favor of SouthTrust Bank (Filed as Exhibit 10.4 on Form 8-K filed June 2, 2003.)
- * 10.6 Amendment of Loan Agreement dated as of May 28, 2003 between Galaxy Nutritional Foods, Inc. and SouthTrust Bank (Filed as Exhibit 10.5 on Form 8-K filed June 2, 2003.)
- * 10.7 Amendment of Security Agreement dated as of May 28, 2003 between Galaxy Nutritional Foods, Inc. and SouthTrust Bank (Filed as Exhibit 10.6 on Form 8-K filed June 2, 2003.)
- * 10.8 Waiver Letter from Textron Financial Corporation to the Company dated August 13, 2003 (Filed as Exhibit 10.53 on Form 10-Q for the fiscal quarter ended June 30, 2003.)
- * 10.9 Second Amended and Restated Employment Agreement dated as of October 13, 2003 between Galaxy Nutritional Foods, Inc. and Angelo S. Morini (Filed as Exhibit 10.1 on Form 8-K filed October 20, 2003.)
- * 10.10 Settlement Agreement dated May 6, 2004 between Galaxy Nutritional Foods, Inc. and Schreiber Foods, Inc. (Filed as Exhibit 10.1 on Form 8-K filed May 11, 2004.)
- 10.11 Modification Letter on the Security Agreement dated as of May 21, 2004 between Galaxy Nutritional Foods, Inc. and SouthTrust Bank (*Filed herewith.*)

- 10.12 Second Amendment to Loan and Security Agreement dated June 25, 2004 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (*Filed herewith.*)
- 10.13 Third Amendment to Lease Agreement dated June 10, 2004 between Galaxy Nutritional Foods, Inc. and Cabot Industrial Properties, L.P. (*Filed herewith.*)
- * 20.1 Audit Committee Charter (Filed as Exhibit 20.1 on Form 10-Q for the fiscal quarter ended September 30, 2003.)
- * 20.2 Compensation Committee Charter (Filed as Exhibit 20.2 on Form 10-Q for the fiscal quarter ended September 30, 2003.)
- 23.1 BDO Seidman, LLP Consent Letter (*Filed herewith.*)
- 31.1 Section 302 Certification of the Company's Chief Executive Officer (*Filed herewith.*)
- 31.2 Section 302 Certification of the Company's Chief Financial Officer (*Filed herewith.*)
- 32.1 Section 906 Certification of the Company's Chief Executive Officer (*Filed herewith.*)
- 32.2 Section 906 Certification of the Company's Chief Financial Officer (*Filed herewith.*)

- * Previously filed and incorporated herein by reference.

Reports on Form 8-K

On February 18, 2004, the Company filed a Current Report on Form 8-K to disclose the press release announcing the Company's financial results for its third fiscal quarter ended December 31, 2003. There was one report on Form 8-K filed on May 11, 2004 announcing the settlement of the litigation suit between the Company and Schreiber Foods, Inc.

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.

GALAXY NUTRITIONAL FOODS, INC.

Date: June 29, 2004

Christopher J. New
Chief Executive Officer

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 and on the dated indicated.

Date: June 29, 2004

Christopher J. New
Chief Executive Officer & Director
(Principal Executive Officer)

Date: June 29, 2004

Salvatore J. Furnari
Chief Financial Officer
(Principal Financial & Accounting Officer)

Date: June 29, 2004

David H. Lipka
Chairman of the Board

Date: June 29, 2004

Michael E. Broll
Director

Date: June 29, 2004

Thomas R. Dyckman
Director

Date: June 29, 2004

Charles L. Jarvie
Director

Date: June 29, 2004

Joseph J. Juliano
Director

Date: June 29, 2004

Angelo S. Morini
Director

Date: June 29, 2004

Patrice M.A. Videlier
Director