

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

OR

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

For the transition period from _____ to _____

Commission File Number 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)

(407) 855-5500

(Registrant's telephone number, including area code)

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

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

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

On November 11, 2005, there were 20,051,327 shares of common stock, \$.01 par value per share, outstanding.

GALAXY NUTRITIONAL FOODS, INC.

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PART I. FINANCIAL INFORMATION
GALAXY NUTRITIONAL FOODS, INC.
Balance Sheets

| | <u>Notes</u> | <u>SEPTEMBER 30, 2005</u> | <u>MARCH 31, 2005</u> |
|---|--------------|-------------------------------|---------------------------|
| | | <u>(Unaudited)</u> | |
| ASSETS | | | |
| CURRENT ASSETS: | | | |
| Cash | | \$ -- | \$ 561,782 |
| Trade receivables, net | 12 | 6,026,258 | 4,644,364 |
| Inventories | | 3,283,094 | 3,811,470 |
| Prepaid expenses and other | | 371,547 | 219,592 |
| | | <hr/> | <hr/> |
| Total current assets | | 9,680,899 | 9,237,208 |
| PROPERTY AND EQUIPMENT, NET | 7 | 9,330,257 | 18,246,445 |
| OTHER ASSETS | | 352,048 | 286,013 |
| | | <hr/> | <hr/> |
| TOTAL | | <u>\$ 19,363,204</u> | <u>\$ 27,769,666</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | | |
| CURRENT LIABILITIES: | | | |
| Line of credit | 2 | \$ 4,275,221 | \$ 5,458,479 |
| Book overdraft | | 130,834 | -- |
| Accounts payable | | 3,198,435 | 3,057,266 |
| Accrued and other current liabilities | 3 | 1,801,241 | 2,130,206 |
| Current portion of accrued employment contracts | 8,11 | 903,362 | 586,523 |
| Current portion of term notes payable | 2 | 8,670,985 | 1,320,000 |
| Current portion of obligations under capital leases | | 114,792 | 194,042 |
| | | <hr/> | <hr/> |
| Total current liabilities | | 19,094,870 | 12,746,516 |
| ACCRUED EMPLOYMENT CONTRACTS , less current portion | 11 | 743,887 | 993,305 |
| TERM NOTES PAYABLE , less current portion | 2 | -- | 6,921,985 |
| OBLIGATIONS UNDER CAPITAL LEASES , less current portion | | 68,258 | 85,337 |
| | | <hr/> | <hr/> |
| Total liabilities | | 19,907,015 | 20,747,143 |
| COMMITMENTS AND CONTINGENCIES | 4 | -- | -- |
| TEMPORARY EQUITY: | | | |
| Common stock, subject to registration | 4 | 2,680,590 | 2,220,590 |
| STOCKHOLDERS' EQUITY (DEFICIT): | | | |
| Common stock | | 175,511 | 164,115 |
| Additional paid-in capital | | 68,360,749 | 65,838,227 |
| Accumulated deficit | | (58,868,000) | (48,307,748) |
| | | <hr/> | <hr/> |
| Less: Notes receivable arising from the exercise of stock options | 11 | 9,668,260 | 17,694,594 |
| Treasury stock | | (12,772,200) | (12,772,200) |
| | | (120,461) | (120,461) |
| | | <hr/> | <hr/> |
| Total stockholders' equity (deficit) | | (3,224,401) | 4,801,933 |
| TOTAL | | <u>\$ 19,363,204</u> | <u>\$ 27,769,666</u> |

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
Statements of Operations
(UNAUDITED)

| | Notes | THREE MONTHS ENDED SEPTEMBER 30, | | SIX MONTHS ENDED SEPTEMBER 30, | |
|---|----------|-------------------------------------|----------------------------------|-----------------------------------|----------------------------------|
| | | 2005 | 2004 | 2005 | 2004 |
| NET SALES | 5 | \$ 10,438,225 | \$ RESTATED 11,900,553 | \$ 20,289,378 | \$ RESTATED 23,092,231 |
| COST OF GOODS SOLD | | 7,817,351 | 9,319,969 | 15,400,206 | 17,571,299 |
| Gross margin | | <u>2,620,874</u> | <u>2,580,584</u> | <u>4,889,172</u> | <u>5,520,932</u> |
| OPERATING EXPENSES: | | | | | |
| Selling | | 1,557,547 | 1,572,470 | 2,493,792 | 3,032,870 |
| Delivery | | 726,078 | 615,257 | 1,341,549 | 1,208,583 |
| Employment contract expense – general and administrative | | -- | 444,883 | -- | 444,883 |
| General and administrative, including \$3,319, (\$121,172), \$870,837 and \$41,202 non-cash compensation related to stock based transactions | 6 | 921,934 | 444,796 | 2,523,464 | 1,240,512 |
| Research and development | | 89,052 | 78,932 | 180,094 | 151,618 |
| Cost of disposal activities | 8 | 499,556 | -- | 754,567 | -- |
| Impairment of property and equipment | 7 | -- | -- | 7,896,554 | -- |
| Loss on sale of assets | | 6,242 | -- | 5,606 | -- |
| Total operating expenses | | <u>3,800,409</u> | <u>3,156,338</u> | <u>15,195,626</u> | <u>6,078,466</u> |
| INCOME (LOSS) FROM OPERATIONS | | <u>(1,179,535)</u> | <u>(575,754)</u> | <u>(10,306,454)</u> | <u>(557,534)</u> |
| OTHER INCOME (EXPENSE): | | | | | |
| Interest expense | | (293,603) | (264,008) | (650,798) | (523,824) |
| Derivative income | 5 | -- | 442,606 | -- | 321,487 |
| Gain/(loss) on fair value of warrants | | 57,000 | 620,247 | 397,000 | 461,351 |
| Total other income (expense) | | <u>(236,603)</u> | <u>798,845</u> | <u>(253,798)</u> | <u>259,014</u> |
| NET INCOME (LOSS) | | \$ (1,416,138) | \$ 223,091 | \$ (10,560,252) | \$ (298,520) |
| Less: | | | | | |
| Preferred stock dividends | 5 | -- | 38,006 | -- | 80,398 |
| Preferred stock accretion to redemption value | 5 | -- | (225,304) | -- | 275,340 |
| NET INCOME (LOSS) TO COMMON STOCKHOLDERS | | \$ <u>(1,416,138)</u> | \$ <u>410,389</u> | \$ <u>(10,560,252)</u> | \$ <u>(654,258)</u> |
| BASIC AND DILUTED NET INCOME (LOSS) PER COMMON SHARE | 9 | \$ <u>(0.07)</u> | \$ <u>0.03</u> | \$ <u>(0.55)</u> | \$ <u>(0.04)</u> |

See accompanying notes to financial statements.

GALAXY NUTRITIONAL FOODS, INC.
Statements of Stockholders' Equity (Deficit)
(UNAUDITED)

| | Common Stock | | Additional Paid-In Capital | Accumulated Deficit | Notes Receivable for Common Stock | Treasury Stock | Total |
|---|--------------|------------|-------------------------------|------------------------|---|-------------------|----------------|
| | Shares | Par Value | | | | | |
| Balance at March 31, 2005 | 16,411,474 | \$ 164,115 | \$ 65,838,227 | \$ (48,307,748) | \$ (12,772,200) | \$ (120,461) | \$ 4,801,933 |
| Exercise of warrants | 1,130,000 | 11,300 | 1,257,700 | -- | -- | -- | 1,269,000 |
| Exercise of options | 2,000 | 20 | 2,540 | -- | -- | -- | 2,560 |
| Issuance of common stock under employee stock purchase plan | 7,603 | 76 | 11,785 | -- | -- | -- | 11,861 |
| Fair value of stock-based transactions | -- | -- | 1,443,053 | -- | -- | -- | 1,443,053 |
| Non-cash compensation related to variable securities | -- | -- | (192,556) | -- | -- | -- | (192,556) |
| Net loss | -- | -- | -- | (10,560,252) | -- | -- | (10,560,252) |
| Balance at September 30, 2005 | 17,551,077 | \$ 175,511 | \$ 68,360,749 | \$ (58,868,000) | \$ (12,772,200) | \$ (120,461) | \$ (3,224,401) |

See accompanying notes to financial statements.

GALAXY NUTRITIONAL FOODS, INC.
Statements of Cash Flows
(UNAUDITED)

| Six Months Ended September 30, | <u>Notes</u> | <u>2005</u> | <u>2004</u> RESTATED |
|--|--------------|--------------------|-------------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net Loss | | \$ (10,560,252) | \$ (298,520) |
| Adjustments to reconcile net loss to net cash from (used in) operating activities: | | | |
| Depreciation and amortization | | 1,075,852 | 1,092,086 |
| Amortization of debt discount and financing costs | | 105,718 | 49,615 |
| Provision for losses on trade receivables | | 754,451 | 164,000 |
| Impairment of property and equipment and (gain)/loss on sale of assets | 7 | 7,902,161 | -- |
| Change in fair value of derivative instrument | 5 | -- | (321,487) |
| (Gain) Loss on fair value of warrants | | (397,000) | (461,351) |
| Non-cash compensation related to stock-based transactions | 1,6 | 870,837 | 41,202 |
| (Increase) decrease in: | | | |
| Trade receivables | | (2,136,345) | (2,019,628) |
| Inventories | | 528,376 | (339,254) |
| Prepaid expenses and other | | (151,955) | (47,802) |
| Increase (decrease) in: | | | |
| Accounts payable | | 141,169 | 1,173,240 |
| Accrued and other liabilities | | 301,456 | 343,691 |
| | | <u>(1,565,532)</u> | <u>(624,208)</u> |
| NET CASH FROM (USED IN) OPERATING ACTIVITIES | | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchase of property and equipment | | (82,525) | (77,207) |
| Proceeds from sale of equipment | | 20,700 | 22,482 |
| | | <u>(61,825)</u> | <u>(54,725)</u> |
| NET CASH FROM (USED IN) INVESTING ACTIVITIES | | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Increase in book overdrafts | 10 | 130,834 | -- |
| Net borrowings (payments) on line of credit | | (1,183,258) | 1,276,485 |
| Borrowing on term notes payable | | 1,200,000 | -- |
| Repayments on term notes payable | | (550,000) | (480,000) |
| Principal payments on capital lease obligations | | (96,329) | (133,731) |
| Financing costs for long term debt | | (179,093) | -- |
| Costs associated with issuance of common stock | | -- | (22,500) |
| Proceeds from issuance of common stock under employee stock purchase plan | | 11,861 | 12,480 |
| Proceeds from exercise of common stock options | | 2,560 | -- |
| Proceeds from exercise of common stock warrants | 5 | 1,729,000 | -- |
| | | <u>1,065,575</u> | <u>652,734</u> |
| NET CASH FROM (USED IN) FINANCING ACTIVITIES | | | |
| NET INCREASE (DECREASE) IN CASH | | (561,782) | (26,199) |
| CASH, BEGINNING OF PERIOD | | <u>561,782</u> | <u>449,679</u> |
| CASH, END OF PERIOD | | <u>\$ --</u> | <u>\$ 423,480</u> |

See accompanying notes to financial statements.

GALAXY NUTRITIONAL FOODS, INC.
Notes To Financial Statements
(UNAUDITED)

(1) Summary of Significant Accounting Policies

The unaudited financial statements have been prepared by Galaxy Nutritional Foods, Inc. (the "Company"), in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and applicable rules and regulations of the Securities and Exchange Commission. The accompanying financial statements contain all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of such financial statements. Certain information and disclosures normally included in the financial statements prepared in accordance with GAAP have been omitted under such rules and regulations although the Company believes that the disclosures are adequate to make the information presented not misleading. The March 31, 2005 balance sheet data was derived from the audited financial statements, but does not include all disclosures required by GAAP. These unaudited financial statements should be read in conjunction with the financial statements and notes included on Form 10-K/A for the fiscal year ended March 31, 2005. Interim results of operations for the six-month period ended September 30, 2005 may not necessarily be indicative of the results to be expected for the full year.

Impairment of Long-Lived Assets

In accordance with SFAS No. 144, "*Accounting for the Impairment of Disposal of Long-Lived Assets*," the Company evaluates the carrying value of long-lived assets when circumstances indicate the carrying value of those assets may not be fully recoverable. The Company evaluates recoverability of long-lived assets held for use by comparing the net carrying value of an asset group to the estimated undiscounted cash flows (excluding interest) during the remaining life of the asset group. If such an evaluation indicates that the future undiscounted cash flows of certain long-lived asset groups are not sufficient to recover the carrying value of such asset groups, the assets are then adjusted to their fair values. The Company recorded an impairment of property and equipment in the first quarter of fiscal 2006 as discussed more fully in Note 7.

Disposal Costs

The Company has recorded significant accruals in connection with its planned asset sale and outsourcing arrangement with Schreiber Foods, Inc. These accruals include estimates pertaining to employee termination costs and, in the future, may also include related abandonment of excess equipment and facilities and other potential costs. Actual costs may differ from these estimates or the Company's estimates may change. In accordance with SFAS 146, "*Accounting for Costs Associated with Exit or Disposal Activities*", costs associated with restructuring activities are recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. Given the significance and complexity of these activities, and the timing of the execution of such activities, the accrual process involves periodic reassessments of estimates made at the time the original decisions were made, including evaluating estimated employment terms and real estate market conditions for sub-lease rents. The Company will continually evaluate the adequacy of the remaining liabilities under its restructuring initiatives. Although the Company believes that these estimates accurately reflect the costs of its activities, actual results may differ, thereby requiring the Company to record additional provisions or reverse a portion of such provisions. Should the timing of employee terminations change, the Company's estimate of restructuring expenses may have to be increased.

Stock Based Compensation

The Company has three stock-based employee compensation plans. Prior to April 1, 2003, the Company accounted for those plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*," (APB No. 25), and related Interpretations.

Effective April 1, 2003, the Company adopted the fair value recognition provisions of 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*," prospectively to all employee awards granted on or after April 1, 2003. These standards require the Company to provide pro-forma information regarding net income (loss) and earnings (loss) per share amounts as if compensation cost for all the Company's employee and director stock-based awards had been determined in accordance with the fair value method prescribed in SFAS No. 123. Awards from the Company's plans vest over periods ranging from immediate to five years. Therefore, the cost related to stock-based compensation included in the determination of net income for the periods is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS No. 123.

The Company estimated the fair value of each stock-based award during the periods presented by using the Black-Scholes pricing model with the following assumptions:

| | | |
|--------------------------|---------------|---------------|
| Six Months Ended: | September 30, | September 30, |
| Dividend Yield | 2005 | 2004 |
| Volatility | None | None |
| Risk Free Interest Rate | 24.9%-46.0% | 44.0%-59.0% |
| Expected Lives in Months | 3.35%-3.45% | 1.46%-3.96% |
| | 1-36 | 6-120 |

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

| | THREE MONTHS ENDED | | SIX MONTHS ENDED | |
|--|---------------------------|-------------------|-------------------------|---------------------|
| | SEPTEMBER 30, | | SEPTEMBER 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | | RESTATED | | RESTATED |
| Net income (loss) to common stockholders as reported | \$ (1,416,138) | \$ 410,389 | \$ (10,560,252) | \$ (654,258) |
| Add: Stock-based compensation expense included in reported net income (loss) | 3,319 | (121,172) | 870,837 | 41,202 |
| Deduct: Stock-based compensation expense determined under fair value based method for all awards | (13,652) | 91,263 | (891,245) | (101,317) |
| Pro forma net income (loss) to common stockholders | <u>\$ (1,426,471)</u> | <u>\$ 380,480</u> | <u>\$ (10,580,660)</u> | <u>\$ (714,373)</u> |
| Net income (loss) per common share: | | | | |
| Basic & Diluted – as reported | \$ (0.07) | \$ 0.03 | \$ (0.55) | \$ (0.04) |
| Basic & Diluted – pro forma | <u>\$ (0.07)</u> | <u>\$ 0.02</u> | <u>\$ (0.55)</u> | <u>\$ (0.05)</u> |

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

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.

Reclassifications

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

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.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, "*Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4.*" SFAS No. 151 requires that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recorded as current period charges and that the allocation of fixed production overheads to inventory be based on the normal capacity of the production facilities. SFAS No. 151 is effective during fiscal years beginning after June 15, 2005, although earlier application is permitted. The Company believes that the adoption of this Statement will not have a significant impact on the financial position, results of operations or cash flows of the Company.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "*Share-Based Payment*" ("SFAS No. 123R"), which addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for (a) equity instruments of the company or (b) liabilities that are based on the fair value of the company's equity instruments or that may be settled by the issuance of equity instruments. SFAS No. 123R supercedes APB Opinion No. 25 and amends SFAS No. 95, "*Statement of Cash Flows.*" Under SFAS No. 123R, companies are required to record compensation expense for all share-based payment award transactions measured at fair value as determined by an option valuation model. Currently, the Company uses the Black-Scholes pricing model to calculate the fair value of its share-based transactions. This statement is effective for fiscal years beginning after June 15, 2005. Since the Company currently recognizes compensation expense at fair value for share-based transactions in accordance with SFAS No. 123, it does not anticipate adoption of this standard will have a significant impact on its financial position, results of operations, or cash flows. However, the Company is still evaluating all aspects of the revised standard.

In December 2004, the FASB issued SFAS No. 153, "*Exchanges of Nonmonetary Assets an Amendment of APB Opinion No. 29.*" SFAS No. 153 amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets from being measured based on the fair value of the assets exchanged. SFAS No. 153 now provides a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. The Company believes that the adoption of this Statement will not have a significant impact on its financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, "*Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and SFAS No. 3.*" SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and a change required by an accounting pronouncement when the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application of changes as if the new accounting principle had always been used. SFAS No. 154 is effective for fiscal years beginning after December 15, 2005. The Company is still evaluating all aspects of the revised standard in order to evaluate the impact on its financial position and results of operations.

(2) Line of Credit, Notes Payable and Going Concern

On May 27, 2003, the Company obtained from Textron Financial Corporation ("Textron") a revolving credit facility (the "Textron Loan") with a maximum principal amount of \$7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 (the "Textron Loan Agreement"). 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) 85% of the net amount of its eligible accounts receivable plus (ii) 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 1.75% per annum (8.5% at September 30, 2005) calculated on the average cash borrowings for the preceding month. The initial term of the Textron loan ends on May 26, 2006. As of September 30, 2005, the outstanding principal balance on the Textron Loan was \$4,275,221.

The Textron Loan Agreement contains certain financial and operating covenants. On June 3, 2005, the Company executed a fourth amendment to the Textron Loan Agreement that provided a waiver on all the existing defaults for the fiscal quarters ended December 31, 2004 and March 31, 2005, and amended the fixed charge coverage ratio and the adjusted tangible net worth requirements for periods after March 31, 2005. Additionally, the fourth amendment allowed the Textron Loan to be in an over-advance position not to exceed \$750,000 until July 31, 2005. In exchange for the waiver and amendments, the Company's interest rate on the Textron Loan was set at Prime plus 4.75% and the Company paid a fee of \$50,000 in four weekly installments of \$12,500.

On June 16, 2005, the Company used a portion of the proceeds from the warrant exercises described in Note 5 to satisfy the \$750,000 over-advance with Textron. In connection with the satisfaction of the over-advance, the Company agreed to immediately terminate Textron's obligation to permit any over-advances under the Textron Loan, which obligation was to expire on July 31, 2005. With the termination of the over-advance facility, the interest rate on the Textron Loan returned to its prior level of Prime plus 1.75%.

Due to the cost of disposal activities and impairment of property and equipment (as discussed in Notes 7 and 8), the Company fell below the requirements in the fixed charge coverage ratio and the adjusted tangible net worth calculation from June 30, 2005 through September 30, 2005. Effective October 1, 2005, the Company executed a fifth amendment to the Textron Loan Agreement that provided a waiver for the defaults in the fixed charge coverage ratio and the adjusted tangible net worth requirements, in addition to certain over-advances on the Textron Loan, during the periods from June 2005 through September 2005. The fifth amendment amends and replaces several financial covenants, allows eligibility for borrowing on inventory until December 31, 2005 and provides that the Textron Loan will expire at the end of the initial term on May 26, 2006. Additionally, Textron has consented to the sale of the Company's manufacturing equipment to Schreiber and the termination of their liens on the assets being sold. In exchange for the waiver and amendments, the Company paid a fee of \$50,000, and has agreed to pay an administration fee in the following installments if the Textron Loan has not then been paid in full: 5,000 on February 1, 2006, \$10,000 on March 1, 2006, \$15,000 on April 1, 2006 and \$20,000 May 1, 2006. The Company anticipates that it will be in compliance with the amended covenants and reporting requirements through the end of the term of the Textron Loan on May 26, 2006.

Simultaneous with the closing of the Textron Loan in May 2003, Wachovia Bank, N.A. successor by merger to SouthTrust Bank ("Wachovia") extended the Company a new term loan in the principal amount of \$2,000,000. This term loan was consolidated with the Company's March 2000 term loan with Wachovia, which had a then outstanding principal balance of \$8,131,985 for a total term loan amount of \$10,131,985. This term loan is secured by all of the Company's equipment and certain related assets. Additionally, the term loan bears interest at Wachovia's Base Rate plus 1% (7.75% at September 30, 2005).

On June 30, 2005, the Company entered into a Loan Modification Agreement with Wachovia regarding its term loan. The agreement modified the following terms of the loan: 1) the loan will mature and be payable in full on July 31, 2006 instead of June 1, 2009; 2) the principal payments will remain at \$110,000 per month with accrued interest at Wachovia's Base Rate plus 1% instead of increasing to \$166,250 on July 1, 2005 as provided by the terms of the promissory note evidencing the loan; and 3) all covenants related to the Company's tangible net worth, total liabilities to tangible net worth, and maximum funded debt to EBITDA ratios are waived and compliance is not required by the Company through the maturity of the loan on July 31, 2006. In connection with the agreement, the Company agreed to pay \$60,000, of which \$30,000 was paid upon execution of the agreement and \$30,000 was paid on August 1, 2005. As required by the terms of the agreement, if the Company sells the equipment securing the loan, the loan will be due and payable in full at the time of sale. Therefore, the proceeds from the sale of the Company's manufacturing equipment to Schreiber will be used to pay the loan in full.

In September 2005, Wachovia assigned this term loan to Beltway Capital Partners LLC. The balance outstanding on the term loan as of September 30, 2005 was \$7,691,985.

Pursuant to a Note and Warrant Purchase Agreement dated September 12, 2005, the Company received \$1,200,000 as a loan from Mr. Frederick A. DeLuca, a greater than 10% shareholder, which loan was evidenced by an unsecured promissory note (the "Note"). The Note requires monthly interest only payments at 3% above the bank prime rate of interest per the Federal Reserve Bank and matures on June 15, 2006. In consideration for the Note and in accordance with an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, the Company issued to Mr. DeLuca a warrant to purchase up to 300,000 shares of the Company's common stock at an exercise price equal to \$1.53 (95% of the lowest closing price of the Company's common stock in the sixty calendar days immediately preceding October 17, 2005). The warrant fully vested on October 17, 2005 and can be exercised on or before the expiration date of October 17, 2008. Also in consideration for the Note, the Company granted Mr. DeLuca "piggy back" registration rights with respect to the shares underlying the warrant. In accordance with the accounting provisions of SFAS No. 123, the Company recorded the \$234,000 initial fair value of the warrant as a discount to debt on September 12, 2005. This discount is being amortized from September 2005 through June 2006. The Company amortized \$13,000 in the three months ended September 30, 2005. Since the exercise price for the warrant was not fixed until October 17, 2005, the Company revalued the warrant obligation on September 30, 2005 and calculated a

fair value of \$177,000. The \$57,000 difference between the initial value of the warrant and the value of the warrant on September 30, 2005 was recorded as a gain on fair value of warrants in the Statement of Operations.

If the Company is unable to refinance or renew the Company's existing credit facilities, or if additional financing is not available on terms acceptable to us, the Company will be unable to satisfy such facilities by their maturity dates. In such an event, Textron, Beltway and the shareholders (including Mr. DeLuca and those discussed in Note 13) could exercise their respective rights under their loan documents, which could include, among other things, declaring defaults under the loans and pursuing foreclosure on the Company's assets that are pledged as collateral for such loans. If such an event occurred, it would be substantially more difficult for us to effectively continue the operation of the Company's business, and it is unlikely that the Company would be able to continue as a going concern.

(3) Accrued and Other Current Liabilities

Accrued and other current liabilities are summarized as follows:

| | <u>September 30, 2005</u> | <u>March 31, 2005</u> |
|----------------------------------|---------------------------|-----------------------|
| Tangible personal property taxes | \$ 1,227,683 | \$ 1,049,841 |
| Warrant liability | 177,000 | 740,000 |
| Other | 396,558 | 340,365 |
| Total | <u>\$ 1,801,241</u> | <u>\$ 2,130,206</u> |

(4) Commitments and Contingencies

In accordance with a registration rights agreement dated October 6, 2004, the Company agreed that within 180 days it would file with the Securities and Exchange Commission ("SEC") and obtain effectiveness of a registration statement that included 2,000,000 shares issued in a private placement and 500,000 shares related to a stock purchase warrant. Per the terms of the agreement, if a registration statement was not filed, or did not become effective within 180 days, then in addition to any other rights the investor may have, the Company would be required to pay certain liquidated damages. The Company filed a registration statement on Form S-3 on March 14, 2005. However, this registration statement has not yet been declared effective. The investor granted an extension of time to have the registration statement declared effective by the SEC and waived all damages and remedies for failure to have an effective registration statement until September 1, 2005. As of September 1, 2005, the Company is accruing liquidated damages of \$71,875 (2.5% times the product of 2,500,000 registerable shares and the share price of \$1.15 per share) every thirty days until the registration statement becomes effective. The Company is in the process of completing a pre-effective amendment to the registration statement and will request acceleration of the effectiveness of the registration statement as soon after its filing as reasonably practicable.

The Emerging Issues Task Force ("EITF") is currently reviewing the accounting for securities with liquidated damages clauses as stated in EITF 05-04, "*The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF 00-19.*" There are currently several views as to how the account for this type of transaction and the EITF has not yet reached a consensus. In accordance with EITF 00-19 and 05-04, because the maximum potential liquidated damages as described above may be greater than the difference in fair values between registered and unregistered shares, the value of the common stock subject to registration should be classified as temporary equity until the registration statement becomes effective. Based on the above determination, the Company has recorded the \$2,680,590 value of common stock subject to registration as temporary equity. Upon effectiveness of the registration statement, the amount will be reclassified into permanent equity.

(5) Capital Stock

Common Stock Issuances

In accordance with a warrant agreement dated April 10, 2003, the Company issued to Mr. Frederick DeLuca, a greater than 10% shareholder, a warrant to purchase up to 100,000 shares of common stock of the Company at an exercise price of \$1.70 per share. Additionally, in accordance with a warrant agreement dated October 6, 2004, the Company issued to Mr. DeLuca a warrant to purchase up to 500,000 shares of common stock of the Company at an exercise price of \$1.15 per share. Subsequently in June 2005, the Company agreed to reduce the per-share exercise price on these warrants to \$1.36 and \$0.92, respectively, in order to induce Mr. DeLuca to exercise his warrants. All of the warrants were exercised on June 16, 2005 for total proceeds of \$596,000.

In accordance with EITF 00-19, "*Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled in the Company's Own Stock,*" and the terms of the above warrant for 500,000 shares of common stock, the fair value of the warrant was accounted for as a liability, with an offsetting reduction to the carrying value of the common stock. On March 31, 2005, the fair value of the warrant was estimated using the Black-Scholes pricing model to be \$740,000

and on June 16, 2005, the fair value was estimated to be \$400,000. The \$340,000 change in fair value was reflected as a gain on the fair value of warrants line item in the Statement of Operations during the three months ended June 30, 2005. The warrant liability was moved to temporary equity upon the exercise of the warrant as described above.

On each of April 24, 2003 and October 6, 2004, BH Capital Investments, LP and Excalibur Limited Partnership each received warrants to purchase up to 250,000 shares of common stock at an exercise price of \$2.00 per share. Also, Excalibur Limited Partnership received a warrant to purchase up to 30,000 shares of common stock at an exercise price of \$2.05 per share on June 26, 2002. Subsequently in June 2005, the Company agreed to reduce the per-share exercise price on all such warrants to \$1.10 in order to induce BH Capital Investments, LP and Excalibur Limited Partnership to exercise their warrants. All of the warrants were exercised on June 16, 2005 for total proceeds of \$1,133,000.

The Company used a portion of the proceeds from the warrant exercises to satisfy the \$750,000 over-advance provided by Textron under the Fourth Amendment and Waiver to the Textron Loan Agreement, as described in Note 2 and the remaining proceeds from the warrant exercises were used for working capital purposes.

In accordance with the accounting provisions of SFAS No. 123, the Company recorded \$1,024,500 in non-cash compensation expense related to the reduction in the exercise price of the warrants in June 2005.

Preferred Stock Issuances and Restatement

On April 6, 2001, the Company received from BH Capital Investments, LP 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 were 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 was equal to the quotient of \$48.18, plus all accrued and unpaid dividends for each share of the Series A convertible preferred stock, divided by the lesser 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.

In total, the Series A Preferred Holders converted 42,330 shares of the Series A convertible preferred stock plus accrued dividends, into 1,806,210 shares of common stock prior to the redemption of the Series A convertible preferred stock on October 6, 2004. The conversion prices ranged from \$1.07 to \$1.75 based on the above formula.

In connection with a Stock Repurchase Agreement dated October 6, 2004, the Company redeemed the remaining 30,316 Series A convertible preferred shares held by the Series A Preferred Holders for a total price of \$2,279,688. All previously outstanding shares of the Series A convertible preferred stock of the Company have now been cancelled.

The Company originally concluded under EITF 00-19, "*Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled in the Company's Own Stock*," that the conversion feature was conventional and that there was no need to separate the conversion right during the period the Series A convertible preferred shares were outstanding. Subsequent to the redemption of the remaining preferred shares, it has been determined that certain features of the conversion option resulted in treatment different from that historically reflected.

The preferred stock was a fixed-income security with no participating rights and the dividend was 10% per annum in the first year and 8% per annum in the second, third and fourth years. Therefore, consistent with paragraph 61(l) of SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*," the Company has concluded that the conversion option was not clearly and closely related to the host instrument. Ordinarily, an issuer does not need to separate a conversion right from a convertible instrument. However, in accordance with paragraph 4 of EITF 00-19, the Company has determined that due to the fact that the embedded conversion option contained a provision that could have resulted in a conversion into an indeterminable number of common shares, that the conversion feature was in fact "unconventional". Further, since the conversion right embedded in the preferred stock has been considered a derivative, the related dividends are also considered derivative instruments. As a result, the embedded derivative was a liability that was required to be separated from the preferred stock and this liability should have been marked to market during reporting periods. The fair value of the derivative instruments was determined using the Black-Scholes pricing model. Based on this determination, the Company adjusted its results for the three and six months ended September 30, 2004 to reflect a derivative income of \$442,606 and \$321,487, respectively, related to the change in the

fair value of the embedded derivative instruments. As of September 30, 2004, there was a derivative liability of \$430,785.

Additionally, since the conversion of the Series A convertible preferred stock could have resulted in a conversion into an indeterminable number of common shares, the Company has determined that under the guidance in paragraph 24 of EITF 00-19, it was prohibited from concluding that it had sufficient authorized and unissued shares to net-share settle any warrants or options issued to non-employees. Therefore, the Company has reclassified to a liability the fair value of all warrants and options issued to non-employees that were outstanding during the period that the Series A convertible preferred stock was outstanding from April 2001 to October 2004. The fair value of the warrants were determined using the Black-Scholes pricing model. Any changes in the fair value of the securities after the initial valuation in April 2001 should have been marked to market during reporting periods. Based on this determination, the Company recorded a warrant liability of \$203,547 as of September 30, 2004. For the three and six months ended September 30, 2004, the Company has restated to record a gain on the fair value of warrants of \$620,247 and 461,351, respectively.

The following table summarizes the changes in the Statement of Operations for the three months ended September 30, 2004:

| | <u>As Previously Reported</u> | <u>Adjustment</u> | <u>As Restated</u> |
|---|-----------------------------------|-------------------|--------------------|
| Income (Loss) From Operations | \$ (575,754) | \$ -- | \$ (575,754) |
| Interest Expense | (264,008) | -- | (264,008) |
| Derivative Income (Expense) | -- | 442,606 | 442,606 |
| Gain (loss) on Fair Value of Warrants | -- | 620,247 | 620,247 |
| Net Income (Loss) | <u>(839,762)</u> | <u>1,062,853</u> | <u>223,091</u> |
| Less: | | | |
| Preferred Stock Dividends | 40,180 | (2,174) | 38,006 |
| Preferred Stock Accretion to Redemption Value | <u>(308,570)</u> | <u>83,266</u> | <u>(225,304)</u> |
| Net Income (Loss) to Common Stockholders | <u>\$ (571,372)</u> | <u>\$ 981,761</u> | <u>\$ 410,389</u> |
| Basic and Diluted Net Loss per Common Share | <u>\$ (0.04)</u> | <u>\$ 0.07</u> | <u>\$ 0.03</u> |

The following table summarizes the changes in the Statement of Operations for the six months ended September 30, 2004:

| | <u>As Previously Reported</u> | <u>Adjustment</u> | <u>As Restated</u> |
|---|-----------------------------------|-------------------|---------------------|
| Income (Loss) From Operations | \$ (557,534) | \$ -- | \$ (557,534) |
| Interest Expense | (523,824) | -- | (523,824) |
| Derivative Income (Expense) | -- | 321,487 | 321,487 |
| Gain (loss) on Fair Value of Warrants | -- | 461,351 | 461,351 |
| Net Income (Loss) | <u>(1,081,358)</u> | <u>782,838</u> | <u>(298,520)</u> |
| Less: | | | |
| Preferred Stock Dividends | 82,572 | (2,174) | 80,398 |
| Preferred Stock Accretion to Redemption Value | <u>203,605</u> | <u>71,735</u> | <u>275,340</u> |
| Net Income (Loss) to Common Stockholders | <u>\$ (1,367,535)</u> | <u>\$ 713,277</u> | <u>\$ (654,258)</u> |
| Basic and Diluted Net Loss per Common Share | <u>\$ (0.09)</u> | <u>\$ 0.05</u> | <u>\$ (0.04)</u> |

The Series A Preferred Holders had the right to receive on any outstanding share of Series A convertible preferred stock a ten percent dividend, 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 three and six

months ended September 30, 2004, the Company recorded preferred dividends of \$38,006 and \$80,398, 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 calculated an estimated redemption value of the remaining preferred stock and then calculated the difference between the initial carrying value and this estimated redemption value. The difference was then accreted over the redemption period (48 months beginning April 2001) using the straight-line method, which approximates the effective interest method. For the three and six months ended September 30, 2004, the Company recorded (\$225,304) and \$275,340, respectively, related to the accretion of the redemption value of preferred stock.

(6) Non-Cash Compensation Related to Stock-Based Transactions

Effective April 1, 2003, the Company elected to record compensation expense measured at fair value for all stock-based award transactions (including, but not limited to, restricted stock awards, stock option grants, and warrant issuances) on or after April 1, 2003 under the provisions of SFAS No. 123. Prior to April 1, 2003, the Company only recorded the fair value of stock-based awards granted to non-employees or non-directors under the provisions of SFAS No. 123. The fair value of the stock-based award is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related award. Prior to April 1, 2003, the Company accounted for its stock-based employee and director compensation plans under the accounting provisions of APB No. 25 as interpreted by FASB Interpretation No. 44 ("FIN 44"). Any modifications of fixed stock options or awards granted to employees or directors originally accounted for under APB No. 25 may result in additional compensation expense under the provisions of FIN 44.

In accordance with the above accounting standards, the Company calculates and records non-cash compensation related to its securities in the general and administrative expense line item in the Statements of Operations based on two primary items:

a. Stock-Based Award Issuances

During the three months ended September 30, 2005 and 2004, the Company recorded \$26,434 and \$36,994, respectively, in non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants. During the six months ended September 30, 2005 and 2004, the Company recorded \$1,063,393 and \$41,202, respectively, in non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants.

b. Option Modifications for Awards granted to Employees or Directors under APB No. 25

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. Prior to the repricing modification, the options were accounted for as a fixed award under APB No. 25. In accordance with FIN 44, the repricing of the employee stock options requires additional compensation expense to be recognized and adjusted in subsequent periods for changes in the price of the Company's common stock that are in excess of the \$2.05 stock price on the date of modification (additional intrinsic value). 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 to reverse all or a portion of the expense recognized in prior periods. Compensation income is limited to the original base exercise price (the intrinsic value) of the options. This variable accounting treatment for these modified stock options began with the quarter ended December 31, 2002 and such variable accounting treatment will continue until the related options have been cancelled, expired or exercised. There are 3,499,841 outstanding modified stock options remaining as of September 30, 2005. The Company recorded non-cash compensation expense/(income) of (\$23,115) and (\$158,166) for the three months ended September 30, 2005 and 2004, respectively, related to the modified options described above. The Company recorded non-cash compensation expense/(income) of (\$192,556) and zero for the six months ended September 30, 2005 and 2004, respectively, related to the modified options described above.

(7) Impairment of Property and Equipment

In light of the Asset Sale and Supply Arrangements discussed in Note 8, the Company determined that it is more likely than not that a majority of its fixed assets related to production activities will be sold or disposed prior to the end of their useful life. These assets represent approximately 98% of the value of Property and Equipment. In accordance with SFAS No. 144, "Accounting for the Impairment of Disposal of Long-Term Assets," the Company wrote down the value of its assets to their estimated fair values in June 2005. The Company will continue to hold and use the assets until they are sold. Therefore, all assets will continue to be reported and depreciated under Property and Equipment in the Balance Sheet until they are sold. The Company estimated the fair value based on the sales price discussed below and the anticipated sales price related to any other assets plus future cash flows related to the assets from July 1, 2005

until the sale. Based on this estimate, the Company recorded an impairment of property and equipment of \$7,896,554 in order to reflect a net fair value of its equipment in June 2005.

(8) Disposal Activities

On June 30, 2005, the Company entered into a Supply Agreement (the “Supply Agreement”) with Schreiber Foods, Inc. (“Schreiber”) whereby Schreiber will manufacture and distribute all of the Company’s products. The Company simultaneously entered into an Asset Purchase Agreement with Schreiber whereby Schreiber will purchase substantially all of the Company’s production machinery and equipment for a total of \$8,700,000 (the “Proposed Asset Sale”).

The Proposed Asset Sale is expected to close on or about December 8, 2005. The closing is subject to the satisfaction of various conditions, including approval of the sale by the Company’s stockholders and certain lenders. The Company is requesting the approval of its stockholders at a Special Meeting of Stockholders to be held on December 5, 2005. As stated in Note 2, the Company has already received the necessary approvals from its lenders.

The initial term of the Supply Agreement is for a period of five years from the effective date of September 1, 2005 and is renewable at the Company’s option for up to two additional five-year periods (for a total term of up to fifteen years). Since October 2005, Schreiber has begun to purchase the Company’s remaining raw materials, ingredients and packaging at the Company’s cost. In mid-November 2005, Schreiber will begin shipping the finished products to the Company or its customers, and will bill the Company for the production and shipments based on a pre-determined price matrix.

The Supply Agreement provides for a contingent short-fall payment obligation by the Company if a specified production level is not met during the one-year period from September 1, 2006 to August 31, 2007. If a contingent short-fall payment is accrued after such one-year period, it may be reduced by the amount by which production levels in the one-year period from September 1, 2007 to August 31, 2008 exceeds the specified target level of production, if any. If the Proposed Asset Sale for \$8,700,000, as contemplated by the Asset Purchase Agreement is not consummated, then the Company will not be required to pay any such short-fall payment.

If the Company does not exercise its option to renew the Supply Agreement at the end of the initial five-year period, there is a cancellation charge of \$1,500,000. If the Company does not exercise its option to renew the Supply Agreement at the end of the second five-year period, there is a cancellation charge of \$750,000. If the Proposed Asset Sale for \$8,700,000, as contemplated by the Asset Purchase Agreement is not consummated, then the Company will not be required to pay any such cancellation charge.

The above transactions were communicated to the Company’s employees on July 6, 2005. It is anticipated that by January 2006, 113 employee positions will be eliminated after the Proposed Asset Sale and the completion of moving all manufacturing operations to Schreiber. The Company is accounting for the costs associated with these transactions in accordance with SFAS No. 146, “*Accounting for Costs Associated with an Exit or Disposal Activity*,” because the above arrangements are planned and controlled by management and materially change the manner in which the Company’s business will be conducted. In accordance with SFAS No. 146, costs associated with disposal activities should be reported as a reduction of income from operations. For the three and six months ended September 30, 2005, the Company incurred and reported \$499,556 and \$754,567 as Costs of Disposal Activities in the Statement of Operations. These costs of disposal activities are comprised of employee termination costs and legal and consulting fees. The Company anticipates that in future periods, there will be additional disposal costs related to legal and consulting fees in addition to possible lease abandonment charges, which have not yet been incurred and therefore have not been accrued. The Company may be required to adjust its accrual and estimated expense related to employee termination costs if the actual timing of the terminations changes from original estimates.

As of September 30, 2005, the Company has accrued the following costs associated with the above transactions:

| | Employee Termination Costs |
|-----------------------------|---|
| Balance March 31, 2005 | \$ -- |
| Expensed | 359,774 |
| Paid | -- |
| Balance, September 30, 2005 | <u>\$ 359,774</u> |

(9) **Earnings Per Share**

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

| | THREE MONTHS ENDED SEPTEMBER 30, | | SIX MONTHS ENDED SEPTEMBER 30, | |
|--|---|--------------------------|---|--------------------------|
| | 2005 | 2004 RESTATED | 2005 | 2004 RESTATED |
| Net income (loss) to common stockholders | \$ <u>(1,416,138)</u> | \$ <u>410,389</u> | \$ <u>(10,560,252)</u> | \$ <u>(654,258)</u> |
| Weighted average shares outstanding – basic | 20,045,953 | 15,767,924 | 19,358,496 | 15,717,439 |
| Potential shares “in-the-money” under stock option agreements | -- | 43,643 | -- | -- |
| Less: Shares assumed repurchased under the treasury stock method | <u>--</u> | <u>(34,355)</u> | <u>--</u> | <u>--</u> |
| Weighted average shares outstanding – basic and diluted | \$ <u>20,045,953</u> | \$ <u>15,777,212</u> | \$ <u>19,358,496</u> | \$ <u>15,717,439</u> |
| Basic and diluted net income (loss) per common share | \$ <u>(0.07)</u> | \$ <u>0.03</u> | \$ <u>(0.55)</u> | \$ <u>(0.04)</u> |

Options for 5,059,809 shares and warrants for 648,213 shares have not been included in the computation of diluted net loss per common share for the three and six months ended September 30, 2005, as their effect would be antidilutive. Potential conversion of Series A convertible preferred stock for 2,148,829 shares, options for 4,783,701 shares and warrants for 1,235,356 shares have not been included in the computation of diluted net loss per common share for the six months ended September 30, 2004, as their effect would be antidilutive. Potential conversion of Series A convertible preferred stock for 2,148,829 shares, options for 4,740,058 shares and warrants for 1,235,356 shares have not been included in the computation of diluted net income per common share for the three months ended September 30, 2004, as their effect would be antidilutive.

(10) **Supplemental Cash Flow Information**

For purposes of the statement of cash flows, all highly liquid investments with a maturity date of three months or less are considered to be cash equivalents.

| <u>Six months ended September 30,</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|
| Non-cash financing and investing activities: | | |
| Accrued preferred stock dividends | \$ -- | \$ 80,398 |
| Accretion of discount on preferred stock | -- | 275,340 |
| Purchase of equipment through a capital lease | -- | 34,476 |
| Cash paid for: | | |
| Interest | 571,876 | 433,391 |

(11) **Related Party Transactions**

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 he is no longer involved in the daily operations of the Company. He retains the title of Founder and has been named Chairman Emeritus. Mr. Morini continues to be 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.

Because Mr. Morini is no longer performing ongoing services for the Company, the Company accrued and expensed the five-year cost of this agreement in October 2003. The total estimated costs expensed under this agreement were \$1,830,329 of which \$1,110,192 remained unpaid but accrued (\$366,305 as short-term liabilities and \$743,887 as

long-term liabilities) as of September 30, 2005. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

In June 1999, in connection with an amended and restated employment agreement for Mr. Morini, 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 single consolidated note is non-interest bearing and non-recourse and is secured by the 2,914,286 underlying shares of the Company's common stock. Per the terms of the June 1999 Employment Agreement that was amended and restated by the October 2003 Second Amended and Restated Employment Agreement between the Company and Mr. Morini, 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 stockholder.

In the event that the \$12,772,200 loan is forgiven, the Company would reflect this amount as a forgiveness of debt in the Statement of Operations. In the event that Mr. Morini is unable to pay the loan when due and the Company forecloses on the shares, the Company will reflect a loss on collection for the amount, if any, that the value of the 2,914,286 underlying collateral shares are below the value of the note. Assuming the market price on September 30, 2005 of \$1.61, the Company would reflect a loss of approximately \$8,080,200 in the Statement of Operations. Although both of these scenarios will result in material losses to the Company's operations, it will not have any affect on the balance sheet since the \$12,772,200 loan amount is already shown as a reduction to Stockholders' Equity.

Christopher J. New

On July 8, 2004, Christopher J. New resigned from his position as Chief Executive Officer in order to pursue other opportunities. In accordance with the Separation and Settlement Agreement between the Company and Mr. New, the Company recorded \$444,883 related to the employment contract expense in July 2004. This settlement will be paid out in nearly equal installments over two years payable on the Company's regular payroll dates. As of September 30, 2005, the remaining unpaid but accrued balance reflected in short-term liabilities was \$177,283.

(12) Economic Dependence

The Company had one customer that accounted for approximately 7% and 10% of sales in the three and six months ended September 30, 2005. As of September 30, 2005, the amount due from this customer is approximately 5% of the balance of accounts receivable. The Company had one customer that accounted for approximately 11% and 13% of sales in the three and six months ended September 30, 2004.

(13) Subsequent Events

In October 2005, pursuant to several Note and Warrant Purchase Agreements dated September 28, 2005, the Company received a \$600,000 loan from Conversion Capital Master, Ltd., a \$485,200 loan from SRB Greenway Capital (Q.P.), L.P., a \$69,600 loan from SRB Greenway Capital, L.P., and a \$45,200 loan from SRB Greenway Offshore Operating Fund, L.P. These loans were evidenced by unsecured promissory notes (the "Notes"). The Notes require monthly interest only payments at 3% above the bank prime rate of interest per the Federal Reserve Bank and mature on June 15, 2006. In consideration for the Notes and in accordance with an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, the Company issued to Conversion Capital Master, Ltd., SRB Greenway Capital (Q.P.), L.P., SRB Greenway Capital, L.P., and SRB Greenway Offshore Operating Fund, L.P., warrants to purchase up to 150,000 shares, 121,300 shares, 17,400 shares, and 11,300 shares, respectively, of the Company's common stock at an exercise price equal to \$1.53 (95% of the lowest closing price of the Company's common stock in the sixty calendar days immediately preceding October 17, 2005). The warrants fully vested on October 17, 2005 and can be exercised on or before the expiration date of October 17, 2008. Also in consideration for the Notes, the Company granted Conversion Capital Master, Ltd., SRB Greenway Capital (Q.P.), L.P., SRB Greenway Capital, L.P., and SRB Greenway Offshore Operating Fund, L.P. "piggy back" registration rights with respect to the shares underlying the warrants. In accordance with the accounting provisions of SFAS No. 123, the Company recorded the \$210,731 initial fair value of the warrant as a discount to debt in October 2005. This discount will be amortized from October 2005 through June 2006.

GALAXY NUTRITIONAL FOODS, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

INFORMATION IN THIS MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS ("MD&A") IS INTENDED TO ENHANCE A READER'S UNDERSTANDING OF THE FINANCIAL CONDITION, CHANGES IN FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF OUR COMPANY. THIS MD&A IS A SUPPLEMENT TO AND SHOULD BE READ IN CONJUNCTION WITH OUR FINANCIAL STATEMENTS AND NOTES THERETO APPEARING ELSEWHERE IN THIS REPORT. THE FOLLOWING DISCUSSION CONTAINS CERTAIN FORWARD-LOOKING STATEMENTS, WITHIN THE MEANING OF THE "SAFE-HARBOR" PROVISIONS OF THE PRIVATE SECURITIES REFORM ACT OF 1995, THE ATTAINMENT OF WHICH INVOLVES VARIOUS RISKS AND UNCERTAINTIES. THESE STATEMENTS RELATE TO FUTURE EVENTS OR OUR FUTURE FINANCIAL PERFORMANCE. THESE FORWARD-LOOKING STATEMENTS ARE BASED ON OUR CURRENT EXPECTATIONS, ESTIMATES AND PROJECTIONS ABOUT OUR INDUSTRY, MANAGEMENT'S BELIEFS AND CERTAIN ASSUMPTIONS MADE BY OUR COMPANY. WORDS SUCH AS "ANTICIPATE," "EXPECT," "INTEND," "PLAN," "BELIEVE," "SEEK," "PROJECT," "ESTIMATE," "MAY," "WILL," 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 MAY DIFFER MATERIALLY FROM OUR HISTORICAL RESULTS AND THOSE EXPRESSED OR FORECASTED IN ANY FORWARD-LOOKING STATEMENTS AS A RESULT OF A VARIETY OF FACTORS, INCLUDING BUT NOT LIMITED TO, COMPETITION IN THE MARKET FOR OUR PRODUCTS, DEPENDENCE ON SUPPLIERS, OUR MANUFACTURING EXPERIENCE, PRODUCTION DELAYS OR INEFFICIENCIES, AND CHANGES IN ACCOUNTING STANDARDS. WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR REVISE ANY FORWARD-LOOKING STATEMENTS FOR ANY REASON, EVEN IF NEW INFORMATION BECOMES AVAILABLE OR OTHER EVENTS OCCUR IN THE FUTURE.

Terms such as "fiscal 2006" or "fiscal 2005" refer to our fiscal years ending March 31, 2006 and 2005, respectively. Terms such as "first quarter," "second quarter," "third quarter," or "fourth quarter" refer to the fiscal quarters ending June 30, September 30, December 31 or March 31, respectively.

This MD&A contains the following sections:

- Restatement
- Business Environment
- Critical Accounting Policies
- Recent Accounting Pronouncements
- Results of Operations
- Liquidity and Capital Resources

Restatement

This Form 10-Q and the restated fiscal 2005 financial statements included herein reflect a correction of our accounting and disclosure primarily related to the warrants that were outstanding during the term of our Series A convertible preferred stock, from April 2001 through October 2004. The issue relates to accounting for securities that are reflected as income or expense through earnings as non-cash charges. These non-cash charges do not affect our revenues, cash flows from past or future operations, or our liquidity. As discussed in Note 5 of the financial statements, for the three and six months ended September 30, 2004, we have restated our financial statements to reflect a net income (loss) of \$223,091 and (\$298,520), which reflects an additional income of \$1,062,853 and \$782,838, respectively, from what was previously reported for this period in the Form 10-Q for the quarterly period ended September 30, 2004.

Business Environment

General

Galaxy Nutritional Foods, Inc. (our "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. These healthy cheese and dairy related products include low or no fat, no saturated fat, no trans-fat, low or no cholesterol and lactose-free varieties. These products are sold throughout the United States and

internationally to customers in the retail and food service markets. Our company headquarters and manufacturing facilities are located in Orlando, Florida.

Our Company is currently in a transition period with respect to its manufacturing operations. We determined that our manufacturing capacity was significantly in excess of our requirements, and that it would be advantageous for us to outsource our manufacturing, packaging and delivery operations. On June 30, 2005, our Company and Schreiber Foods, Inc., a Wisconsin corporation (“Schreiber”), entered into a Supply Agreement, whereby we agreed that, among other things, as of November 1, 2005, Schreiber would become our sole source of supply of substantially all of our products and we would purchase our requirements of substantially all of our products exclusively from Schreiber. Schreiber has also agreed to deliver such products directly to our customers. The prices for such products are based on cost conversions determined by the parties from time to time.

In connection with the Supply Agreement, we also entered into an Asset Purchase Agreement, dated as of June 30, 2005, by and between Schreiber and our Company, whereby we agreed to sell our manufacturing equipment to Schreiber in exchange for \$8,700,000, in cash, payable at closing. The closing of the sale is subject to approval by our stockholders and satisfaction of certain other conditions. If the stockholders do not approve the sale, we have agreed to consummate one or two alternative transactions designed to facilitate Schreiber’s manufacturing responsibilities under the Supply Agreement. Regardless of whether the proposed asset sale is consummated, our Company will convert into a branded marketing company that will continue to market and sell our products, but will no longer manufacture all of our products.

Healthy Cheese and Alternative Cheese Industry

We are the market leader within our alternative cheese category niche, but in being so, the category increases or decreases partly as a result of our marketing efforts. We believe that the greatest source of future growth in the cheese alternative category will come through customers shifting to cheese alternatives from natural cheese. Rather than focusing primarily on consumers with a preference or medical condition predisposing them to non-dairy cheese and comparing our products to other cheese alternative brands, we intend to focus on educating cheese consumers on the healthy attributes of cheese alternatives versus traditional cheese.

We use several internal and external reports to monitor sales by brand, segment, form and channel of sale to determine which items 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, we analyze trends in the consumer marketplace and make decisions on which brands to promote.

In the second quarter of fiscal 2006, we launched a consumer marketing sales campaign focused on the following three primary strategies:

- Consumer focused advertising. We plan to increase consumer advertising (in TV, magazine, and event sponsorship) and consumer promotions (for example, on-pack “cents off” coupons, “cents off” coupons delivered via newspapers, in-store product sampling, and product benefit communication at the point of purchase/shelf) that highlight and communicate the benefits of our products to meet the consumer demand for low fat, no cholesterol and high calcium products.
- Increase retailer penetration and geographical distribution. By increasing our presence on the store shelves, we seek to increase household penetration and build market share in specific markets.
- Increase brand awareness. We seek to increase sales by increasing our customer base and generating consumer awareness of new products or flavors through product trials and generating more repeat purchases on our Veggie™ brand through improved taste, color, aroma, texture and packaging.

We began the consumer television advertising campaign the first week in September 2005 for the West Coast, InterMountain and Minneapolis markets. In support of that advertising, we distributed coupons through the newspapers in all those markets as well. Initial sales data from these markets in the four weeks following the promotions, indicate that sales increased more than 10% from sales in the four weeks prior to the promotions. At this time, we are unable to determine if we will experience continued positive effects from the advertising campaigns. Thus, sales improvements in these four weeks are not necessarily indications of future results. We have also secured distribution of our new product snack dips and chipotle- flavored chunks with over 70% of our current customers. These new products have not had enough market time to impact sales, but we are hopeful that by the end fiscal 2006, they will contribute to increased sales and improved margins.

We believe that the combination of “healthy” product attributes, improved taste and product functionality will lead to better than expected consumer experiences with our products. Our focus is to transfer those improved consumer experiences into enhanced market share and increased sales of our higher margin products.

Recent Material Developments

The Schreiber Transactions

Asset Purchase Agreement

On June 30, 2005, we entered into an Asset Purchase Agreement for the sale of certain of our manufacturing and production equipment to Schreiber for \$8,700,000 in cash (the “Proposed Asset Sale”). The Proposed Asset Sale is expected to close on or about December 8, 2005. The closing is subject to the satisfaction of various conditions, including approval of the sale by our stockholders and certain lenders. We are requesting the approval of our stockholders at a Special Meeting of Stockholders to be held on December 5, 2005. Additionally, we have already received the necessary approvals from our lenders.

If our stockholders do not approve the transaction, the Asset Purchase Agreement provides for an alternative transaction whereby we would sell to Schreiber a smaller portion of the assets, which would not constitute substantially all of our assets and therefore would not require stockholder approval. The purchase price for this alternative sale would be \$2,115,000. This alternative sale is subject to obtaining approval from our lenders.

If we are unable to obtain approval from our lenders with respect to this alternative sale, then we will negotiate in good faith with Schreiber to make the smaller portion of the assets available for Schreiber’s use on reasonably acceptable terms, not to exceed a term of 180 days. This alternative arrangement is also subject to obtaining approval from our lenders.

The Supply Agreement

On June 30, 2005, our Company and Schreiber entered into a Supply Agreement, whereby we agreed that, among other things, as of November 1, 2005, Schreiber will manufacture and distribute all of our products directly to our customers. The prices for such products are based on cost conversions determined by the parties from time to time. Other key provisions of the Supply Agreement are as follows:

- The initial term of the Supply Agreement is for a period of five years from the effective date of September 1, 2005 and is renewable at our option for up to two additional five-year periods (for a total term of up to fifteen years). Since October 2005, Schreiber has begun to purchase our remaining raw materials, ingredients and packaging at our cost. In mid-November 2005, Schreiber will begin shipping the finished products to our Company or its customers, and will bill our Company for the production and shipments based on a pre-determined price matrix.
- The Supply Agreement provides for a contingent short-fall payment obligation by our Company if a specified production level is not met during the one-year period from September 1, 2006 to August 31, 2007. If a contingent short-fall payment is accrued after such one-year period, it may be reduced by the amount by which production levels in the one-year period from September 1, 2007 to August 31, 2008 exceeds the specified target level of production, if any. If the Proposed Asset Sale for \$8,700,000, as contemplated by the Asset Purchase Agreement is not consummated, then we will not be required to pay any such short-fall payment.
- If we do not exercise our option to renew the Supply Agreement at the end of the initial five-year period, there is a cancellation charge of \$1,500,000. If we do not exercise our option to renew the Supply Agreement at the end of the second five-year period, there is a cancellation charge of \$750,000. If the Proposed Asset Sale for \$8,700,000, as contemplated by the Asset Purchase Agreement is not consummated, then we will not be required to pay any such cancellation charge.
- Schreiber is required to deliver products to our Company or our customers that are in compliance with our standards and specifications and all applicable laws. Schreiber will deliver all products within 10 business days of the effective date of such order, which is one business day after receipt of the order.
- After the transfer of all production responsibilities to Schreiber, we may not manufacture any products governed by the Supply Agreement during the term of the Supply Agreement.

- Schreiber may not manufacture our products or use any of our intellectual property other than pursuant to the terms of the Supply Agreement.
- We may terminate the Supply Agreement if our stockholders do not approve the Proposed Asset Sale, by providing notice to Schreiber within 30 days of the date that our stockholders vote on, but do not approve, the Proposed Asset Sale. The effectiveness of such termination may not be more than 180 days after the date of such notice.
- If we do not terminate the Supply Agreement and we are unable to consummate an alternative asset sale or use transaction with Schreiber (as described above) prior to January 1, 2006, then Schreiber may terminate the Supply Agreement by providing written notice to our Company prior to February 1, 2006. The effectiveness of such termination may not be less than 180 days after the date of such notice.
- As indicated above, there are a number of conditions that must be met prior to the consummation of these transactions. There can be no guarantee that we will satisfy these conditions and, therefore, there can be no guarantee that the transactions will be consummated.

Transition Challenges

We will face many challenges during this transition to solely a branded marketing company, including, but are not limited to, the following:

- Coordinating customer shipments while the inventory and production equipment is in transit from our facilities to the Schreiber facilities;
- Reserving enough inventory on-hand to fill customer orders while production equipment is in transit;
- Maintaining consistent formulas and quality in our products after the transition;
- Maintaining enough cash to build inventory and pay any severance arrangements during the transition;
- Reducing production personnel and agreeing upon severance arrangements related to these personnel;
- Negotiating with our lenders to the extent debt is not paid in full from the sale proceeds so that they will release their liens on the assets to permit the sale. If they will not agree to do so, we may be required to raise additional funds to pay our lenders in full prior to their maturity dates; and
- Negotiating with the landlords of our leased premises to terminate or assign our lease or to sublease our facilities.

Each one of these events must be carefully timed and coordinated in order to avoid problems with cash flow, litigation, loss of customer sales, and other tangible and intangible effects. In the event the asset sale to Schreiber as contemplated by the Asset Purchase Agreement is not consummated, these challenges will be much more difficult to overcome and we will be faced with the additional challenge of seeking alternative options involving the sale of any manufacturing equipment not sold to Schreiber. There can be no assurance that any third party will offer to purchase our manufacturing equipment for a price equal to or greater than the price proposed to be paid by Schreiber, or that such equipment can otherwise be sold at all. Our failure to adequately address any of these challenges would negatively affect our business, results of operations and cash flows.

Transaction Effect

We believe that the long-term benefits in the transition from a manufacturing company to a branded marketing company will far outweigh the short-term challenges of the transition. Without the cash-flow burden of carrying inventory and managing manufacturing overhead and production issues, we believe that we can focus a substantially greater amount of time and resources on the sale of our products. Additionally, we plan to enhance our marketing efforts in order to increase our consumer base and sales volume.

Assuming that the sale of assets to Schreiber is completed in accordance with the Proposed Asset Sale and we continue to operate under the Supply Agreement with Schreiber, some of the effects of the transaction will be as follows:

- We will no longer be a manufacturing company, but will be solely a branded marketing company.
- We have two facilities that we lease in Orlando, Florida. After all production is moved completely to Schreiber, we may be required to have discussions with our landlords regarding the use of our facilities. We are still exploring our options regarding the facilities, which include, but are not limited to: 1) negotiating an early

termination with the landlords; 2) continuing to make lease payments until the end of the lease terms; or 3) subleasing the facilities.

- We will be eliminating 115 employee positions and creating 5 new employee positions. Our anticipated total number of full-time employees after December 31, 2005 will be 31.
- We will use all the proceeds to pay down accrued liabilities and short-term debt. Upon closing of the Proposed Asset Sale, we expect to pay \$1,319,583 to the Orange County Tax Collector for accrued tangible property taxes and \$7,361,985 to Beltway Capital Partners LLC to pay the term loan in full. Any remaining balance will be used to pay down our line of credit with Textron. Repayment of these liabilities will result in annual interest savings in excess of \$800,000.
- We will no longer have the carrying value of inventory nor need to use asset based financing to support the production of inventory. In the recent past, we averaged 50 to 60 days of sales in inventory.
- We will be able to take advantage of Schreiber's lower production costs rather than the high production costs of our underutilized production facility.
- We anticipate substantial savings on delivery charges related to the distribution of our products to our customers.

Debt Maturity and Going Concern Issues

We have incurred substantial debt in connection with the financing of our business. The aggregate principal amount outstanding under our credit facilities is approximately \$12,200,608 as of November 11, 2005. This amount includes a revolving line of credit from Textron Financial Corporation ("Textron") in the amount of \$2,328,623, a note payable to Beltway Capital Partners LLC, successor by assignment from Wachovia Bank, ("Beltway") in the amount of \$7,471,985, and several notes payable to certain shareholders (as described under *Debt Financing*) totaling \$2,400,000. We anticipate that the proceeds from the sale of our assets to Schreiber will pay the Beltway term loan in full. However, in the event that the sale is not completed as anticipated, we will need to refinance the Beltway term loan on or before its maturity date of July 31, 2006. Additionally, we will need to refinance or raise proceeds to pay the Textron line of credit on or before its maturity date of May 26, 2006 and the notes payable to shareholders on or before their maturity date of June 15, 2006.

If we are unable to refinance or renew our existing credit facilities, or if additional financing is not available on terms acceptable to us, we will be unable to satisfy such facilities by their maturity dates. In such an event, Textron, Beltway and the shareholders could exercise their respective rights under their loan documents, which could include, among other things, declaring defaults under the loans and pursuing foreclosure on our assets that are pledged as collateral for such loans. If such an event occurred, it would be substantially more difficult for us to effectively continue the operation of our business, and it is unlikely that we would be able to continue as a going concern.

Del Sunshine LLC

Pursuant to an oral contract manufacturing and distribution arrangement among our Company, Del Sunshine LLC ("Del"), a Delaware limited liability company, and Non-Dairy Specialty Foods, LLC ("Non-Dairy"), a Nevada limited liability company and affiliate of Del, we began manufacturing certain private label products for Del and delivering them directly to Del's customers, including Del's major customer, Wal-Mart, Inc. in April 2004. These private label products were produced using label and packaging trademarks owned by Del. Sales to Del accounted for 12% of our sales during fiscal 2005, which attributed to 65% of the increase in sales over fiscal 2004.

On April 11, 2005, we executed with Del a Trademark License Agreement and an Assignment of Accounts Receivable Agreement. Pursuant to the Trademark License Agreement, Del licensed to us the rights in certain Del trademarks, which allowed us to sell products directly to Del's customers, including Wal-Mart, Inc. and other food retailers, using such trademarks. In consideration for the license, we agreed to pay to Del a 5% royalty on the net sales of such products. In accordance with the Trademark License Agreement, we can offset any royalties that we may owe to Del under the agreement against our account receivable and other amounts owed to us by Del.

Pursuant to the Assignment of Accounts Receivable Agreement, Del assigned to us any and all accounts receivable owed to Del by Wal-Mart, Inc. and other food retailers, plus monies owed to Del under current purchase orders. It was intended that the assignment of the accounts receivable and purchase order amounts would offset, in part, our account receivable from Del. We also agreed not to commence any legal proceedings against Del or Non-Dairy to collect amounts owed to us by them, excluding defenses and counterclaims against Del or Non-Dairy made in any legal proceeding brought by them.

The effectiveness of the Trademark License Agreement and the Assignment of Accounts Receivable Agreement was conditioned upon Del providing us with proof, satisfactory to us, that (a) Del would be transferring to us under the Assignment of Accounts Receivable Agreement accounts receivable and purchase orders in excess of \$400,000 and (b) that Wal-Mart, Inc. would consent to the transactions contemplated under both agreements. Del has not satisfied either of the

foregoing conditions and we do not believe that it is likely that Del will be able to satisfy the conditions in the future. Although we waived the conditions as they relate to the Trademark License Agreement, we did not waive them with respect to the Assignment of Accounts Receivable Agreement. Currently, we are exploring our options in addressing the issues with Del related to the effectiveness and continuation of the Assignment of Accounts Receivable Agreement and Del's payment of our account receivable. On or about June 15, 2006, we ceased selling products under Del's trademarks and we allowed the Trademark License Agreement to expire according to its terms on September 30, 2005.

In the fourth quarter of fiscal 2005, we reserved nearly \$1,550,000 in accounts receivable and wrote off \$210,000 in inventory related to Del based upon our determination in April 2005 that collection from Del was questionable as of March 31, 2005. During the first quarter of fiscal 2006, we accrued approximately \$40,000 in royalties under the Trademark License Agreement and offset them against the receivable owed to us by Del. During the six months ended September 30, 2005, we recorded approximately \$261,000 in additional bad debt related to Del. As of September 30, 2005, all amounts owed by Del have been written off as uncollectible.

Measurements of Financial Performance

We focus on several items in order to measure our performance. In the short term (1 to 3 years), we are 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 stock based transactions
- EBITDA excluding certain employment contract expenses and non-cash compensation related to stock based transactions
- Liquidity
- Net sales trends (as it relates to consumer demand)
- Key financial ratios (such as accounts receivable, accounts payable and inventory turnover ratios)
- Other operating ratios and statistics

In the long term (over 3 years), we are striving to generate consistent and predictable net sales growth with increased gross margins, while incrementally enhancing net cash flow from operations.

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. Our significant estimates include the allowance for doubtful accounts receivable, provision for obsolete inventory, valuation of deferred taxes, valuation of compensation expense on options and warrants, and accruals for disposal costs. Although we believe 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 management and the methodology for estimates and assumptions are as follows:

Valuation of Accounts Receivable and Chargebacks

We record revenue upon shipment of products to our customers and reasonable assurance of collection on the sale. We generally provide credit terms to customers based on net 30-day terms. We perform ongoing credit evaluations of our accounts receivable balances and based on historical experience, make reserves for anticipated future customer credits for promotions, discounts, spoils, and other reasons. In addition, we evaluate the accounts for potential uncollectible amounts based on a specific identification methodology and record a general reserve for all remaining balances.

Based on the age of the receivable, cash collection history and past dilution in the receivables, we make an estimate of our 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, we reserved \$1,186,000 and \$797,000 for known and anticipated future credits and doubtful accounts at September 30, 2005 and 2004, respectively. The reserve is higher at September 30, 2005 primarily due to additional promotions that we initiated in August and September 2005. We believe that this estimate is reasonable, but there can be no assurance that our estimate

will not change given a change in economic conditions or business conditions within the food industry, our individual customer base or our Company.

Inventory

Inventories are valued at the lower of cost or market. Cost is determined using a weighted average, first-in, first out method. We review our inventory valuation each month and write off the inventory related to obsolete and damaged inventory. In addition, we reduce the value of any finished good item to market value when that value is believed to be 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. We have reserved our net deferred tax assets in full.

Valuation of Non-Cash Compensation

We have three stock-based employee compensation plans. Prior to April 1, 2003, we accounted for those plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," (APB No. 25), and related Interpretations.

Effective April 1, 2003, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," and apply SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure," prospectively to all employee awards granted on or after April 1, 2003. Awards from our plans vest over periods ranging from immediate to five years. Therefore, the cost related to stock-based compensation included in the determination of net income for the periods is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS No. 123. The fair value of the stock-based award (including, but not limited to, restricted stock awards, stock option grants, and warrant issuances) is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related award. The difference between the proforma and reported net loss per common share related to the issuance of employee stock options during the three and six months ended September 30, 2005 and 2004 ranged from nearly zero to \$0.01.

Several management estimates are needed to compute the fair value of the stock-based transactions including anticipated life, risk free interest rates, and volatility of our stock price. Currently, we estimate the life of all awards granted assuming that the award will remain outstanding and not be exercised until the end of its term. This results in the highest possible value of the award. If we were to change our estimate of the anticipated life to something less than the maximum term, then the fair value expense per share would decrease by approximately \$.01 to \$.02 per month. If we were to change our estimate of the volatility percentage, the fair value expense per share would change by approximately \$.02 per percentage change in the volatility. If we were to change our estimate of the interest rate, the fair value expense per share would change by approximately \$.03 per percentage change in the interest rate.

SFAS No. 123 requires that we provide pro-forma information regarding net income (loss) and earnings (loss) per share amounts as if compensation cost for all our employee and director stock-based awards had been determined in accordance with the fair value method prescribed in SFAS No. 123. We estimated the fair value of each stock-based award (i.e. restricted stock awards, stock option grants, and warrant issuances) during the periods presented by using the Black-Scholes pricing model with the following assumptions:

| Six Months Ended: | September 30, 2005 | September 30, 2004 |
|--------------------------|-----------------------|-----------------------|
| Dividend Yield | None | None |
| Volatility | 24.9%-46.0% | 44.0%-59.0% |
| Risk Free Interest Rate | 3.35%-3.45% | 1.46%-3.96% |
| Expected Lives in Months | 1-36 | 6-120 |

In addition to non-cash compensation expense related to new stock-based transactions, we also record non-cash compensation expense in accordance with the Financial Accounting Standards Board ("FASB") Interpretation No. 44 ("FIN 44") related to modifications in stock-based transactions. FIN 44 only relates to original stock-based transactions with our employees and directors that were granted prior to April 1, 2003 and accounted for under the accounting provisions of APB No. 25.

FIN 44 states that when an option is repriced or there are items that effectively reduce the price of an option, it is treated as a variable option that is marked to market each quarter. Accordingly, any increase in the market price of our 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 our common stock compared to the prior reporting period, the reduction is recorded as compensation income to reverse all or a portion of the expense recognized in prior periods. Compensation income is limited to the original base exercise price (the intrinsic value) of the options. Each period we record non-cash compensation expense or income related to our analysis on approximately 3.5 million option shares. Assuming that the stock price exceeds the intrinsic value on all the variable option shares, a \$0.01 increase or decrease in our common stock price results in an expense or income, respectively, of \$35,000. Due to the volatility of the market price of our common stock, we are incapable of predicting whether this expense will increase or decrease in the future.

Disposal Costs

We have recorded significant accruals in connection with the Proposed Asset Sale and outsourcing arrangement with Schreiber. These accruals include estimates pertaining to employee termination costs and, in the future, may also include related abandonment of excess equipment and facilities and other potential costs. Actual costs may differ from these estimates or our estimates may change. In accordance with SFAS 146, *“Accounting for Costs Associated with Exit or Disposal Activities”*, costs associated with restructuring activities are recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. Given the significance and complexity of these activities, and the timing of the execution of such activities, the accrual process involves periodic reassessments of estimates made at the time the original decisions were made, including evaluating estimated employment terms and real estate market conditions for sub-lease rents. We will continually evaluate the adequacy of the remaining liabilities under our restructuring initiatives. Although we believe that these estimates accurately reflect the costs of our activities, actual results may differ, thereby requiring us to record additional provisions or reverse a portion of such provisions. Should the timing of employee terminations change, our estimate of restructuring expenses may have to be increased.

Recent Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, *“Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4.”* SFAS No. 151 requires that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recorded as current period charges and that the allocation of fixed production overheads to inventory be based on the normal capacity of the production facilities. SFAS No. 151 is effective during fiscal years beginning after June 15, 2005, although earlier application is permitted. We believe that the adoption of this Statement will not have a significant impact on our financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *“Share-Based Payment”* (“SFAS No. 123R”), which addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for (a) equity instruments of the company or (b) liabilities that are based on the fair value of the company’s equity instruments or that may be settled by the issuance of equity instruments. SFAS No. 123R supercedes APB Opinion No. 25 and amends SFAS No. 95, *“Statement of Cash Flows.”* Under SFAS No. 123R, companies are required to record compensation expense for all share-based payment award transactions measured at fair value as determined by an option valuation model. Currently, we use the Black-Scholes pricing model to calculate the fair value of its share-based transactions. This statement is effective for fiscal years beginning after June 15, 2005. Since we currently recognize compensation expense at fair value for share-based transactions in accordance with SFAS No. 123, we do not anticipate adoption of this standard will have a significant impact on our financial position, results of operations, or cash flows. However, we are still evaluating all aspects of the revised standard.

In December 2004, the FASB issued SFAS No. 153, *“Exchanges of Nonmonetary Assets an Amendment of APB Opinion No. 29.”* SFAS No. 153 amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets from being measured based on the fair value of the assets exchanged. SFAS No. 153 now provides a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. We believe that the adoption of this Statement will not have a significant impact on our financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, *“Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and SFAS No. 3.”* SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and a change required by an accounting pronouncement when the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application of changes as if the new accounting principle had always been used. SFAS No. 154 is effective for fiscal years beginning after December 15, 2005. We are

still evaluating all aspects of the revised standard in order to evaluate the impact on our financial position and results of operations.

Results of Operations

| | 3-Months Ended September 30, | | | | 6-Months Ended September 30, | | | |
|-----------------------|------------------------------|------------------|---------------|-------------|------------------------------|------------------|------------------|---------------|
| | 2005 | 2004 | \$ Change | % Change | 2005 | 2004 | \$ Change | % Change |
| Net Sales | 10,438,225 | 11,900,553 | (1,462,328) | -12.3% | 20,289,378 | 23,092,231 | (2,802,853) | -12.1% |
| Cost of Goods Sold | 7,817,351 | 9,319,969 | (1,502,618) | -16.1% | 15,400,206 | 17,571,299 | (2,171,093) | -12.4% |
| Gross Margin | 2,620,874 | 2,580,584 | 40,290 | 1.6% | 4,889,172 | 5,520,932 | (631,760) | -11.4% |
| Gross Profit % | 25.1% | 21.7% | | | 24.1% | 23.9% | | |

Net Sales

Net sales in the three and six months ended September 30, 2005 decreased 12% from net sales in such periods in the prior year primarily due to a decline in private label sales volume to Wal-Mart. During fiscal 2005, we sold indirectly to Wal-Mart through Del Sunshine, a private label customer, but beginning in April 2005, we began selling direct to Wal-Mart. During the first six months of fiscal 2005, Del accounted for approximately 13% of net sales. During the first six months of fiscal 2006, sales to Wal-Mart accounted for approximately 10% of net sales. Private label and imitation sales consist primarily of products that generate high sales volumes but lower gross margins. Sales also decreased in the first quarter of fiscal 2006 due to a package size change in our Veggie™ and Vegan products. Our customers did not reorder our products in the new package size until they had sold out every product in the old package size. The size change was completed by early September. Finally, sales declines can also be attributed to overall consumer resistance to the multiple price increases we have taken during the past fourteen months to offset our rising production costs.

Certain key initiatives and tactical actions were initiated by our Company during fiscal 2005 and will be continued throughout fiscal 2006. Such key initiatives and tactical actions for fiscal 2006 include, but are not limited to, the following:

- Creating and communicating a new more meaningful brand position for our flagship Veggie™ brand and adding new products. The recent focus is to highlight the superior nutritional factors such as cholesterol and trans-fat free, as well as targeting a broader universe of consumers. We are attempting to attract incremental users by convincing users of conventional cheese that the Veggie™ brand items can satisfy their needs with great tasting nutrition. This is a departure from our past product positioning where physiological and medical requirements were a key driver in why consumers should buy the “healthy alternatives.”
- Improving product quality in terms of taste, color, aroma, and texture of our Veggie™ and Rice and Vegan products.
- Reducing or eliminating most of our contract manufacturing customers due to the continued high cost of certain raw materials which result in gross margins that are below our acceptance level.
- Continued emphasis and resource allocation of our marketing strategy to increase sales through consumer advertising (in TV, magazine, and event sponsorship) 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). These marketing campaigns were launched in the second quarter of fiscal 2006. In fiscal 2006, we saw an increase in sales through our consumer advertising and promotions, which highlighted and communicated the benefits of our products to meet the consumer demand for low fat, no cholesterol and high calcium products. We experienced over a 10% increase in sales in those markets where there were consumer- advertising promotions in the second quarter of fiscal 2006.

While initial response from the advertising campaign in the limited markets are positive, we are unable to determine if we will experience continued positive effects from the advertising campaigns. Thus, sales improvements in the test markets in September 2006 are not necessarily indications of future results.

We use 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, we make decisions on which brands to promote and analyzes trends in the consumer marketplace.

We anticipate that our direct sales to Wal-Mart will range between 5% and 10% of sales in fiscal 2006. Due to the reduction in our estimate of lower margin sales to Wal-Mart, we anticipate a decline of 5% and 10% in sales volume in fiscal 2006 compared to fiscal 2005, but we expect to continue to show improved margins so that the gross margin dollars in fiscal 2006 will exceed the gross margin dollars in fiscal 2005.

Cost of Goods Sold

Cost of goods sold was approximately 76% of net sales for each of the first six months of fiscal 2006 and 2005. However, we noted a 3% percentage point decrease in cost of goods sold to 75% of net sales in the second quarter of fiscal 2006 compared to 78% of net sales in the second quarter of fiscal 2005. This three percentage point decrease in cost of goods sold was primarily due to a \$270,000 decrease in direct labor expenses and a \$491,000 decrease in overhead costs. We experienced lower costs in direct labor and overhead costs as a result of improved production efficiencies and changes in the allocation of certain overhead costs to various departments. Certain allocation costs are allocated based on a square footage method. As a result of lower square footage in our production areas in fiscal 2006 compared to prior fiscal years, there is a higher percentage of overhead allocated to non-production departments beginning in April 2005. We anticipate that the cost of goods sold will also decrease as a result of the outsourcing arrangement with Schreiber. However, actual results could differ from our expectations.

We monitor our costs and production efficiencies through various ratios including pounds produced per hour and cost per pound sold and use these ratios to make decisions in purchasing, production and setting sales prices.

In the second quarter of fiscal 2006, gross margin has improved because casein prices have stabilized and our current sales mix of the branded and remaining private label products are able to give us a higher level of income. In fiscal 2006, we expect our annual gross profit percentage to improve over the annual fiscal 2005 levels because we have implemented price increases on some of our products, additional sales growth is expected in our higher margin products and we have eliminated certain low margin private label manufacturing accounts.

EBITDA

We utilize certain GAAP measures such as Operating Income and Net Income and certain non-GAAP measures such as EBITDA and exclude non-cash compensation related to stock based transactions included in general and administrative expenses and certain employment contract expenses in order to compute our key financial measures that are reviewed by management, lenders and investors in order to effectively review our current on-going operations and analyze trends related in our financial condition and results of operations. Additionally, these measures are key factors upon which we prepare our budgets and forecasts, calculate bonuses, and evaluate loan covenants. These adjusted measures are not in accordance with, or an alternative for, generally accepted accounting principles and may be different from non-GAAP measures reported by other companies.

| | 3-Months Ended September 30, | | | | 6-Months Ended September 30, | | | |
|---|------------------------------|-----------|--------------|-------------|------------------------------|-----------|--------------|-------------|
| | 2005 | 2004 | \$ Change | % Change | 2005 | 2004 | \$ Change | % Change |
| Gross Margin | 2,620,874 | 2,580,584 | 40,290 | 1.6% | 4,889,172 | 5,520,932 | (631,760) | -11.4% |
| | | Restated | | | | Restated | | |
| Selling | 1,557,547 | 1,572,470 | (14,923) | -0.9% | 2,493,792 | 3,032,870 | (539,078) | -17.8% |
| Delivery | 726,078 | 615,257 | 110,821 | 18.0% | 1,341,549 | 1,208,583 | 132,966 | 11.0% |
| Employment contract expense ⁽²⁾ | - | 444,883 | (444,883) | -100.0% | - | 444,883 | (444,883) | -100.0% |
| General and administrative, including \$3,319, (\$121,172), \$870,837 and \$41,202 in non-cash stock compensation ⁽¹⁾ | 921,934 | 444,796 | 477,138 | 107.3% | 2,523,464 | 1,240,512 | 1,282,952 | 103.4% |
| Research and development | 89,052 | 78,932 | 10,120 | 12.8% | 180,094 | 151,618 | 28,476 | 18.8% |
| Cost of disposal activities | 499,556 | - | 499,556 | 100.0% | 754,567 | - | 754,567 | 100.0% |
| Impairment of fixed assets | - | - | - | 0.0% | 7,896,554 | - | 7,896,554 | 100.0% |
| (Gain)Loss on disposal of assets | 6,242 | - | 6,242 | 100.0% | 5,606 | - | 5,606 | 100.0% |
| Total operating expenses | 3,800,409 | 3,156,338 | 644,071 | 20.4% | 15,195,626 | 6,078,466 | 9,117,160 | 150.0% |

| | | | | | | | | |
|--|------------------|------------------|--------------------|----------------|--------------------|------------------|---------------------|----------------|
| Income (Loss) from Operations⁽³⁾ | (1,179,535) | (575,754) | (603,781) | 104.9% | (10,306,454) | (557,534) | (9,748,920) | 1748.6% |
| Other Income (Expense), Net | | | | | | | | |
| Interest expense | (293,603) | (264,008) | (29,595) | 11.2% | (650,798) | (523,824) | (126,974) | 24.2% |
| Derivative income | - | 442,606 | (442,606) | -100.0% | - | 321,487 | (321,487) | -100.0% |
| Gain/(loss) on FV of warrants | 57,000 | 620,247 | (563,247) | -90.8% | 397,000 | 461,351 | (64,351) | -13.9% |
| Total | <u>(236,603)</u> | <u>798,845</u> | <u>(1,035,448)</u> | <u>-129.6%</u> | <u>(253,798)</u> | <u>259,014</u> | <u>(512,812)</u> | <u>-198.0%</u> |
| NET INCOME (LOSS) | (1,416,138) | 223,091 | (1,639,229) | -734.8% | (10,560,252) | (298,520) | (10,261,732) | 3437.5% |
| Interest expense | 293,603 | 264,008 | 29,595 | 11.2% | 650,798 | 523,824 | 126,974 | 24.2% |
| Depreciation | <u>536,749</u> | <u>546,045</u> | <u>(9,296)</u> | <u>-1.7%</u> | <u>1,075,852</u> | <u>1,092,086</u> | <u>(16,234)</u> | <u>-1.5%</u> |
| EBITDA, (a non-GAAP measure) | <u>(585,786)</u> | <u>1,033,144</u> | <u>(1,618,930)</u> | <u>-156.7%</u> | <u>(8,833,602)</u> | <u>1,317,390</u> | <u>(10,150,992)</u> | <u>-770.5%</u> |

- (1) In our calculation of key financial measures, we exclude the non-cash compensation related to stock-based transactions because we believe that this item does not accurately reflect our current on-going operations. Many times non-cash compensation is calculated based on fluctuations in our stock price, which can skew the financial results dramatically up and down. The price of our common shares as traded on AMEX is outside our control and typically does not reflect our current operations. Additionally, this item is excluded by our lenders when calculating compliance with loan covenants.
- (2) In our calculation of key financial measures, we exclude the employment contract expenses related to Angelo S. Morini and Christopher J. New because we believe that these items do not reflect expenses related to our current on-going operations. Additionally, these items are excluded by our lenders when calculating compliance with loan covenants.
- (3) Operating Income (Loss) has declined due the increase in non-cash stock compensation expense as discussed below under general and administrative and the fixed asset impairment charges and disposal costs related to the Asset Purchase Agreement and the Supply Agreement with Schreiber as discussed under *Recent Material Developments*.

Selling

Selling expenses in the second quarter of fiscal 2006 compared to the second quarter of fiscal 2005 were nearly the same in dollars, but they were 2% higher as a percentage of net sales. This is due to increased promotion, demonstration and sampling costs in the second quarter of fiscal 2006. We anticipate that the selling expenses will continue to increase as a percentage of net sales due to large promotion and advertising campaigns that will be continue throughout fiscal 2006. We sell our products through our internal sales force and an independent broker network.

Selling expenses in the first six months of fiscal 2006 compared to the first six months of fiscal 2005 were lower in dollars, but 1% lower as a percentage of net sales due to lower promotion, demonstration and print advertising costs in the first quarter of fiscal 2006.

Delivery

Delivery expense is primarily a function of sales. In the past, delivery expense remained consistent at approximately 5% of net sales. However, this increased to 7% of net sales in the second quarter of fiscal 2006 due to higher fuel prices and surcharges charged by the transportation companies and due to higher overhead allocation charges as discussed under *Cost Of Goods Sold*.

After the anticipated transfer of all production and distribution responsibilities to Schreiber by the end of the third quarter of fiscal 2006, we expect our delivery expenses to decrease significantly as a result of an agreed upon delivery price per pound of product with Schreiber that is lower than our current delivery cost per pound of product.

General and administrative

General and administrative expenses increased in the first six months of fiscal 2006 due to approximately \$830,000 in additional non-cash compensation related to stock-based transactions, as detailed below, approximately \$261,000 of additional bad debt costs related to the Del Sunshine account as discussed under *Recent Material Developments*, \$71,875 in liquidated damages accrued in related to a registration rights agreement as discussed below under *Equity Financing*,

\$65,000 additional insurance costs due to higher coverages and increased premiums effective in April 2005, and \$135,000 in additional professional fees for legal and audit services due to additional contracts and SEC filings during the first six months of fiscal 2006.

In May 2003, we entered into a Master Distribution and Licensing Agreement (the Prior Agreement) with Fromageries Bel S.A. (“Bel”), a French corporation that is a leading branded cheese company in Europe. Under the agreement, we granted Bel exclusive distribution rights for our products in a territory comprised of the European Union States and to more than 21 other European countries and territories (the “Territory”). We 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. Pursuant to a Termination, Settlement and Release Agreement signed on July 22, 2005 and effective February 15, 2005 (the “Termination Agreement”), the parties mutually agreed to cancel the Prior Agreement and to terminate the distribution relationship. In consideration for our time, effort and expenses incurred during the distribution relationship, Bel paid \$150,000 to our Company. This payment was recorded as a reduction of general and administrative expenses in the second quarter of fiscal 2006.

Excluding the effects of non-cash compensation related to stock-based transactions, which cannot be predicted, we anticipate that general and administrative expenses will be higher than prior year levels for the first three quarters of fiscal 2006 due to the higher insurance costs and increased audit services required. However, we expect that general and administrative expenses in the fourth quarter of fiscal 2006 will be significantly reduced due to the non-recurrence of the \$1.6 million in bad debt expense that occurred in the fourth quarter of fiscal 2005.

The change in non-cash compensation related to stock-based transactions that are included in general and administrative expenses are detailed as follows:

| | 3-Months Ended September 30, 2005 | | | | 6-Months Ended September 30, 2005 | | | |
|---|-----------------------------------|-----------|-----------|----------|-----------------------------------|--------|-----------|----------|
| | 2005 | 2004 | \$ Change | % Change | 2005 | 2004 | \$ Change | % Change |
| Stock-based award compensation - initial issuance | 26,434 | 36,994 | (10,560) | -28.5% | 1,063,393 | 41,202 | 1,022,191 | 2480.9% |
| Option modifications under APB 25 awards | (23,115) | (158,166) | 135,051 | -85.4% | (192,556) | - | (192,556) | -100.0% |
| Non-cash compensation related to stock based transactions | 3,319 | (121,172) | 124,491 | -102.7% | 870,837 | 41,202 | 829,635 | 2013.6% |

Effective April 1, 2003, we elected to record compensation expense measured at fair value for all stock-based award transactions (including, but not limited to, restricted stock awards, stock option grants, and warrant issuances) on or after April 1, 2003 under the provisions of SFAS No. 123. Prior to April 1, 2003, we only recorded the fair value of stock-based awards granted to non-employees or non-directors under the provisions of SFAS No. 123. The fair value of the stock-based award is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related award. Prior to April 1, 2003, we accounted for our stock-based employee and director compensation plans under the accounting provisions of APB No. 25 as interpreted by FASB Interpretation No. 44 (“FIN 44”). Any modifications of fixed stock options or awards granted to employees or directors originally accounted for under APB No. 25 may result in additional compensation expense under the provisions of FIN 44. FIN 44 covers specific events that occurred after December 15, 1998 and was effective as of July 1, 2000.

In accordance with the above accounting standards, we calculate and record non-cash compensation related to our securities in the general and administrative line item in our Statements of Operations based on two primary items:

a. Stock-Based Award Issuances

During the three months ended September 30, 2005 and 2004, we recorded \$26,434 and \$36,994, respectively, in non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants. During the six months ended September 30, 2005 and 2004, we recorded \$1,063,393 and \$41,202, respectively, in non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants.

b. Option Modifications for Awards granted to Employees or Directors under APB No. 25

On October 11, 2002, we 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. Prior to the repricing modification, the options were accounted for as a fixed award under APB No. 25. In accordance with FIN 44, the repricing of the employee stock options requires additional compensation expense to be recognized and adjusted in

subsequent periods for changes in the price of our common stock that are in excess of the \$2.05 stock price on the date of modification (additional intrinsic value). If there is a decrease in the market price of our common stock compared to the prior reporting period, the reduction is recorded as compensation income to reverse all or a portion of the expense recognized in prior periods. Compensation income is limited to the original base exercise price (the intrinsic value) of the options. This variable accounting treatment for these modified stock options began with the quarter ended December 31, 2002 and such variable accounting treatment will continue until the related options have been cancelled, expired or exercised. There are 3,499,841 outstanding modified stock options remaining as of September 30, 2005. We recorded non-cash compensation expense/(income) of (\$23,115) and (\$158,166) for the three months ended September 30, 2005 and 2004, respectively, related to the modified options described above. We recorded non-cash compensation expense/(income) of (\$192,556) and zero for the six months ended September 30, 2005 and 2004, respectively, related to the modified options described above.

Research and development

Research and development expense increased in the first six months of fiscal 2006 primarily due to the addition of one employee to the department during the first quarter of fiscal 2006. The remaining increase was due to higher overhead allocation charges during fiscal 2006 as discussed under *Cost Of Goods Sold*.

We anticipate that there may be a significant increase in research and development expenses in fiscal 2006 due to an increase in the number of personnel in the department and renewed focus on developing new products for the market.

Cost of disposal activities

We are accounting for the costs associated with the Schreiber transactions in accordance with SFAS No. 146, "*Accounting for Costs Associated with an Exit or Disposal Activity*," because the arrangements are planned and controlled by management and materially change the manner in which our business will be conducted. In accordance with SFAS No. 146, costs associated with disposal activities should be reported as a reduction of income from operations. For the three and six months ended September 30, 2005, we incurred and reported \$499,556 and \$754,567 as Costs of Disposal Activities in the Statement of Operations. These costs of disposal activities are comprised of employee termination costs and legal and consulting fees. During the second quarter of fiscal 2006, we accrued \$359,774 in anticipated employee termination costs related to the termination of nearly 115 employee positions during the transition. We anticipate that in future periods, there will be additional disposal costs related to legal and consulting fees in addition to possible lease abandonment charges, which have not yet been incurred and therefore have not been accrued. We may be required to adjust our accrual and estimated expense related to employee termination costs if the actual timing of the terminations changes from original estimates.

Impairment of property and equipment

In light of the Schreiber transactions discussed above under *Recent Material Developments*, we determined that it is more likely than not that a majority of our fixed assets related to production activities will be sold or disposed prior to the end of their useful life. These assets represent approximately 98% of the value of property and equipment. In accordance with SFAS No. 144, "*Accounting for the Impairment of Disposal of Long-Term Assets*," we wrote down the value of our assets to their estimated fair values in June 2005. We will continue to hold and use the assets until they are sold. Therefore, all assets will continue to be reported and depreciated under Property and Equipment in the Balance Sheet until they are sold. We estimated the fair value based on the sales price in the Asset Purchase Agreement and the anticipated sales price related to any other assets plus future cash flows related to the assets from July 1, 2005 until the sale. Based on this estimate, we recorded an impairment of property and equipment of \$7,896,554 in June 2005.

Other income and expense

Interest expense increased approximately \$30,000 and \$127,000 in the three and six months ended September 30, 2005, respectively, due to higher prime rates (on average 2.5% higher) and 3% higher rates charged by Textron Financial Corporation during May and June as further described below. We are incurring increased interest expense, and anticipate further increases during the first three quarters of fiscal 2006 compared to the first three quarters of fiscal 2005 due to increases in the floating interest rates used by our lenders which are based on prevailing market interest rates. However, assuming the consummation of the Asset Purchase Agreement as discussed under *Recent Material Developments*, we expect that our debt to Beltway will be paid in full and there will be a significant reduction in interest expense due to lower debt balances in the fourth quarter of fiscal 2006 as compared to the fourth quarter of fiscal 2005.

Derivative income/expense represents the adjustment for the change in the fair value of the embedded derivative in our Series A convertible preferred stock, which met the criteria for bifurcation and separate accounting under SFAS No. 133. The fair value of the embedded derivative was computed based on several factors including the underlying value of our common stock at the end of each quarter. This income was \$442,606 and \$321,487 in the three and six months ended

September 30, 2005, respectively, but there was no income or expense in these comparative periods in fiscal 2006 because the Series A convertible preferred stock was partially converted and the remaining shares redeemed in the third quarter of fiscal 2005.

Since the conversion of our Series A convertible preferred stock could have resulted in a conversion into an indeterminable number of common shares, we determined that under the guidance in paragraph 24 of EITF 00-19, "Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled in the Company's Own Stock," we were prohibited from concluding that we had sufficient authorized and unissued shares to net-share settle any warrants or options issued to non-employees. Therefore, we reclassified to a liability the fair value of all warrants and options issued to non-employees that were outstanding during the period that the Series A convertible preferred stock was outstanding from April 2001 to October 2004. Additionally, in accordance with EITF 00-19, if a contract requires settlement in registered shares, then it may be required to record the value of the securities as a liability and/or temporary equity. Any changes in the fair value of the securities based on the Black-Scholes pricing model after the initial valuation are marked to market during reporting periods.

Additionally, pursuant to a Note and Warrant Purchase Agreement dated September 12, 2005, as further described under *Debt Financing*, we issued a warrant to purchase up to 300,000 shares of our common stock at an exercise price equal to \$1.53 (95% of the lowest closing price of our common stock in the sixty calendar days immediately preceding October 17, 2005). In accordance with the accounting provisions of SFAS No. 123, we recorded the \$234,000 initial fair value of the warrant as a discount to debt on September 12, 2005. This discount is being amortized from September 2005 through June 2006. We amortized \$13,000 in the second quarter of fiscal 2006. Since the exercise price for the warrant was not fixed until October 17, 2005, we revalued the warrant obligation on September 30, 2005 and calculated a fair value of \$177,000. The \$57,000 difference between the initial value of the warrant and the value of the warrant on September 30, 2005 was recorded as a gain on fair value of warrants in the Statement of Operations.

During the second quarter of fiscal 2006 and 2005, we recorded a gain of \$57,000 and \$620,247 related to the change in the fair values of the warrants. During the first six months of fiscal 2006 and 2005, we recorded a gain of \$340,000 and a 461,351, respectively, related to the change in the fair values of the warrants.

Liquidity And Capital Resources

| September 30, | 6-Months Ended | | | |
|--|-----------------------|-------------|------------------|-----------------|
| | 2005 | 2004 | \$ Change | % Change |
| Cash from (used in) operating activities | (1,565,532) | (624,208) | (941,324) | 150.8% |
| Cash from (used in) investing activities | (61,825) | (54,725) | (7,100) | 13.0% |
| Cash from (used in) financing activities | 1,065,575 | 652,734 | 412,841 | 63.2% |
| Net increase (decrease) in cash | (561,782) | (26,199) | (535,583) | 2044.3% |

Operating and Investing Activities

Cash from operating activities declined in the first half of fiscal 2006 due to higher operating expenses and reductions in inventory levels related selling activities and the outsourcing transition costs described under *Recent Material Developments*. Additionally, accounts receivable is increasing back to its levels similar to those as of September 2004. The accounts receivable balance as of March 31, 2005 was lower than average for the sales volume due to a large reserve of nearly \$1.6 million that was recorded as of March 31, 2005 (See Del Sunshine LLC under *Recent Material Developments* for further details). We are continually reviewing our collection practices, payment terms to vendors and inventory levels in order to maximize cash flow from operations.

Cash used in investing activities primarily relates to our purchase of office and manufacturing equipment in each fiscal period. We do not anticipate any large capital expenditures during fiscal 2006, but rather expect to receive substantial cash provided by investing activities from the consummation of the Proposed Asset Sale to Schreiber in the third quarter of fiscal 2006.

As part of the outsourcing transition, we expect to see a decrease in cash from operations due to the additional disposal costs. However, upon complete implementation in the fourth quarter of fiscal 2006, we expect to improve cash flows from operations due to the elimination of excess overhead costs and inventory costs. We will need additional cash to build up finished good inventory levels to maintain standard orders to customers and to pay one-time costs associated with the

transition such as severance arrangements, and contract and lease cancellation fees. Based on current projections, we expect that much of the additional cash requirements will be returned in the sale of our usable raw materials and packaging inventory and production equipment to Schreiber in the third quarter of fiscal 2006.

Financing Activities

| September 30, | 6-Months Ended | | | |
|---|-----------------------|-------------|-------------|-----------|
| | 2005 | 2004 | \$ | % |
| Net borrowings (payments) on line of credit and bank overdrafts | (1,052,424) | 1,276,485 | (2,328,909) | -182.4% |
| Net borrowings (payments) of debt and capital leases & associated costs | 374,578 | (613,731) | 988,309 | -161.0% |
| Issuances of stock & associated costs | 1,743,421 | (10,020) | 1,753,441 | -17499.4% |
| Cash from (used in) financing activities | 1,065,575 | 652,734 | 412,841 | 63.2% |

Debt Financing

On May 27, 2003, we obtained from Textron Financial Corporation (“Textron”) a revolving credit facility (the “Textron Loan”) with a maximum principal amount of \$7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 (the “Textron Loan Agreement”). The Textron Loan is secured by our 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 our Company from time to time is equal to the sum of (i) 85% of the net amount of its eligible accounts receivable plus (ii) 60% of our 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 1.75% per annum (8.5% at September 30, 2005) calculated on the average cash borrowings for the preceding month. The initial term of the Textron Loan ends on May 26, 2006. As of September 30, 2005, the outstanding principal balance on the Textron Loan was \$4,275,221.

The Textron Loan Agreement contains certain financial and operating covenants. On June 3, 2005, we executed a fourth amendment to the Textron Loan that provided a waiver on all the existing defaults for the fiscal quarters ended December 31, 2004 and March 31, 2005, and amended the fixed charge coverage ratio and the adjusted tangible net worth requirements for periods after March 31, 2005. Additionally, the fourth amendment allowed the Textron Loan to be in an over-advance position not to exceed \$750,000 until July 31, 2005. In exchange for the waiver and amendments, our interest rate on the Textron Loan was set at Prime plus 4.75% and we paid a fee of \$50,000 in four weekly installments of \$12,500.

On June 16, 2005, we used a portion of the proceeds from the warrant exercises described below under Equity Financing to satisfy the \$750,000 over-advance with Textron. In connection with the satisfaction of the over-advance, we agreed to immediately terminate Textron’s obligation to permit any over-advances under the Textron Loan, which obligation was to expire on July 31, 2005. With the termination of the over-advance facility, the interest rate on the Textron Loan returned to its prior level of Prime plus 1.75%.

Due to the Cost of Disposal Activities and Impairment of Property and Equipment, we fell below the requirements for the fixed charge coverage ratio and the adjusted tangible net worth requirements in the fixed charge coverage ratio and the adjusted tangible net worth calculation from June 30, 2005 through September 30, 2005. Effective October 1, 2005, we executed a fifth amendment to the Textron Loan Agreement that provided a waiver for the defaults in the fixed charge coverage ratio and the adjusted tangible net worth requirements, in addition to certain over-advances on the Textron Loan, during the periods from June 2005 through September 2005. The fifth amendment amends and replaces several financial covenants, allows eligibility for borrowing on inventory until December 31, 2005 and provides that the Textron Loan will expire at the end of the initial term on May 26, 2006. Additionally, Textron consented to the sale of our manufacturing equipment to Schreiber and the termination of their liens on the assets being sold. In exchange for the waiver and amendments, we paid a fee of \$50,000, and has agreed to pay an administration fee in the following installments if the Textron Loan has not then been paid in full: 5,000 on February 1, 2006, \$10,000 on March 1, 2006, \$15,000 on April 1, 2006 and \$20,000 May 1, 2006. We anticipate that we will be in compliance with the amended covenants and reporting requirements through the end of the term of the Textron Loan on May 26, 2006.

Simultaneous with the closing of the Textron Loan in May 2003, Wachovia Bank, N.A. successor by merger to SouthTrust Bank (“Wachovia”) extended our Company a new term loan in the principal amount of \$2,000,000. This term loan was consolidated with our March 2000 term loan with Wachovia, which had a then outstanding principal balance of \$8,131,985 for a total term loan amount of \$10,131,985. This term loan is secured by all of our equipment and certain related assets. Additionally, the term loan bears interest at Wachovia’s Base Rate plus 1% (7.75% at September 30, 2005).

On June 30, 2005, we entered into a Loan Modification Agreement with Wachovia regarding its term loan. The agreement modified the following terms of the loan: 1) the loan will mature and be payable in full on July 31, 2006 instead of June 1, 2009; 2) the principal payments will remain at \$110,000 per month with accrued interest at Wachovia’s Base Rate plus 1% instead of increasing to \$166,250 on July 1, 2005 as provided by the terms of the promissory note evidencing the loan; and 3) all covenants related to our tangible net worth, total liabilities to tangible net worth, and maximum funded debt to EBITDA ratios are waived and compliance is not required by us through the maturity of the loan on July 31, 2006. In connection with the agreement, we agreed to pay \$60,000, of which \$30,000 was paid upon execution of the agreement and \$30,000 was paid on August 1, 2005. As required by the terms of the agreement, if we sell our equipment securing the loan as discussed under the Schreiber Transactions in *Recent Material Developments* above, the loan will be due and payable in full at the time of sale. Therefore, the proceeds from the sale of our manufacturing equipment to Schreiber will be used to pay the loan in full.

In September 2005, Wachovia assigned this term loan to Beltway Capital Partners LLC. The balance outstanding on the term loan as of September 30, 2005 was \$7,691,985.

Pursuant to a Note and Warrant Purchase Agreement dated September 12, 2005, we received \$1,200,000 as a loan from Mr. Frederick A. DeLuca, a greater than 10% shareholder, which loan was evidenced by an unsecured promissory note (the “Note”). The Note requires monthly interest only payments at 3% above the bank prime rate of interest per the Federal Reserve Bank and matures on June 15, 2006. In consideration for the Note and in accordance with an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, we issued to Mr. DeLuca a warrant to purchase up to 300,000 shares of our common stock at an exercise price equal to \$1.53 (95% of the lowest closing price of our common stock in the sixty calendar days immediately preceding October 17, 2005). The warrant fully vested on October 17, 2005 and can be exercised on or before the expiration date of October 17, 2008. Also in consideration for the Note, we granted Mr. DeLuca “piggy back” registration rights with respect to the shares underlying the warrant. In accordance with the accounting provisions of SFAS No. 123, we recorded the \$234,000 initial fair value of the warrant as a discount to debt on September 12, 2005. This discount is being amortized from September 2005 through June 2006.

Pursuant to several Note and Warrant Purchase Agreements dated September 28, 2005, in October 2005, we received a \$600,000 loan from Conversion Capital Master, Ltd., a \$485,200 loan from SRB Greenway Capital (Q.P.), L.P., a \$69,600 loan from SRB Greenway Capital, L.P., and a \$45,200 loan from SRB Greenway Offshore Operating Fund, L.P. These loans were evidenced by unsecured promissory notes (the “Notes”). The Notes require monthly interest only payments at 3% above the bank prime rate of interest per the Federal Reserve Bank and mature on June 15, 2006. In consideration for the Notes and in accordance with an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, we issued to Conversion Capital Master, Ltd., SRB Greenway Capital (Q.P.), L.P., SRB Greenway Capital, L.P., and SRB Greenway Offshore Operating Fund, L.P., warrants to purchase up to 150,000 shares, 121,300 shares, 17,400 shares, and 11,300 shares, respectively, of our common stock at an exercise price equal to \$1.53 (95% of the lowest closing price of our common stock in the sixty calendar days immediately preceding October 17, 2005). The warrants fully vested on October 17, 2005 and can be exercised on or before the expiration date of October 17, 2008. Also in consideration for the Notes, we granted Conversion Capital Master, Ltd., SRB Greenway Capital (Q.P.), L.P., SRB Greenway Capital, L.P., and SRB Greenway Offshore Operating Fund, L.P. “piggy back” registration rights with respect to the shares underlying the warrants. In accordance with the accounting provisions of SFAS No. 123, we recorded the \$210,731 initial fair value of the warrant as a discount to debt in October 2005. This discount will be amortized from October 2005 to June 2006.

Equity Financing

In accordance with a warrant agreement dated April 10, 2003, we issued to Mr. Frederick DeLuca, a greater than 10% shareholder, a warrant to purchase up to 100,000 shares of our common stock at an exercise price of \$1.70 per share. Additionally, in accordance with a warrant agreement dated October 6, 2004, we issued to Mr. DeLuca a warrant to purchase up to 500,000 shares of our common stock at an exercise price of \$1.15 per share. Subsequently in June 2005, we agreed to reduce the per-share exercise price on these warrants to \$1.36 and \$0.92, respectively, in order to induce Mr. DeLuca to exercise his warrants. All of the warrants were exercised on June 16, 2005 for total proceeds of \$596,000.

On each of April 24, 2003 and October 6, 2004, BH Capital Investments, LP and Excalibur Limited Partnership each received warrants to purchase up to 250,000 shares of our common stock at an exercise price of \$2.00 per share. Also, Excalibur Limited Partnership received a warrant to purchase up to 30,000 shares of our common stock at an exercise price of \$2.05 per share on June 26, 2002. Subsequently in June 2005, we agreed to reduce the per-share exercise price on all such warrants to \$1.10 in order to induce BH Capital Investments, LP and Excalibur Limited Partnership to exercise their warrants. All of the warrants were exercised on June 16, 2005 for total proceeds of \$1,133,000.

In accordance with the accounting provisions of SFAS No. 123, we recorded \$1,024,500 in non-cash compensation expense related to the reduction in the exercise price of the above-mentioned warrants in June 2005.

We used a portion of the proceeds from the warrant exercises to satisfy the \$750,000 over-advance provided by Textron under the Fourth Amendment and Waiver to the Textron Loan Agreement, as described under *Debt Financing* and the remaining proceeds from the warrant exercises were used for working capital purposes.

In accordance with a registration rights agreement dated October 6, 2004 with Mr. Frederick DeLuca, we agreed that within 180 days we would file with the Securities and Exchange Commission ("SEC") and obtain effectiveness of a registration statement that included 2,000,000 shares issued in a private placement and 500,000 shares related to a stock purchase warrant. Per the terms of the agreement, if a registration statement was not filed, or did not become effective within 180 days, then in addition to any other rights Mr. DeLuca may have, we would be required to pay certain liquidated damages. We filed a registration statement on Form S-3 on March 14, 2005. However, this registration statement has not yet been declared effective. Mr. DeLuca granted an extension of time to have the registration statement declared effective by the SEC and waived all damages and remedies for failure to have an effective registration statement until September 1, 2005. As of September 1, 2005, we are accruing liquidated damages of \$71,875 (2.5% times the product of 2,500,000 registerable shares and the share price of \$1.15 per share) every thirty days until the registration statement becomes effective. We are in the process of completing a pre-effective amendment to the registration statement and will request acceleration of the effectiveness of the registration statement as soon after its filing as reasonably practicable.

Summary

As we continue with the Proposed Asset Sale and outsourcing transition, we anticipate that we will see additional non-recurring expenses, gains/losses from the sale of assets, and a general decrease in our line of credit with Textron due to no inventory for lending purposes. However, we expect that we will reduce interest bearing debt and property tax accruals by nearly \$8,700,000 resulting in annual interest savings in excess of \$800,000.

We believe that with the above debt service savings and anticipated reductions in our costs of goods sold beginning in January 2006, we will have enough cash to meet our needs for general operations through September 30, 2006. However, it is uncertain at this time if we will have enough cash from operations to repay the Textron Loan that matures in May 2006 and the aggregate of \$2,400,000 in shareholder loans that mature in June 2006 as discussed under *Debt Financing*. If we cannot generate enough cash from operations and the sale of our assets by these maturity dates, and we are unable to refinance or renew these loans, or if additional financing is not available on terms acceptable to us, we will be unable to satisfy such facilities by their maturity dates. In such an event, Textron and the shareholders could exercise their respective rights under their loan documents, which could include, among other things, declaring defaults under the loans and pursuing foreclosure on our assets that are pledged as collateral for such loans. If such an event occurred, it would be substantially more difficult for us to effectively continue the operation of our business, and it is unlikely that we would be able to continue as a going concern.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our exposure to market risk results primarily from fluctuations in interest rates. The interest rates on our outstanding debts to Wachovia 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 September 30, 2005 with respect to our debt as of such date would increase or decrease interest expense and hence reduce or increase the net income of our Company by approximately \$132,000 per year or \$33,000 per quarter.

Our sales during the quarters ended September 30, 2005 and 2004, which were denominated in a currency other than U.S. Dollars, were less than 5% of gross sales and no net assets were maintained in a functional currency other than U. S. Dollars during such periods. However, further declines in the U.S. Dollar on the international market, may cause our

foreign suppliers of raw materials, particularly casein, to increase their U.S. Dollar prices on future orders from our Company. Therefore, while we believe that the effects of changes in foreign currency exchange rates have not historically been significant to our operations or net assets, we are unable to forecast the effects that foreign currency exchange rates may have on our future operations.

Item 4. Controls and Procedures

As of September 30, 2005, an evaluation was performed under the supervision and with the participation of our management, including the Chief Executive Officer ("CEO"), and the Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of our 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, our management, including the CEO and CFO, concluded that our disclosure controls and procedures were effective in timely bringing to their attention material information related to our Company required to be included in our periodic Securities and Exchange Commission filings, except for the control noted below. Since the date of this evaluation, there have been no changes in our internal controls or in other factors that are reasonably likely to materially affect those controls, except as noted below.

The CEO and CFO considered the restatement of our financial statements in October 2005 for the periods from March 31, 2001 through June 30, 2005 and concluded that such restatements were the result of a material weakness relating to the accounting and disclosure for complex and non-standard stockholders' equity transactions. To address our Company's material weakness related to the accounting and disclosure for complex and non-standard stockholders' equity transactions, we have enhanced our internal control processes in order to be able to comprehensively review the accounting and disclosure implications of such transactions on a timely basis. As part of the enhancement, we have subscribed to additional outside research materials and will consult with additional outside consultants to confirm our understanding of complex transactions, as necessary.

PART II. OTHER INFORMATION

Item 3. Defaults Upon Senior Securities

On May 27, 2003, we obtained from Textron Financial Corporation (“Textron”) a revolving credit facility (the “Textron Loan”) with a maximum principal amount of \$7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 (the “Textron Loan Agreement”). The Textron Loan is secured by our 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 our Company from time to time is equal to the sum of (i) 85% of the net amount of its eligible accounts receivable plus (ii) 60% of our 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 1.75% per annum (8.5% at September 30, 2005) calculated on the average cash borrowings for the preceding month. The initial term of the Textron Loan ends on May 26, 2006. As of September 30, 2005, the outstanding principal balance on the Textron Loan was \$4,275,221.

The Textron Loan Agreement contains certain financial and operating covenants. On June 3, 2005, we executed a fourth amendment to the Textron Loan Agreement that provided a waiver on all the existing defaults for the fiscal quarters ended December 31, 2004 and March 31, 2005, and amended the fixed charge coverage ratio and the adjusted tangible net worth requirements for periods after March 31, 2005. Additionally, the fourth amendment allowed the Textron Loan to be in an over-advance position not to exceed \$750,000 until July 31, 2005. In exchange for the waiver and amendments, our interest rate on the Textron Loan was set at Prime plus 4.75% and we paid a fee of \$50,000 in four weekly installments of \$12,500.

On June 16, 2005, we used a portion of the proceeds from the warrant exercises described in Note 5 to satisfy the \$750,000 over-advance with Textron. In connection with the satisfaction of the over-advance, we agreed to immediately terminate Textron’s obligation to permit any over-advances under the Textron Loan, which obligation was to expire on July 31, 2005. With the termination of the over-advance facility, the interest rate on the Textron Loan returned to its prior level of Prime plus 1.75%.

Due to the cost of disposal activities and impairment of property and equipment, we fell below the requirements in the fixed charge coverage ratio and the adjusted tangible net worth calculation from June 30, 2005 through September 30, 2005. Effective October 1, 2005, we executed a fifth amendment to the Textron Loan Agreement that provided a waiver for the defaults in the fixed charge coverage ratio and the adjusted tangible net worth requirements, in addition to certain over-advances on the Textron Loan, during the periods from June 2005 through September 2005. The fifth amendment amends and replaces several financial covenants, allows eligibility for borrowing on inventory until December 31, 2005 and provides that the Textron Loan will expire at the end of the initial term on May 26, 2006. Additionally, Textron has consented to the sale of our manufacturing equipment to Schreiber and the termination of their liens on the assets being sold. In exchange for the waiver and amendments, we paid a fee of \$50,000, and has agreed to pay an administration fee in the following installments if the Textron Loan has not then been paid in full: 5,000 on February 1, 2006, \$10,000 on March 1, 2006, \$15,000 on April 1, 2006 and \$20,000 May 1, 2006.

We anticipate that we will be in compliance with the amended covenants and reporting requirements through the end of the term of the Textron Loan on May 26, 2006.

PART II. OTHER INFORMATION

Item 6. Exhibits

The following exhibits are filed as part of this Form 10-Q.

| <u>Exhibit No</u> | <u>Exhibit Description</u> |
|-------------------|--|
| * 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 Wachovia 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.)
- * 4.18 Securities Purchase Agreement dated as of October 6, 2004 between Galaxy Nutritional Foods, Inc. and Frederick A. DeLuca (Filed as Exhibit 4.18 on Form 8-K filed October 8, 2004.)
- * 4.19 Registration Rights Agreement dated as of October 6, 2004 between Galaxy Nutritional Foods, Inc. and Frederick A. DeLuca (Filed as Exhibit 4.19 on Form 8-K filed October 8, 2004.)
- * 4.20 Warrant to Purchase Securities of Galaxy Nutritional Foods, Inc. dated as of October 6, 2004 in favor of Frederick A. DeLuca (Filed as Exhibit 4.20 on Form 8-K filed October 8, 2004.)
- * 4.21 Stock Repurchase Agreement dated as of October 6, 2004 by and among Galaxy Nutritional Foods, Inc., BH Capital Investments L.P. and Excalibur Limited Partnership (Filed as Exhibit 4.21 on Form 8-K filed October 8, 2004.)
- * 4.22 Registration Rights Agreement dated as of October 6, 2004 by and among Galaxy Nutritional Foods, Inc., BH Capital Investments L.P. and Excalibur Limited Partnership (Filed as Exhibit 4.22 on Form 8-K filed October 8, 2004.)
- * 4.23 Warrant to Purchase Securities of Galaxy Nutritional Foods, Inc. dated as of October 6, 2004 in favor of BH Capital Investments L.P. (Filed as Exhibit 4.23 on Form 8-K filed October 8, 2004.)
- * 4.24 Warrant to Purchase Securities of Galaxy Nutritional Foods, Inc. dated as of October 6, 2004 in favor of Excalibur Limited Partnership (Filed as Exhibit 4.24 on Form 8-K filed October 8, 2004.)
- * 4.25 Investor relations contract between Galaxy Nutritional Foods, Inc. and R.J. Falkner dated as of September 29, 2004 (Filed as Exhibit 4.25 on Form S-3 filed March 14, 2005.)
- * 4.26 Asset Purchase Agreement dated June 30, 2005 between Galaxy Nutritional Foods, Inc. and Schreiber Foods, Inc. (Filed as Exhibit 4.25 on Form 8-K filed July 6, 2005.)
- * 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 Wachovia 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 Wachovia 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 Wachovia 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 Wachovia 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 Wachovia Bank (Filed as Exhibit 10.11 on Form 10-K for the fiscal year ended March 31, 2004.)
- * 10.12 Second Amendment to Loan and Security Agreement dated June 25, 2004 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (Filed as Exhibit 10.12 on Form 10-K for the fiscal year ended March 31, 2004.)
- * 10.13 Third Amendment to Lease Agreement dated June 10, 2004 between Galaxy Nutritional Foods, Inc. and Cabot Industrial Properties, L.P. (Filed as Exhibit 10.13 on Form 10-K for the fiscal year ended March 31, 2004.)
- * 10.14 Separation and Settlement Agreement dated July 8, 2004 between Galaxy Nutritional Foods, Inc. and Christopher J. New (Filed as Exhibit 10.14 on Form 8-K filed July 13, 2004.)
- * 10.15 Employment Agreement dated July 8, 2004 between Galaxy Nutritional Foods, Inc. and Michael E. Broll (Filed as Exhibit 10.15 on Form 8-K filed July 13, 2004.)
- * 10.16 Third Amendment to Loan and Security Agreement dated November 10, 2004 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (Filed as Exhibit 10.16 on Form 10-Q for the fiscal quarter ended December 31, 2004.)
- * 10.17 Fourth Amendment to Loan and Security Agreement dated June 3, 2005 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (Filed as Exhibit 10.17 on Form 8-K filed June 22, 2005.)
- * 10.18 Letter Agreement dated June 17, 2005 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (Filed as Exhibit 10.18 on Form 8-K filed June 22, 2005.)
- * 10.19 Supply Agreement dated June 30, 2005 between Galaxy Nutritional Foods, Inc. and Schreiber Foods, Inc. (Filed as Exhibit 10.19 on Form 8-K filed July 6, 2005.)
- * 10.20 Loan Modification Agreement June 30, 2005 between Galaxy Nutritional Foods, Inc. and Wachovia Bank N.A (formerly SouthTrust Bank). (Filed as Exhibit 10.20 on Form 8-K filed July 6, 2005.)
- * 10.21 Termination, Settlement and Release Agreement dated July 20, 2005 between Galaxy Nutritional Foods, Inc. and Fromageries Bel S.A. (Filed as Exhibit 10.21 on Form 8-K filed July 26, 2005.)
- * 10.22 Note and Warrant Purchase Agreement dated September 12, 2005 between Galaxy Nutritional Foods, Inc. and Frederick A. DeLuca (Filed as Exhibit 10.22 on Form 8-K filed September 16, 2005.)

- * 10.23 Note and Warrant Purchase Agreement dated September 28, 2005 between Galaxy Nutritional Foods, Inc. and Conversion Capital Master, Ltd. (Filed as Exhibit 10.23 on Form 8-K filed October 4, 2005.)
- * 10.24 Note and Warrant Purchase Agreement dated September 28, 2005 between Galaxy Nutritional Foods, Inc. and SRB Greenway Capital, L.P. (Filed as Exhibit 10.24 on Form 8-K filed October 4, 2005.)
- * 10.25 Note and Warrant Purchase Agreement dated September 28, 2005 between Galaxy Nutritional Foods, Inc. and SRB Greenway Capital (Q.P.), L.P. (Filed as Exhibit 10.25 on Form 8-K filed October 4, 2005.)
- * 10.26 Note and Warrant Purchase Agreement dated September 28, 2005 between Galaxy Nutritional Foods, Inc. and SRB Greenway Offshore Operating Fund, L.P. (Filed as Exhibit 10.26 on Form 8-K filed October 4, 2005.)
- 10.27 First Amendment to Note and Warrant Purchase Agreement dated October 7, 2005 between Galaxy Nutritional Foods, Inc. and Frederick A. DeLuca (*Filed herewith.*)
- 10.28 Fifth Amendment to Loan and Security Agreement dated November 14, 2005 between Galaxy Nutritional Foods, Inc. and Textron Financial Corporation (*Filed herewith.*)
- * 14.1 Code of Ethics (Filed as Exhibit 14.1 on Form 10-K for the fiscal year ended March 31, 2005.)
- * 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.)
- 31.1 Section 302 Certification of our Chief Executive Officer (*Filed herewith.*)
- 31.2 Section 302 Certification of our Chief Financial Officer (*Filed herewith.*)
- 32.1 Section 906 Certification of our Chief Executive Officer (*Filed herewith.*)
- 32.2 Section 906 Certification of our Chief Financial Officer (*Filed herewith.*)
- * Previously filed and incorporated herein by reference.

SIGNATURES

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

GALAXY NUTRITIONAL FOODS, INC.

Date: November 14, 2005

Michael E. Broll
Chief Executive Officer
(Principal Executive Officer)

Date: November 14, 2005

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