

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K/A
(Amendment No. 1)**

(Mark One)

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

For the fiscal year ended March 31, 2005

OR

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

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)

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

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$.01 per share

(Title of Class)

American Stock Exchange

(Name of exchange on which registered)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the 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

The aggregate market value of the common equity held by non-affiliates as of September 30, 2004 (the last business day of the registrant's most recently completed second fiscal quarter) was \$9,041,667 based on the closing price of such common equity of \$1.27 per share on that date. All executive officers and directors of the registrant and all persons filing a Schedule 13D or a Schedule 13G with the Securities and Exchange Commission in respect to the registrant's common stock have been deemed, solely for the purpose of the foregoing calculation, to be "affiliates" of the registrant.

The number of shares outstanding of the registrant's common stock as of July 12, 2005 was 20,043,474.

DOCUMENTS INCORPORATED BY REFERENCE: **None**

EXPLANATORY NOTE

The purpose of this Form 10-K/A is to amend Part II, Items 6, 7, 8 and 9A of the Annual Report on Form 10-K (the "Form 10-K") of Galaxy Nutritional Foods, Inc. (the "Company") for its fiscal year ended March 31, 2005, as filed with the Securities and Exchange Commission on July 14, 2005. Except as set forth in this Form 10-K/A, this Form 10-K/A does not reflect any events that occurred after the filing of the Form 10-K or modify, amend or update any disclosures contained in the Form 10-K to reflect any subsequent events. Except as set forth in this Form 10-K/A, the Company is not making any changes to, or updating any disclosures contained in, the Form 10-K.

This Form 10-K/A is being filed in response to comments that the Staff of the Securities and Exchange Commission made to the Form 10-K primarily related to the Company's accounting for its Series A convertible preferred stock during the periods from April 2001 through October 2004 and other mark-to-market securities, including warrants and shares exercised through a note receivable, during the periods from March 2001 through October 2004. The issues relate to accounting for securities that are reflected as income or expense through earnings as non-cash charges. These non-cash charges do not affect the Company's revenues, cash flows from past or future operations, or its liquidity. As discussed in Note 17 of the financial statements, the Company has reflected a net increase in additional paid-in-capital and accumulated deficit in the amount of \$383,684 as of March 31, 2005. For the years ended March 31, 2005, 2004, 2003, 2002 and 2001, the Company has restated its financial statements to reflect a net loss of (\$3,859,783), (\$3,299,277), (\$957,221), (\$16,721,149) and (\$5,385,763), respectively. This is a gain/(loss) of \$506,766, (\$337,104), (\$1,991,349), \$338,003, and \$1,100,000, respectively from what was previously reported.

Additionally, the Company reclassified the \$2,220,590 value of those shares of common stock, which the Company has undertaken the obligation to register for resale pursuant to a registration rights agreement, out of stockholders' equity and into temporary equity due to a change in estimate related to the assumption that the maximum potential liquidated damages under such registration rights agreement may be greater than the difference in fair values between registered and unregistered shares.

In addition, this Form 10-K/A also updates Part II, Item 9A to reflect management's conclusion that the changes reflected in Part II, Items 6, 7 and 8 of this Form 10-K/A are the result of a material weakness relating to the accounting and disclosure for complex and non-standard stockholders' equity transactions.

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PART I

FORWARD LOOKING STATEMENTS

THIS FORM 10-K/A CONTAINS FORWARD-LOOKING STATEMENTS. 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 THOSE SET FORTH IN "RISK FACTORS" AND ELSEWHERE IN, OR INCORPORATED BY REFERENCE INTO, THIS FORM 10-K/A. 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.

ITEM 6. SELECTED FINANCIAL DATA (Restated).

	Fiscal Year Ended March 31,				
	(1) 2005	(1) 2004	(1) 2003	(2) 2002	2001
Net sales	\$44,510,487	\$36,176,961	\$40,008,769	\$42,927,104	\$45,085,937
Employment contract expense (3)	(444,883)	(1,830,329)	--	--	--
Income tax benefit (expense)	--	--	--	(1,560,000)	240,000
Cumulative effect of change in accounting policy	--	--	--	--	(786,429)
Net income (loss)	(3,859,783)	(3,299,277)	(957,221)	(16,721,1494)	(5,385,763)
Net income (loss) to common stockholders	(4,261,855)	(4,757,087)	(2,530,390)	(18,748,345)	(5,385,763)
Net income (loss) per common share – basic & diluted	(0.25)	(0.32)	(0.21)	(1.78)	(0.57)
Total assets	27,769,666	29,961,816	33,325,334	36,115,051	48,083,126
Long-term obligations	8,000,627	9,740,094	10,170,195	12,511,461	14,720,875
Redeemable Convertible Preferred Stock	--	2,573,581	2,324,671	2,156,311	--

- (1) See Material Historical Events under *Business Environment* in Item 7 for a summary of the major events during the fiscal years ended March 31, 2005, 2004 and 2003.
- (2) In addition to the line items detailed above, the net loss for fiscal year ended March 31, 2002 included approximately \$5.4 million in accounts receivable and inventory write-downs, non-cash compensation expense of approximately \$400,000, approximately \$1 million in fixed asset disposals and unused trade credit write-offs, and approximately \$2.4 in non-cash interest, derivative and fair value expenses.
- (3) See Employment Contract Expense under *Results of Operations* in Item 7 below for further information.

ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following 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 contained in Item 8. Terms such as “fiscal 2005”, “fiscal 2004” or “fiscal 2003” refer to our fiscal years ended March 31, 2005, 2004 and 2003, respectively.

This MD&A contains the following sections:

- Restatement
- Business Environment
- Critical Accounting Policies
- Recent Accounting Pronouncements
- Results of Operations
- Liquidity and Capital Resources
- Contractual Obligations
- Forward Looking Statements

Restatement

This Form 10-K/A and the restated financial statements included herein reflect a correction of our accounting and disclosure primarily related to our Series A convertible preferred stock during the periods from April 2001 through October 2004 and other mark-to-market securities, including warrants and shares exercised through a note receivable, during the periods from March 2001 through October 2004. The issues relate 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 17 of the financial statements, we have reflected a net increase in additional paid-in-capital and accumulated deficit in the amount of \$383,684 as of March 31, 2005. For the years ended March 31, 2005, 2004, 2003, 2002 and 2001, we have restated our financial statements to reflect a net loss of (\$3,859,783), (\$3,299,277), (\$957,221), (\$16,721,149) and (\$5,385,763), respectively. This is a gain/(loss) of \$506,766, (\$337,104), (\$1,991,349), \$338,003, and \$1,100,000, respectively from what was previously reported.

Additionally, the Company reclassified the \$2,220,590 value of those shares of common stock, which the Company has undertaken the obligation to register for resale pursuant to a registration rights agreement, out of stockholders’ equity and into temporary equity due to a change in estimate related to the assumption that the maximum potential liquidated damages under such registration rights agreement may be greater than the difference in fair values between registered and unregistered shares.

Business Environment

General

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.

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 order to positively impact sales volume throughout fiscal 2006, we are focusing on the following initiatives:

- 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 carbohydrate and high protein 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 generating consumer awareness of new products or flavors through product trials and generating more repeat purchases on our Veggie™ and Wholesome Valley® brands through improved taste, color, aroma, texture and packaging.

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.

Material Historical Events

During fiscal 2003, we achieved positive cash flows from operations on an annual basis for the first time in our Company’s history as a publicly-traded company. We achieved this goal through efficiencies in production, purchase discounts, realignment of the sales mix toward higher margin items, reduction in overall number of items being sold and inventoried, improved customer fulfillment levels, new terms of sale, new customer invoice promotion settlement processes, new trade spending strategies and additional cost reductions through rigorous management.

During fiscal 2004, we refinanced or paid in full all of our credit facilities that were in existence at the end of fiscal 2003. This payoff and refinancing was accomplished through a new asset based lender, renewing and increasing our loans with our bank and through equity financings. This financial restructuring improved our operations and financial position and reduced interest expense nearly \$1.6 million during fiscal 2004. Additionally, in fiscal 2004, we nearly doubled the positive cash flow from operations due to the restructuring and continued focus on producing only high margin items.

During fiscal 2005, we redeemed the remaining 30,316 Series A convertible preferred shares that were outstanding as of October 6, 2004 for \$2,279,688. The cash for the redemption was obtained through an equity financing (see *Equity Financing* under Liquidity and Capital Resources for further details).

In early fiscal 2005, we made the decision to take on a few additional private-label manufacturing contracts at lower margins in order to utilize some of our excess production capacity. One of the new contract customers accounted for 12% of our sales during fiscal 2005, which attributed to 65% of the increase in sales over fiscal 2004. In the fourth quarter of fiscal 2005, we reserved nearly \$1,550,000 in accounts receivable

and \$210,000 in inventory related to this customer for which we believed collection thereon was questionable. See Del Sunshine LLC under *Recent Material Developments* for further details.

Also during fiscal 2005, we experienced a 32% (or nearly \$2.7 million) increase in the prices of our primary ingredient used in production. Only a portion of this overall increase could be passed on to our customers. Additionally, the price increase cannot be implemented immediately.

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 Foods, Inc., a Wisconsin corporation (“Schreiber”), for \$8.7 million in cash.

Other key terms of the transaction are as follows:

- Since the transaction may constitute a sale of substantially all of our assets, the transaction will be subject to obtaining approval from our stockholders.
- The transaction is subject to other closing conditions, including obtaining approval from our lenders, Textron Financial Corporation and Wachovia Bank (formerly SouthTrust Bank).
- Subject to the satisfaction of the conditions described above and other conditions as set forth in the Asset Purchase Agreement, the anticipated closing date is November 1, 2005.
- 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 Outsourcing Agreement

On June 30, 2005, our Company and Schreiber entered into a Supply Agreement (the “Outsourcing Agreement”), whereby we will purchase all of our requirements for products from Schreiber, and Schreiber will manufacture and distribute all of our products.

Other key terms of the transaction are as follows:

- The initial term of the Outsourcing Agreement is for five years from the effective date of September 1, 2005, and is renewable at our option for up to two additional five-year periods.
- After November 1, 2005 and throughout the remainder of the Outsourcing Agreement’s term, Schreiber will be the sole source of supply of our products.

- If we do not exercise our option to renew the Outsourcing Agreement at the end of the initial five-year period, there is a cancellation charge of \$1.5 million. If we do not exercise our option to renew the Outsourcing Agreement at the end of the second five-year period, there is a cancellation charge of \$750,000. If the sale of the assets to Schreiber for \$8,700,000, as contemplated by the Asset Purchase Agreement described above, is not consummated, then we will not be required to pay any cancellation charge.
- On or before November 1, 2005, Schreiber will purchase our remaining usable raw materials, ingredients and packaging at our cost.
- The Outsourcing Agreement provides for a contingent short-fall payment obligation by our Company if a specified production level is not met during the second year after the effective date. If a contingent short-fall payment is accrued after the second year, it may be reduced at the end of the third year if the production level during the third year exceeds the specified level of production. If the sale of the assets to Schreiber 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.
- 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 on November 1, 2005, we may not manufacture any products governed by the Outsourcing Agreement during the term of the Outsourcing Agreement.
- Schreiber may not manufacture our products or use any of our intellectual property other than pursuant to the terms of the Outsourcing Agreement.
- We may terminate the Outsourcing Agreement if our stockholders do not approve the transaction contemplated by the Asset Purchase Agreement, by providing notice to Schreiber within 30 days of the date that our stockholders vote on, but do not approve, the transactions contemplated by the Asset Purchase Agreement. The effectiveness of such termination may not be more than 180 days after the date of such notice.
- If we do not terminate the Outsourcing Agreement and we are unable to consummate an alternative transaction with Schreiber (as described above) prior to January 1, 2006, then Schreiber may terminate the Outsourcing 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

The asset sale and outsourcing arrangement with Schreiber are subject to a number of conditions that must be met prior to the consummation of these transactions. In addition to the closing conditions described above, we will face additional challenges during the transition. These challenges include, 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;

- Having enough cash to build inventory and pay any severance arrangements during the transition;
- Reduction of production personnel and severance arrangements related to these personnel; and
- In the event of a sale of the assets whereby we would not receive enough sale proceeds to pay off our debt to our lenders in full, we would need to negotiate with our lenders so that they would agree to release their liens on the assets. 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.
- We may be required to negotiate with the landlords of our leased premises the possibilities of early lease termination or subleasing 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 affects. However, 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.

Transaction Effect

Assuming that the sale of assets to Schreiber is completed in accordance with the Asset Purchase Agreement and we continue to operate under the Outsourcing 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 November 1, 2005 will be 31.
- Upon the sale of the assets, we will be removing in excess of 84% of the net book value of our equipment. The extent to which the proceeds of \$8,700,000 do not exceed the net book value of the assets, will result in a substantial loss on sale of assets.
- It is likely that the majority, if not all, of the proceeds from the sale of the assets will be paid to our lenders. In particular, our debt to Wachovia Bank will be required to be paid in full. Repayment of the Wachovia Bank debt will result in a reduction of annual debt service payments in excess of \$1,800,000.
- 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 Maturities

We have incurred substantial debt in connection with the financing of our business. The aggregate principal amount outstanding under our two credit facilities is approximately \$13,201,134 as of July 12, 2005. This amount includes a revolving line of credit from Textron Financial Corporation ("Textron") in the amount of \$5,399,149 and a note payable to Wachovia Bank ("Wachovia") in the amount of \$7,801,985. We anticipate that the proceeds from the sale of our assets to Schreiber will pay the Wachovia term loan in full. However, in the event that the sale is not completed as anticipated, we will need to refinance the Wachovia term loan

on or before its maturity date of July 31, 2006. The initial term of the Textron loan ends on May 26, 2006, but this loan automatically renews for additional one-year periods unless terminated by our Company or Textron through a written notice 90-days prior thereto or as otherwise provided in the loan agreement. 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 and Wachovia 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 with either Textron or Wachovia, it is unlikely that we would be able to effectively continue the operation of our business.

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. The business with Del resulted in an account receivable owed to our Company of approximately \$1,550,000 as of April 11, 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.

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 Four Hundred Thousand Dollars (\$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 have waived the conditions as they relate to the Trademark License Agreement, we have not waived 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. Since April 11, 2005, we have accrued approximately \$40,000 in royalties under the Trademark License Agreement and offset them against the receivable owed to us by Del. On or about June 15, 2006, we ceased selling products under Del's trademarks. However, the Trademark License Agreement will continue in effect until September 30, 2005 unless we extend it for up to two additional 6-month periods or terminate it sooner.

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 and valuation of compensation expense on options and warrants. 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. Actual bad debt expense increased from 1% of gross sales during fiscal 2004 to 3% of gross sales during fiscal 2005 due to the \$1,550,000 reserve for Del Sunshine as described under *Recent Material Developments*. Based on this analysis, we reserved \$2,299,000 and \$633,000 for known and anticipated future credits and doubtful accounts at March 31, 2005 and 2004, respectively. 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. Income tax expense is the tax payable or refundable for the period plus or minus the change in deferred tax assets and liabilities during the period.

Valuation of Non-Cash Compensation

Prior to April 1, 2003, we accounted for our stock-based employee compensation plans under the accounting provisions of Accounting Principles Board Opinion No. 25, “*Accounting for Stock Issued to Employees*,” (APB No. 25).

Effective April 1, 2003, we elected to record compensation expense measured at fair value for all stock-based payment award transactions on or after April 1, 2003, in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 123, “*Accounting for Stock-Based Compensation*.” Additionally, we furnish the pro forma disclosures required under SFAS No. 123 and apply SFAS No. 148, “*Accounting for Stock-Based Compensation – Transition and Disclosure*” on a prospective basis for all stock-based awards on or after April 1, 2003. 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. The negative impact on diluted earnings per share related to the issuance of employee stock options during the years ended March 31, 2005, 2004 and 2003 was approximately \$0.01, \$0.03 and \$0.55, respectively.

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 our employee and director stock-based awards had been determined in accordance with the fair market value method prescribed in SFAS No. 123. We estimated the fair value of each stock-based award at the grant date by using the Black-Scholes pricing model with the following assumptions:

Year Ended	March 31, 2005	March 31, 2004	March 31, 2003
Dividend Yield	None	None	None
Volatility	45% to 46%	41% to 45%	37% to 44%
Risk Free Interest Rate	3.38% to 4.12%	2.01% to 4.28%	1.71% to 5.03%
Expected Lives in Months	60 to 120	36 to 120	60 to 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 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.

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.

Results Of Operations

12 Months Ending March 31,	2005	2004	2003	2005-2004	2004-2003	2005-2004	2004-2003	2005	2004	2003
				\$	\$	%	%	% of	% of	% of
				Change	Change	Change	Change	Sales	Sales	Sales
Net Sales	44,510,487	36,176,961	40,008,769	8,333,526	(3,831,808)	23.0%	-9.6%	100.0%	100.0%	100.0%
Cost of Goods Sold	34,736,594	24,864,289	28,080,188	9,872,305	(3,215,899)	39.7%	-11.5%	78.0%	68.7%	70.2%
Gross Margin	9,773,893	11,312,672	11,928,581	(1,538,779)	(615,909)	-13.6%	-5.2%	22.0%	31.3%	29.8%

Net Sales

The following chart sets forth the percentage of net sales derived from our product brands during the fiscal years ended March 31, 2005, 2004 and 2003:

Brand	Percentage of Net Sales		
	Fiscal Year Ended March 31,		
	2005	2004	2003
Veggie™	47.5%	59.6%	61.5%
Private Label, Imitation & Other	36.2%	22.5%	20.9%
Rice™	6.6%	8.1%	7.2%
Veggy™	4.7%	6.2%	6.7%
Wholesome Valley® Organic	3.2%	1.1%	1.1%
Vegan™	1.8%	2.5%	2.6%

Net sales for fiscal 2005 increased by 23% over net sales for fiscal 2004 primarily due to increased sales in private label and Wholesome Valley® Organic products. During fiscal 2005, we had one new private label customer that accounted for approximately 12% of net sales. This customer accounted for nearly 65% of the increase in fiscal 2005 sales. However, we are no longer selling to this customer due to a shift in sales between customers (See Del Sunshine LLC under *Recent Material Developments* for further details). Private label and imitation sales consist primarily of products that generate high sales volumes but lower gross margins.

Certain key initiatives and tactical actions implemented by our Company during fiscal 2005 have helped counter some of the market factors that negatively impacted the business in fiscal 2004 as described below. Such key initiatives and tactical actions included, but were not limited to, the following:

- Created and communicated a new more meaningful brand position for our flagship Veggie™ Brand and added 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 prior users and light users of conventional cheese that the Veggie™ brand items can satisfy their needs with great tasting nutrition. This is a departure from our past product positioning where physiological and medical requirements were a key driver in why consumers should buy the “healthy alternatives.”
- Improved product quality in terms of taste, color, aroma, and texture of our Veggie™ and Rice slices product line.
- Secured certain contract manufacturing opportunities, which we previously turned away or did not pursue in prior years due to cash constraints. This enabled us to better utilize some of our excess production capacity. We increased our contract manufacturing activities by nearly 331%, which resulted in a 19% increase in sales during fiscal 2005 compared to fiscal 2004. Our contract manufacturing activities relate primarily to products that generate lower margins. As we added additional contract manufacturing business to our product mix, our gross margin percentage has decreased.
- Shifted the emphasis and resource allocation of our marketing strategy from vendor promotions (retailer publications/flyers featuring price reductions and on-shelf temporary price reductions) 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). 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 carbohydrate and high protein products. This was a significant strategy shift from past fiscal years and is based upon retail consumption data purchased from IRI (Information Resources

Incorporated) that indicates increased sales potential from consumer focused marketing efforts versus similar dollars being spent toward price related vendor advertising and promotions. We experienced an average 17% increase in sales in those markets where there were consumer-advertising promotions.

During fiscal 2004, sales declined from fiscal 2003 levels due to several market factors that had a negative affect on our business. First, consumers' eating habits changed with the publicly recognized trend toward low-carbohydrate meal preparation during all meals (breakfast, lunch, snack, and dinner). This led to decreased consumption of high-carbohydrate items such as bread and those complimentary items such as our cheese slices. Second, the number of consumers shopping in the retail grocery and natural food stores was down versus fiscal 2003 due to the further national emergence and presence of Wal*Mart superstores and other similar superstores that include extensive grocery operations. Third, the Veggie™ brand sales were down due to the Southern California retail grocery labor strike that occurred during fiscal 2004, but has since been resolved.

We anticipate that our direct sales to Wal*Mart will increase from 2% of sales in fiscal 2005 to a range between 10% and 15% of sales in fiscal 2006. This increase is due to a shift in sales between customers rather than an increase in product sales. Prior to fiscal 2006, we produced certain private label products for Del Sunshine who then sold the product to Wal*Mart. Del Sunshine accounted for 12% of sales in fiscal 2005. In fiscal 2006, we began selling these products directly to Wal*Mart instead of through Del Sunshine (See Del Sunshine LLC under *Recent Material Developments* for further details).

Based on our current projections, we anticipate continued double-digit growth in sales through improved distribution and penetration of our core brands into the mainstream consumer markets.

Cost of Goods Sold

Cost of goods sold increased from 70% and 69% of net sales in fiscal 2003 and fiscal 2004 to 78% of net sales in fiscal 2005. This nine percentage point increase in cost of goods sold was primarily due to rising raw material costs. Of this nine percentage point increase in cost of goods sold in relation to net sales, six percentage points were a direct result of higher key raw material costs (including primarily casein, and to a lesser extent packaging and film supplies) and the balance of the increase was due to the addition of certain private label items that were sold at a lower margin resulting in a higher cost in relation to net sales.

The principal raw material used by our Company is casein, which accounted for approximately 65% of our raw material purchases in fiscal 2005. As casein is a significant component of our product formulation, we are vulnerable to short-term and long-term changes in casein pricing, which at times has been volatile.

We experienced a 32% increase in average casein prices in fiscal 2005 compared to average casein prices in fiscal 2004, which resulted in an increase in cost of goods of approximately \$2.7 million. In fiscal 2006, we are continuing to experience high casein prices, the averages of which are approximately 31% higher than the average prices for fiscal 2005. Based on current pricing trends with our suppliers, we believe that casein prices will remain at historical highs at least through September 30, 2005. Every 10% increase in casein prices over the fiscal 2005 average will result in an annual cost increase of approximately \$1,100,000 assuming the same amount of pounds purchased as in fiscal 2005. Casein prices are still high due to greater worldwide demand, as well as lower foreign government subsidies and the decline in the US Dollar value versus the Euro. In order to offset the high casein costs, we are incorporating alternative formula modifications that maintain the integrity of our product benefits as well as reducing costs in several other raw materials and operational labor categories. We have also passed along some of the increased costs to our customers during fiscal 2005 and will implement additional price increases as appropriate. However, these price increases often cannot be passed on to the customers at the same time or in proportion to the increase in our costs and therefore, we experience lower margins on the sales of our products.

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 fiscal 2006, we expect our gross profit percentage to improve over the fiscal 2005 levels despite the continued increases in raw material costs 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, (a non-GAAP measure) as restated:

12 Months Ending March 31,				2005-2004	2004-2003	2005-2004	2004-2003	2005	2004	2003
	2005	2004	2003	\$ Change	\$ Change	% Change	% Change	% of Sales	% of Sales	% of Sales
Gross Margin	9,773,893	11,312,672	11,928,581	(1,538,779)	(615,909)	-13.6%	-5.2%	22.0%	31.3%	29.8%
Operating Expenses:										
Selling	5,148,426	4,981,996	4,958,272	166,430	23,724	3.3%	0.5%	11.6%	13.8%	12.4%
Delivery	2,307,166	1,877,682	2,008,638	429,484	(130,956)	22.9%	-6.5%	5.2%	5.2%	5.0%
Employment contract expense	444,883	1,830,329	-	(1,385,446)	1,830,329	-75.7%	100.0%	1.0%	5.1%	0.0%
General and administrative, including \$409,746, \$651,273 and \$153,238 non-cash stock compensation	4,380,436	3,954,303	3,724,127	426,133	230,176	10.8%	6.2%	9.8%	10.9%	9.3%
(Gain)Loss on disposal of assets	(4,500)	8,519	47,649	(13,019)	(39,130)	-152.8%	-82.1%	0.0%	0.0%	0.1%
Research and development	309,054	260,410	232,552	48,644	27,858	18.7%	12.0%	0.7%	0.7%	0.6%
Total operating expenses	12,585,465	12,913,239	10,971,238	(327,774)	1,942,001	-2.5%	17.7%	28.3%	35.7%	27.4%
Income (Loss) from Operations	(2,811,572)	(1,600,567)	957,343	(1,211,005)	(2,557,910)	75.7%	-267.2%	-6.3%	-4.4%	2.4%
Other Income (Expense), Net										
Interest expense, net	(1,129,977)	(1,361,606)	(2,923,215)	231,629	1,561,609	-17.0%	-53.4%	-2.5%	-3.8%	-7.3%
Derivative expense	62,829	(94,269)	(105,704)	157,098	11,435	-166.6%	-10.8%	0.1%	-0.3%	-0.3%
Gain (Loss) on FV of warrants	18,937	(242,835)	1,174,355	261,772	(1,417,190)	-107.8%	-120.7%	0.0%	-0.7%	2.9%
Other	-	-	(60,000)	-	60,000	0.0%	-100.0%	0.0%	0.0%	-0.1%
Total	(1,048,211)	(1,698,710)	(1,914,564)	650,499	215,854	-38.3%	-11.3%	-2.4%	-4.7%	-4.8%
NET INCOME (LOSS)	(3,859,783)	(3,299,277)	(957,221)	(560,506)	(2,342,056)	17.0%	244.7%	-8.7%	-9.1%	-2.4%
Interest expense, net	1,129,977	1,361,606	2,923,215	(231,629)	(1,561,609)	-17.0%	-53.4%	2.5%	3.8%	7.3%
Depreciation	2,172,566	2,205,053	2,273,349	(32,487)	(68,296)	-1.5%	-3.0%	4.9%	6.1%	5.7%
EBITDA, (a non-GAAP measure)	(557,240)	267,382	4,239,343	(824,622)	(3,971,961)	-308.4%	-93.7%	-1.3%	0.7%	10.6%

- (1) 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.

- (2) 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.
- (3) 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.
- (4) Operating Income (Loss) has declined in the past two years due to less dollars contributed by gross margin as discussed above under sales and cost of goods sold and due to a large bad debt expense in fiscal 2005 as discussed below under general and administrative. We anticipate that operating income, as adjusted will increase in the future so that current operations support our business objectives and growth plans.

Selling

We have experienced higher selling expenses primarily due to the increase in marketing efforts. During fiscal 2005, we increased our marketing costs by approximately \$190,000 over fiscal 2004, but shifted our marketing efforts from trade promotions to consumer advertising. The large consumer advertising costs were primarily related to a strategic television campaign, which was undertaken to promote our Veggie™ products during the second and third quarter of fiscal 2005. During fiscal 2004, advertising costs also increased by approximately \$414,000, because these costs were limited in fiscal 2003 due to the prior financial constraints of our Company. During fiscal 2004, we noted a decrease of approximately \$298,000 in brokerage costs and \$117,000 in promotional costs, which corresponded to the decrease in sales in fiscal 2004 from fiscal 2003. We expect selling expenses for fiscal 2006 to be higher in dollars due to increased sales, but stable or slightly lower as a percentage of net sales as the fixed expenses of the selling category do not increase in direct proportion to sales. We sell our products through our internal sales force and an independent broker network.

Delivery

Delivery expense is primarily a function of sales, and has remained consistent at approximately 5% of net sales. We anticipate that delivery costs will increase in the future periods due to higher fuel prices and surcharges charged by the transportation companies, but as sales continue to increase, we anticipate that the delivery expense will remain between 5% and 6% of net sales.

After the anticipated transfer of all production and distribution of our products to Schreiber by November 2005, 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.

Employment Contract Expense

In connection with a Separation and Settlement Agreement dated July 8, 2004 between our Company and Christopher J. New (as further described under Item 11), we accrued and expensed \$444,883 as the two-year cost of this agreement under employment contract expense in the second quarter of fiscal 2005. As of March 31, 2005, the remaining balance accrued was \$287,253 (\$220,218 in short-term liabilities and \$67,035 in long-term liabilities).

In October 2003, our Company and Angelo S. Morini entered into a Second Amended and Restated Employment Agreement (as further described under Item 11). In connection with this agreement, we accrued and expensed the five-year cost of this agreement as employment contract expense in the third quarter of fiscal 2004. The total estimated costs expensed under this agreement are \$1,830,329 of which \$1,292,575 remained unpaid but accrued (\$366,305 as short-term liabilities and \$926,270 as long-term liabilities) as of March 31, 2005. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

General and administrative

During fiscal 2005, we noted an increase of approximately \$426,000 in expenses compared to fiscal 2004. This increase is the net effect of approximately a \$1.6 million increase in bad debt expense (see Del Sunshine LLC under *Recent Material Developments* for further details) and decreases in non-cash compensation income related to stock-based transactions, as detailed below, personnel costs and professional fees for legal and audit services. Personnel costs declined nearly \$250,000 due to the change in the employment status of Angelo S. Morini per the amended employment agreement in October 2003. Additionally, legal fees decreased in fiscal 2005 due to the settlement of the Schreiber lawsuit in May 2004 and the completion of the financial restructuring in early fiscal 2004.

During fiscal 2004, there was an increase of approximately \$132,000 in legal fees due to the Schreiber lawsuit, refinancing activities and additional reporting requirements during fiscal 2004. Additionally, we had an increase of approximately \$183,000 in director and related insurance expenses due to the expanded Board of Directors and their activities in fiscal 2004. These increases were offset by decreases of approximately \$115,000 in consulting fees, \$106,000 in personnel costs, \$67,000 in bad debt write-offs, \$50,000 in bank charges, \$44,000 in audit fees, and general allocation costs such as rent, depreciation and telephone charges of approximately \$200,000.

General and administrative expenses averaged 10% of net sales for the past three years. Excluding the effects of non-cash compensation related to stock-based transactions, we anticipate that in fiscal 2006 general and administrative expenses will be lower both in dollars and as a percentage of sales due to the non-recurrence of large bad debt write-offs and to increasing sales levels without the need for an incremental increase in administrative costs.

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

12 Months Ending March 31,	2005	2004	2003	2005-2004	2004-2003	2005	2004	2003
				\$	\$	% of	% of	% of
				Change	Change	Sales	Sales	Sales
Stock-based award issuances	194,097	643,272	153,238	(449,175)	490,034	0.4%	1.8%	0.4%
Option modifications under APB 25 awards	215,649	8,001	-	207,648	8,001	0.5%	0.0%	0.0%
Non-cash compensation related to stock based transactions	409,746	651,273	153,238	(241,527)	498,035	0.9%	1.8%	0.4%

Effective April 1, 2003, we elected to record compensation expense measured at fair value for all stock-based award transactions on or after April 1, 2003 under the provisions of SFAS 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 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 fiscal years ended March 31, 2005, 2004, and 2003, we recorded \$194,097, \$643,272 and \$153,238, respectively, as non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants. This expense was computed in accordance with SFAS No. 123 only for stock-based transactions awarded to consultants prior to April 1, 2003 and for all stock-based transactions awarded on or after April 1, 2003.

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 March 31, 2005.

We recorded non-cash compensation expense of \$193,649 and \$8,001 related to these modified options for the years ended March 31, 2005 and March 31, 2004. There was no non-cash compensation expense recorded for the year ended March 31, 2003, as the market price of our stock at the end of the period was less than the \$2.05 intrinsic value of the modified options.

In connection with a Separation and Settlement Agreement dated July 8, 2004 between our Company and Mr. New (as further described under Item 11), we agreed that Mr. New's stock option rights under that certain Non-Qualified Stock Option Agreement dated December 5, 2002 (for 25,000 shares at an exercise price of \$1.67 per share) and that certain Non-Qualified Stock Option Agreement dated July 16, 2001 (for 100,000 shares at an exercise price of \$2.05 per share) would continue in full force and effect as if he were still employed by our Company. The stock price on the date of the modification was \$2.15. In accordance with FIN 44 for modifications that renew or increase the life on existing options, we recorded \$22,000 as additional non-cash compensation expense in the fiscal year ended March 31, 2005.

Research and development

Research and development expenses increased each year primarily as a result of an increase in research and development personnel costs. 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.

Other Income and Expense

Interest expense decreased \$231,629 or 17% in fiscal 2005. The decrease in fiscal 2005 compared to fiscal 2004 resulted primarily due to the elimination of interest on a mezzanine loan from FINOVA Mezzanine Capital that was recorded in the first two months of fiscal 2004 and lower lender fees charged on our debt facilities in fiscal 2005. We are incurring and anticipate increased interest expense during fiscal 2006 compared to fiscal 2005 due to increases in the floating interest used by our lenders which are based on prevailing market interest rates.

Interest expense decreased \$1,561,609 or 53% in fiscal 2004. During fiscal 2003, we amortized to interest expense \$614,230 related to debt discounts on its prior mezzanine loan from FINOVA Mezzanine Capital,

Inc. This non-cash amortization ended in September 2002 and did not occur during fiscal 2004. We also noted a decrease in loan costs of approximately \$413,722 in fiscal 2004 due to the lower fees charged under the Textron credit facility compared to the FINOVA credit facility. The remaining decrease in interest expense was the result of lower debt balances, and lower interest rates on the outstanding debt balances partly due to a reduction in the average prime rate during fiscal 2004 compared to fiscal 2003. See “Debt Financing” below for further detail on our outstanding debts and interest rates thereon.

Derivative 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 using the Black-Scholes pricing model based on several factors including the underlying value of our common stock at the end of each period. This benefit/(expense) was \$62,829, (\$94,269) and (\$105,704) in fiscal 2005, 2004 and 2003, respectively.

Since the conversion of our Series A convertible preferred stock could have resulted in a conversion into an indeterminable numbers of commons shares, we determined that under the guidance in paragraph 24 of EITF 00-19, 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 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 as a liability. 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. During the fiscal years ended March 31, 2005, 2004, and 2003, we recorded a gain/(loss) on the fair value of warrants of \$443,937, (\$242,835) and \$1,174,355, respectively, related to the change in the fair values of the warrants.

Assuming the consummation of the Asset Purchase Agreement as discussed under *Recent Material Developments*, we expect that our debt to Wachovia Bank will be paid in full and there will be a significant reduction in interest expense due to lower debt balances in fiscal 2006 as compared to fiscal 2005.

Liquidity And Capital Resources

Cash Flows from Operating Activities and Investing Activities

				2005-2004	2004-2003
12 Months Ending March 31,	2005	2004	2003	\$ Change	\$ Change
Cash from operating activities	779,746	2,236,350	1,175,875	(1,456,604)	1,060,475
Cash used in investing activities	(65,002)	(231,778)	(100,026)	166,776	(131,752)
Cash used in financing activities	(602,641)	(1,556,491)	(1,074,419)	953,850	(482,072)
Net increase in cash	112,103	448,081	1,430	(335,978)	446,651

During the past three fiscal years, we have achieved positive cash flow from operations. This was achieved mainly through higher sales volumes in fiscal 2005 and improved margins on sales in fiscal 2003 and fiscal 2004 compared to fiscal 2002. In fiscal 2005, we noted a 65% decrease in cash from operating activities compared to fiscal 2004. This was primarily attributable to an approximate 17% increase in net accounts receivable associated with our increase in sales. This increase in cash used was offset by further reductions in inventory levels and increases in accounts payable. 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 year. Additionally, we noted an increase in cash from investing activities due to decreases in our deposits and other assets in fiscal 2005. We do not anticipate any large capital expenditures during fiscal 2006.

We expect to maintain positive cash flows from ongoing operations during fiscal 2006. However, we anticipate a decrease in cash flow as we begin to outsource our production late in the second quarter of fiscal 2006. 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, if not all, will come from the sale of our usable raw materials and packaging inventory and production equipment to Schreiber in the third quarter of fiscal 2006.

Cash Flows From Financing Activities

12 Months Ending March 31,	2005	2004	2003
Net borrowings (payments) on line of credit and bank overdrafts	853,202	(1,485,893)	(625,561)
Issuances of debt	-	2,000,000	500,000
Payments of debt and capital leases	(1,417,103)	(6,226,625)	(2,434,741)
Issuances of stock	2,240,948	4,156,027	1,485,883
Redemption of preferred stock	(2,279,688)	-	-
Cash used in financing activities	<u>(602,641)</u>	<u>(1,556,491)</u>	<u>(1,074,419)</u>

During fiscal 2005, we increased our line of credit with Textron Financial Corporation to primarily fund our business growth. Additionally, we issued 2,000,000 shares of our common stock for aggregate gross proceeds of \$2,300,000. These proceeds were then used to redeem the remaining 30,316 Series A convertible preferred shares held by the holders of such Series A convertible preferred shares for a total price of \$2,279,688. See “Equity Financing” below for further details.

During fiscal 2004, we refinanced all of our credit facilities that were in existence at the end of fiscal 2003. This refinancing was accomplished through the payment of \$4,000,000 to FINOVA Mezzanine by renewing and increasing our loan with Wachovia Bank by \$2,000,000 and through \$3,850,000 in private placement equity financings. Additionally, we replaced FINOVA Capital Corporation with Textron Financial Corporation as our new asset based lender. This financial restructuring improved our operations and financial position and reduced interest expense nearly \$1.6 million during fiscal 2004. The remaining proceeds from the refinancing were used for operations and to further reduce our accounts payable and debt balances.

During fiscal 2003, we received loan proceeds from Excalibur Limited Partnership in the amount of \$500,000 in cash. The proceeds of which were used to pay down a portion of our outstanding debt under our term loan from Wachovia Bank. In addition, we raised \$1,500,000 through the issuance of common stock to Stonestreet Limited Partnership. These proceeds were used to pay off our term loan from Excalibur Limited Partnership and for working capital purposes. We used our cash from operating activities to reduce the balance of our outstanding debt under our line of credit from FINOVA Capital and to pay down our term loan with Wachovia Bank.

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 (7.5% at March 31, 2005) calculated on the average cash borrowings for the preceding month. The initial term of the Textron Loan ends on May 26, 2006, but this loan automatically renews for additional one-year periods unless terminated by our Company or Textron through a written notice 90-days prior thereto or as otherwise provided in the loan agreement. As of March 31, 2005, the outstanding principal balance on the Textron Loan was \$5,458,479.

The Textron Loan Agreement contains certain financial and operating covenants. As of March 31, 2005, we failed to comply with certain requirements and financial covenants in the Textron Loan Agreement. We fell below the fixed charge ratio and the adjusted tangible net worth financial covenant ratios primarily because of a large bad debt reserve and inventory write off related to one of our customers in March 2005, as discussed under Del Sunshine LLC in *Recent Material Developments*. On April 29, 2005, Textron also determined that the credit risk increased substantially enough to downgrade our accounts receivable with respect to such customer and deemed such accounts receivable as ineligible for purposes of calculating our borrowing base under the Textron Loan. This action by Textron placed our balance owed into an over-advance position with respect to the Textron Loan. As a result, effective as of April 29, 2005, our interest rate on the Textron Loan was increased from Prime plus 1.75% to Prime plus 4.75%.

On June 3, 2005, we executed a fourth amendment to the Textron Loan that provided a waiver of 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 would remain at Prime plus 4.75% on the Textron Loan 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 by BH Capital Investments L.P., Excalibur Limited Partnership and Mr. Frederick A. DeLuca (as described under *Equity Financing* below) 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% (7.75% as of June 16, 2005). In July 2005, Textron will review our financial forecasts that reflect the outsourcing arrangement (as described under the Schreiber Transactions in *Recent Material Developments* above) and will evaluate whether any further amendments to our loan agreement will be required. Until such time, they have reduced our borrowing availability under our line by \$200,000. However, there is no guarantee if or when they will lift this restriction on our borrowing availability. Additionally, we may experience future credit tightening by Textron by virtue of reserves they may require, receivables they may deem ineligible or other rights they have under the Textron Loan Agreement.

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 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. The balance outstanding on the term loan as of March 31, 2005 is \$8,241,985.

On June 30, 2005, we entered into a Loan Modification Agreement with Wachovia regarding our 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 our compliance with such covenants is not required 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 is due on August 1, 2005. As required by the terms of the agreement, if we sell our equipment 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.

The Wachovia term loan contains certain financial and operating covenants. We fell below the requirement for the tangible net worth covenant for the quarter ended March 31, 2005 and the requirement for the maximum funded debt to EBITDA ratio for the year ended March 31, 2005. In accordance with the Loan Modification Agreement referenced above, Wachovia agreed to waive compliance on the covenants for the periods ended March 31, 2005 and through the maturity of the loan on July 31, 2006.

Equity Financing

On April 6, 2001, in accordance with an exemption from registration under Regulation D promulgated under the Securities Act of 1933, as amended, we received from BH Capital Investments L.P. and Excalibur Limited Partnership ("BH Capital and Excalibur") proceeds of approximately \$3,082,000 less costs of \$181,041 for the issuance of 72,646 shares of our Series A convertible preferred stock with a face value of \$3,500,000 and warrants to purchase up to 500,000 shares of our common stock. The holders of our Series A convertible preferred stock had the right to receive on any outstanding Series A convertible preferred stock a ten percent (10%) stock dividend on the shares, payable one year after the issuance of such preferred stock, and an eight percent (8%) stock dividend for the subsequent three years thereafter, payable in either cash or shares of preferred stock. The Series A convertible preferred stock was subject to certain designations, preferences and rights set forth in our Restated Certificate of Incorporation, including the right to convert such shares into shares of common stock at any time, at a current conversion rate (subject to appropriate adjustment for stock splits, stock dividends, recapitalizations and other events) of the number of shares of common stock for each share of Series A convertible preferred stock equal to the quotient of \$48.18, plus all accrued dividends that are then unpaid for each share of the Series A convertible preferred stock divided by the lesser of (x) \$1.75 or (y) 95% of the average of the two lowest closing bid prices of our common stock on the American Stock Exchange out of the fifteen trading days immediately prior to conversion.

Prior to October 6, 2004, BH Capital and Excalibur had converted 32,052 shares of the Series A convertible preferred stock plus accrued dividends, into 1,206,240 shares of common stock. The conversion prices ranged from \$1.28 to \$1.75 based on the above formula.

On October 6, 2004, BH Capital and Excalibur converted 10,278 Series A convertible preferred shares into approximately 600,000 shares of common stock. Simultaneously, the remaining 30,316 Series A convertible preferred shares held by BH Capital and Excalibur were acquired by our Company for a total price of \$2,279,688. All previously outstanding shares of the Series A convertible preferred stock of our Company have now been cancelled. As part of the transaction, BH Capital and Excalibur also received warrants to purchase up to 500,000 shares of common stock at an exercise price of \$2.00 per share for a period of five years. The market price of our common stock on October 6, 2004 was \$1.30. The fair value of the warrants is \$205,000. In June 2005, we agreed to reduce the per-share exercise price on all these warrants along with 530,000 other warrants issued to BH Capital and Excalibur in prior years to \$1.10 in order to induce them to exercise their warrants. All of these warrants were exercised on June 16, 2005 for total proceeds of \$1,133,000.

On October 6, 2004, we completed a private placement of our common stock, whereby we issued a total of 2,000,000 shares to Mr. Fredrick DeLuca (an existing stockholder of our Company) for aggregate gross

proceeds to our Company of \$2,300,000. These proceeds were used to redeem our Series A convertible preferred stock as discussed above. The purchase price of the shares was \$1.15 per share (95% of the prior 5-day trading closing stock price average). Mr. DeLuca also received a warrant to purchase up to 500,000 shares of our common stock at an exercise price of \$1.15 per share for a period of five years. In June 2005, we agreed to reduce the per-share exercise price on this warrant to \$0.92 and reduced the per-share exercise price on a warrant issued in a prior year to purchase up to 100,00 shares to \$1.36 to induce him to exercise his warrants. All of these warrants were exercised on June 16, 2005 for total proceeds of \$596,000.

In accordance with a registration rights agreement with Mr. DeLuca, we agreed to file and obtain effectiveness of a registration statement with the Securities and Exchange Commission within 180 days of closing to register the shares issued in the private placement and to include the shares underlying the warrants described above. We agreed that if a registration statement was not filed, or did not become effective within the defined period of time, then in addition to any other rights Mr. DeLuca may have, we would be required to pay certain liquidated damages of \$57,500 per month. We filed a registration statement on Form S-3 on March 14, 2005. However, this registration statement has not yet been declared effective. We have received from Mr. DeLuca an extension of time until September 1, 2005 to have the registration statement declared effective by the SEC. Additionally, Mr. DeLuca waived all damages and remedies for failure to have an effective registration statement until September 1, 2005.

Summary

We believe that with the cash available on our credit facilities and proceeds received from the equity financings together with cash flow from current operations, we will have enough cash to meet our current liquidity needs for general operations through March 31, 2006.

Based on current projections, we expect that much, if not all, of the additional cash requirements for the transition charges will come from the sale of our usable raw materials and packaging inventory and production equipment to Schreiber in the third quarter of fiscal 2006.

Contractual Obligations

We lease our operating facilities and certain equipment under operating and capital leases, expiring at various dates through fiscal year 2010. In addition, we have several loan obligations as described in detail above. The table below summarizes the principal balances of our obligations for indebtedness and lease obligations as of March 31, 2005 in accordance with their required payment terms:

Contractual Obligations	Payments due by fiscal period				
	Total	2006	2007-2008	2009-2010	Thereafter
Textron credit facility ⁽¹⁾	\$ 5,458,479	\$ 5,458,479	\$ --	\$ --	\$ --
Wachovia Bank term loan	8,241,985	1,320,000	6,921,985	--	--
Interest on debt facilities ⁽²⁾	1,088,000	922,000	166,000	--	--
Contractual employment agreements	1,579,828	586,523	799,644	193,661	
Capital Lease Obligations ⁽³⁾	497,117	400,756	76,984	19,377	--
Operating Lease Obligations	1,479,214	547,737	566,974	364,503	--
Total	<u>\$ 18,344,623</u>	<u>\$ 9,235,495</u>	<u>\$ 8,531,587</u>	<u>\$ 577,541</u>	<u>\$ --</u>

- (1) In accordance with EITF 95-22, "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that involve both a Subjective Acceleration Clause and a Lock-Box Arrangement," the \$5,458,479 balance owed to Textron is reflected as current on the balance sheet and in the above schedule. However, per the Textron Loan Agreement, the initial term of the loan does not end until May 26, 2006.

- (2) The Wachovia Bank term loan bears interest at prime plus 1% and the Textron credit facility bears interest at prime plus 1.75%. Interest is estimated assuming that the credit facility balance will remain unchanged and that the prime rate will remain at its current level of 5.75%.
- (3) Includes the principal and interest portion of capital lease payments to be paid and an additional \$197,000 in fiscal 2006 related to the purchase option on a piece of equipment at the end of its lease term.

On May 22, 2003, we entered into a Master Distribution and Licensing Agreement with Fromageries Bel S.A., (“Bel”) a leading branded cheese company in Europe who is a greater than 5% stockholder in our Company. 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. The term of the agreement is ten years, provided that either of the parties may elect to terminate the agreement by delivery of notice to the other between March 24, 2007 and May 22, 2007, which termination shall be effective as of the first anniversary of the date of the notice of termination. Alternatively, the parties may mutually agree to continue operating under the agreement, to convert the agreement to a manufacturing and license agreement, or to terminate the agreement. We have come to an understanding with Bel whereby we mutually agreed to terminate the licensing agreement. We anticipate that this understanding will be formalized in an agreement in the near future.

Forward-Looking Information

Statements other than historical information contained in this Form 10-K/A are considered “forward-looking statements” as defined under the Private Securities Litigation Reform Act of 1995. 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 Company’s historical results and those expressed or forecasted in any forward-looking statement as a result of a variety of factors as set forth below. We believe that these forward-looking statements are reasonable at the time they are made. However, 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.

In addition to the other information in this Form 10-K/A, the following are some of the factors that could cause our Company’s actual results to differ materially from the expected results described in or underlying our Company’s forward-looking statements. These factors should be considered carefully while evaluating our business and prospects. If any of the following risks actually occur, they could seriously harm our business, financial condition, results of operations or cash flows.

We are in the process of outsourcing the production of our products and selling our major production assets.

The asset sale and outsourcing arrangement with Schreiber Foods, Inc are subject to a number of conditions that must be met prior to the consummation of these transactions. In addition to the closing conditions as described above under the Schreiber Transactions in *Recent Material Developments*, we will face additional challenges during the transition. These challenges include, 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;
- Having enough cash to build inventory and pay any severance arrangements during the transition;
- Reduction of production personnel and severance arrangements related to these personnel
- In the event of a sale of the assets whereby we would not receive enough sale proceeds to pay off our debt to our lenders in full, we would need to negotiate with our lenders so that they would agree to release their liens on the assets. 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;
- We may be required to negotiate with the landlords of our leased premises the possibilities of early lease termination or subleasing 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 affects.

We have previously been in technical default of our credit facilities.

We have a revolving line of credit from Textron Financial Corporation and a note payable to Wachovia Bank that require us to comply with certain financial and reporting requirements. During the fiscal years ended March 31, 2005, 2004 and 2003, we were in violation of the financial and other covenants, but the lenders routinely waived such violations and amended the covenants in return for the payment of waiver fees, increases in interest rates, acceleration of maturity dates and other considerations.

In July 2005, Textron will review our financial forecasts that reflect the subsequent events described under *Material Future Events* above and will evaluate whether any further amendments to our loan agreement will be required. Pursuant to the above Loan Modification Agreement dated June 30, 2005, Wachovia Bank agreed to waive compliance on our three main financial covenants for the periods ended March 31, 2005 and through the maturity of the loan on July 31, 2006. In the event that we are in future violations of the covenants under the Textron revolving line of credit or non-financial covenants under the Wachovia Bank loan and we cannot amend the covenants or obtain waivers for these covenant failures, Textron and Wachovia Bank could exercise their respective rights under their loan documents to, among other things, declare a default under the loans, accelerate their indebtedness such that they would become immediately due and payable, and pursue foreclosure on our assets which are pledged as collateral for such loans. In either event, it is unlikely that we would be able to continue the operation of our business.

We will need additional financing and such financing may not be available.

We have incurred substantial debt in connection with the financing of our business. The aggregate principal amount outstanding under our two credit facilities is approximately \$13,201,134 as of July 12, 2005. This amount includes a revolving line of credit from Textron Financial Corporation (“Textron”) in the amount of \$5,399,149 and a note payable to Wachovia Bank (“Wachovia”) in the amount of \$7,801,985. We anticipate that the proceeds from the sale of our assets to Schreiber will pay the Wachovia term loan in full. However, in the event that the sale is not completed as anticipated, we will need to refinance the Wachovia term loan on or before its maturity date of July 31, 2006. The initial term of the Textron loan ends on May 26, 2006, but this loan automatically renews for additional one-year periods unless terminated by our Company or Textron through a written notice 90-days prior thereto or as otherwise provided in the loan agreement. 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 and Wachovia 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 with either Textron or Wachovia, it is unlikely that we would be able to effectively continue the operation of our business.

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

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

Our founder and a private investor own a large percentage of the outstanding shares, which could materially limit the ownership rights of investors.

As of July 12, 2005, Angelo S. Morini, our founder, beneficially owned approximately 17% of our issued and outstanding common stock and held options and warrants which, if exercised and assuming the exercise of no other outstanding options or warrants, would give him approximately 28% of our issued and outstanding common stock. As of July 12, 2005, Frederick DeLuca, a private investor, owned approximately 19% of our issued and outstanding common stock. Investors who purchase common stock in our Company may be unable to elect any specific members of the board of directors or exercise significant control over us or our business as a result of Mr. Morini's and Mr. Deluca's ownership.

Forgiveness of or foreclosure on our note receivable will result in a material affect to our reported earnings.

In June 1999, in connection with an amended and restated employment agreement for Angelo S. Morini, our Founder, we 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 our 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 our 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 our 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, we would show this amount as a forgiveness of debt in our Statement of Operations. In the event that Mr. Morini is unable to pay the loan when due and we foreclose on the shares, we will show 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 July 12, 2005 of \$2.03, we would show a loss of approximately \$6,850,000 in the Statement of Operations. Although both of these scenarios will result in material losses to our operations, it will not have any affect on the balance sheet since the \$12,772,200 loan amount is already shown as a negative amount in Stockholders' Equity.

Stockholders may experience further dilution.

We have a substantial number of outstanding options and warrants to acquire shares of common stock. As of July 12, 2005, we have a total of 5,715,165 shares reserved for issuance upon exercise of options and warrants that we have granted or may grant in the future. Of this total, there are 2,388,135 exercisable options and warrants that are "in the money." "In the money" generally means that the current market price of the common stock is above the exercise price of the shares subject to the warrant or option. The issuance of common stock upon the exercise of these options and warrants could adversely affect the market price of the common stock or result in substantial dilution to our existing stockholders.

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

Currently, we purchase our major ingredient, a milk protein called casein, from several foreign suppliers. We purchase casein from foreign suppliers because they have lower prices than domestic suppliers. However, their lower prices are generally the result of governmental export supports or subsidies. We do have contractual arrangements with our principal suppliers for terms up to one-year subject to quarterly price adjustments. Because we purchase casein from foreign suppliers, its availability is subject to a variety of factors, including federal import regulations. If the export supports or subsidies are reduced or eliminated or the United States takes retaliatory action or otherwise establishes trade barriers with any of the countries in which our casein suppliers are located, our business and results of operations would be negatively affected. Moreover, exchange rate fluctuations or the imposition of import quotas or tariffs could have an adverse effect on our business and our ability to compete with competitors that do not rely on foreign suppliers. We cannot assure you that we could obtain casein from U.S. sources if the foreign supply of casein were reduced or terminated. Even if we could obtain casein from U.S. sources, our production may be reduced during the time it takes to change suppliers and the prices for the casein would likely be significantly higher than we are paying now. Any of these events would negatively affect our business, results of operations and cash flows.

We experienced a 32% increase in average casein prices in fiscal 2005 compared to the average casein prices in fiscal 2004. In fiscal 2006, we are continuing to experience high casein prices, the averages of which are approximately 31% higher than the average prices for fiscal 2005. Based on current pricing trends with our suppliers, we believe that casein prices will remain at historical highs at least through September 30, 2005. Every 10% increase in casein prices over the fiscal 2005 average will result in an annual cost increase of approximately \$1,100,000 assuming the same amount of pounds purchased as in fiscal 2005. Casein prices are still high due to greater worldwide demand, as well as lower foreign government subsidies and the decline in the US Dollar value versus the Euro. In order to offset the high casein costs, we are incorporating alternative formula modifications that maintain the integrity of our product benefits as well as reducing costs in several other raw materials and operational labor categories. Finally, we have passed along some of the increased costs to our customers during fiscal 2005 and will propose additional price increases as appropriate.

Competition in our industry is intense.

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

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

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

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

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

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

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

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

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

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

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

contractual indemnification available, product liability claims relating to defective products could have a material adverse effect on our financial condition, results of operations and cash flows.

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

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

Rising interest rates could negatively affect our results of operations.

The interest rates of most of our outstanding debts fluctuate based upon changes in our lenders' prime rate. Increases in the prime rate will result in an increase in our cost of funds, and would negatively affect our results of operations. We are anticipating future increases in interest rates during the fiscal year ending March 31, 2006. We have not entered into any derivative instruments such as interest rate swap or hedge agreements to manage our exposure to rising interest rates.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Report of Registered Public Accounting Firm

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

We have audited the accompanying balance sheets of Galaxy Nutritional Foods, Inc. as of March 31, 2005 and 2004 and the related statements of operations, stockholders' equity and cash flows for each of the three years in the period ended March 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Galaxy Nutritional Foods, Inc. as of March 31, 2005 and 2004 and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2005 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 17 to the accompanying financial statements, the Company has restated its 2001 through 2005 financial statements.

/s/ BDO Seidman, LLP

Atlanta, Georgia
July 12, 2005, except in Note 17 as to which the date is September 28, 2005.

GALAXY NUTRITIONAL FOODS, INC.
Balance Sheets

	Notes 17	MARCH 31, 2005 RESTATED	MARCH 31, 2004 RESTATED
ASSETS			
CURRENT ASSETS:			
Cash		\$ 561,782	\$ 449,679
Trade receivables, net of allowance for doubtful accounts of \$2,299,000 and \$633,000	2	4,644,364	3,964,198
Inventories	3	3,811,470	4,632,843
Prepaid expenses and other	4	219,592	266,301
Total current assets		9,237,208	9,313,021
PROPERTY AND EQUIPMENT, NET	5	18,246,445	20,232,089
OTHER ASSETS		286,013	416,706
TOTAL		\$ 27,769,666	\$ 29,961,816
LIABILITIES AND STOCKHOLDERS' EQUITY			
CURRENT LIABILITIES:			
Line of credit	6	\$ 5,458,479	\$ 4,605,277
Accounts payable		3,057,266	1,266,346
Accrued and other current liabilities	7	2,130,206	3,284,191
Current portion of accrued employment contract	8	586,523	366,305
Current portion of term notes payable	6	1,320,000	1,140,000
Current portion of obligations under capital leases	8	194,042	231,432
Total current liabilities		12,746,516	10,893,551
ACCRUED EMPLOYMENT CONTRACT , less current portion	8	993,305	1,293,142
TERM NOTES PAYABLE , less current portion	6	6,921,985	8,241,985
OBLIGATIONS UNDER CAPITAL LEASES , less current portion	8	85,337	204,967
Total liabilities		20,747,143	20,633,645
COMMITMENTS AND CONTINGENCIES	8	--	--
TEMPORARY EQUITY:			
Series A redeemable convertible preferred stock, \$.01 par value; authorized 200,000 shares; 43,894 shares outstanding	9	--	2,573,581
Common stock, subject to registration, \$.01 par value; 2,000,000 shares issued and outstanding	9	2,220,590	--
STOCKHOLDERS' EQUITY:			
Common stock, \$.01 par value; authorized 85,000,000 shares; 16,411,474 and 15,657,321 shares issued		164,115	156,573
Additional paid-in capital		65,838,227	63,938,643
Accumulated deficit		(48,307,748)	(44,447,965)
		17,694,594	19,647,251
Less: Notes receivable arising from the exercise of stock options	8	(12,772,200)	(12,772,200)
Treasury stock, 30,443 shares, at cost		(120,461)	(120,461)
Total stockholders' equity		4,801,933	6,754,590
TOTAL		\$ 27,769,666	\$ 29,961,816

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
Statements of Operations
RESTATED (Note 17)

Years ended March 31,	<u>2005</u>	<u>2004</u>	<u>2003</u>
NET SALES	\$ 44,510,487	\$ 36,176,961	\$ 40,008,769
COST OF GOODS SOLD	<u>34,736,594</u>	<u>24,864,289</u>	<u>28,080,188</u>
Gross margin	<u>9,773,893</u>	<u>11,312,672</u>	<u>11,928,581</u>
OPERATING EXPENSES:			
Selling	5,148,426	4,981,996	4,958,272
Delivery	2,307,166	1,877,682	2,008,638
Employment contract expense-general and administrative (Note 8)	444,883	1,830,329	--
General and administrative, including \$409,746, \$651,273 and \$153,238 non-cash charges related to stock transactions (Note 9)	4,380,436	3,954,303	3,724,127
(Gain) Loss on asset disposals	(4,500)	8,519	47,649
Research and development	309,054	260,410	232,552
Total operating expenses	<u>12,585,465</u>	<u>12,913,239</u>	<u>10,971,238</u>
INCOME (LOSS) FROM OPERATIONS	<u>(2,811,572)</u>	<u>(1,600,567)</u>	<u>957,343</u>
OTHER INCOME (EXPENSE):			
Interest expense	(1,129,977)	(1,361,606)	(2,923,215)
Derivative income (expense)	62,829	(94,269)	(105,704)
Gain (loss) on fair value of warrants	18,937	(242,835)	1,174,355
Other expense	--	--	(60,000)
Total other income (expense)	<u>(1,048,211)</u>	<u>(1,698,710)</u>	<u>(1,914,564)</u>
NET INCOME (LOSS)	\$ (3,859,783)	\$ (3,299,277)	\$ (957,221)
Less:			
Preferred Stock Dividends (Note 9)	82,572	201,791	264,314
Preferred Stock Accretion to Redemption Value (Note 9)	<u>319,500</u>	<u>1,256,019</u>	<u>1,308,855</u>
NET LOSS TO COMMON STOCKHOLDERS	<u>\$ (4,261,855)</u>	<u>\$ (4,757,087)</u>	<u>\$ (2,530,390)</u>
BASIC AND DILUTED NET LOSS PER COMMON SHARE (Note 11)	<u>\$ (0.25)</u>	<u>\$ (0.32)</u>	<u>\$ (0.21)</u>

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
STATEMENTS OF STOCKHOLDERS' EQUITY
RESTATED (Note 17)

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Notes Receivable for Common Stock	Treasury Stock	Total
	Shares	Par Value					
Balance at March 31, 2002	11,540,041	\$ 115,400	\$ 56,439,191	\$ (40,191,467)	\$ (12,772,200)	\$ (120,461)	\$ 3,470,463
Exercise of options	1,000	10	4,240	--	--	--	4,250
Issuance of common stock under employee stock purchase plan	9,880	99	19,564	--	--	--	19,663
Issuance of common stock	585,828	5,859	2,295,269	--	--	--	2,301,128
Conversion of preferred stock	624,936	6,249	845,726	--	--	--	851,975
Fair value of stock-based transactions	--	--	18,200	--	--	--	18,200
Dividends on preferred stock	--	--	(264,314)	--	--	--	(264,314)
Accretion of discount on preferred stock	--	--	(339,446)	--	--	--	(339,446)
Net loss	--	--	--	(957,221)	--	--	(957,221)
Balance at March 31, 2003	12,761,685	127,617	59,018,430	(41,148,688)	(12,772,200)	(120,461)	5,104,698
Exercise of options	7,911	79	16,138	--	--	--	16,217
Exercise of warrants	200,000	2,000	358,000	--	--	--	360,000
Issuance of common stock under employee stock purchase plan	16,339	163	28,364	--	--	--	28,527
Issuance of common stock	2,211,478	22,115	3,929,242	--	--	--	3,951,357
Conversion of preferred stock	459,908	4,599	794,921	--	--	--	799,520
Fair value of stock-based transactions	--	--	491,308	--	--	--	491,308
Non-cash compensation related to variable securities	--	--	8,001	--	--	--	8,001
Dividends on preferred stock	--	--	(201,791)	--	--	--	(201,791)
Accretion of discount on preferred stock	--	--	(503,970)	--	--	--	(503,970)
Net loss	--	--	--	(3,299,277)	--	--	(3,299,277)
Balance at March 31, 2004	15,657,321	156,573	63,938,643	(44,447,965)	(12,772,200)	(120,461)	6,754,590
Exercise of options	13,893	139	18,717	--	--	--	18,856
Costs associated with issuance of common stock	--	--	(22,500)	--	--	--	(22,500)
Issuance of common stock under employee stock purchase plan	18,894	189	23,813	--	--	--	24,002
Conversion of preferred stock	721,366	7,214	840,215	--	--	--	847,429
Fair value of stock-based transactions	--	--	83,224	--	--	--	83,224
Non-cash compensation related to variable securities	--	--	215,649	--	--	--	215,649
Dividends on preferred stock	--	--	(82,572)	--	--	--	(82,572)
Accretion of discount on preferred stock	--	--	823,038	--	--	--	823,038
Net loss	--	--	--	(3,859,783)	--	--	(3,859,783)
Balance at March 31, 2005	16,411,474	\$ 164,115	\$ 65,838,227	\$ (48,307,748)	\$ (12,772,200)	\$ (120,461)	\$ 4,801,933

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
Statements of Cash Flows

Years Ended March 31, (Note 17)	<u>2005</u>	<u>2004</u>	<u>2003</u>
	(RESTATED)	(RESTATED)	(RESTATED)
CASH FLOWS FROM OPERATING ACTIVITIES: (Note 12)			
Net Loss	\$ (3,859,783)	\$ (3,299,277)	\$ (957,221)
Adjustments to reconcile net loss to net cash from (used in) operating activities:			
Depreciation and amortization	2,172,566	2,205,053	2,273,349
Amortization of debt discount and financing costs	116,522	236,321	1,264,273
Provision for losses on trade receivables (Note 2)	1,666,000	(221)	(177,245)
Derivative (income) expense	(62,829)	94,269	105,704
(Gain) Loss on fair value of warrants	(18,937)	242,835	(1,174,355)
Non-cash compensation related to stock-based transactions (Note 9)	409,746	651,273	153,238
(Gain) Loss on disposal of assets	(4,500)	8,519	47,649
(Increase) decrease in:			
Trade receivables	(2,346,166)	999,049	364,907
Inventories	821,373	661,657	454,152
Prepaid expenses and other	46,709	189,012	(67,369)
Increase (decrease) in:			
Accounts payable	1,790,920	(1,426,143)	(1,520,021)
Accrued and other liabilities	48,125	1,674,003	408,814
NET CASH FROM (USED IN) OPERATING ACTIVITIES	<u>779,746</u>	<u>2,236,350</u>	<u>1,175,875</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of property and equipment	(104,339)	(221,585)	(214,003)
Proceeds from sale of equipment	4,500	--	--
(Increase) decrease in other assets	34,837	(10,193)	113,977
NET CASH FROM (USED IN) INVESTING ACTIVITIES	<u>(65,002)</u>	<u>(231,778)</u>	<u>(100,026)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Decrease in book overdrafts	--	(1,151,276)	(41,580)
Net borrowings (payments) on line of credit	853,202	(334,617)	(583,981)
Borrowings on term notes payable	--	2,000,000	500,000
Repayments on term notes payable	(1,140,000)	(1,572,760)	(1,763,265)
Repayments on subordinated note payable	--	(4,000,000)	--
Financing costs for long term debt	(37,500)	(288,230)	(239,539)
Principal payments on capital lease obligations	(239,603)	(365,635)	(431,937)
Proceeds from exercise of common stock options	18,856	16,217	4,250
Proceeds from exercise of common stock warrants, net of costs	--	360,000	--
Proceeds from issuance of common stock under employee stock purchase plan	24,002	28,527	19,663
Proceeds from issuance of common stock, net of costs	2,198,090	3,751,283	1,461,970
Redemption of preferred stock	(2,279,688)	--	--
NET CASH FROM (USED IN) FINANCING ACTIVITIES	<u>(602,641)</u>	<u>(1,556,491)</u>	<u>(1,074,419)</u>
NET INCREASE (DECREASE) IN CASH	112,103	448,081	1,430
CASH, BEGINNING OF YEAR	<u>449,679</u>	<u>1,598</u>	<u>168</u>
CASH, END OF YEAR	<u>\$ 561,782</u>	<u>\$ 449,679</u>	<u>\$ 1,598</u>

See accompanying notes to financial statements.

GALAXY NUTRITIONAL FOODS, INC.
NOTES TO FINANCIAL STATEMENTS

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

Business

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

Accounts Receivable

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

Inventories

Inventories are valued at the lower of cost (weighted average, which approximates FIFO) or market. The cost elements included in inventories are direct material cost, direct labor and overhead allocations. Material cost consists of the cost of ingredients and packaging that go into the production of the item. Labor consists of the wages for those employees directly making the item. Overhead is applied to inventory units based on the normal capacity of the production facilities and consists of factory overhead costs such as indirect labor, benefits, supplies, repairs, depreciation and utilities expended during the production process.

Property and Equipment

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

Revenue Recognition

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

Marketing and Advertising

The Company expenses the production costs of advertising the first time the advertising takes place and expenses slotting fees and direct response advertising costs in the period incurred. Advertising expense was approximately \$1,539,000, \$910,000, and \$224,000 during the years ended March 31, 2005, 2004, and 2003, respectively.

Shipping and Handling Costs

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

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

Stock Based Compensation

Prior to April 1, 2003, the Company accounted for its stock-based employee compensation plans under the accounting provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," (APB No. 25).

Effective April 1, 2003, the Company elected to record compensation expense measured at fair value for all stock-based payment award transactions on or after April 1, 2003, in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." Additionally, the Company furnishes the pro forma disclosures required under SFAS No. 123 and applies SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" on a prospective basis for all stock-based awards on or after April 1, 2003. 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. The negative impact on diluted earnings per share related to the issuance of employee stock options during the years ended March 31, 2005, 2004 and 2003 was approximately \$0.01, \$0.03 and \$0.55, respectively.

SFAS No. 123 requires the Company to provide pro-forma information regarding net income (loss) and earnings (loss) per share amounts as if compensation cost for the Company's employee and director stock-based awards had been determined in accordance with the fair market value method prescribed in SFAS No. 123. The Company estimated the fair value of each stock-based award at the grant date by using the Black-Scholes pricing model with the following assumptions:

Year Ended	<u>March 31, 2005</u>	<u>March 31, 2004</u>	<u>March 31, 2003</u>
Dividend Yield	None	None	None
Volatility	45% to 46%	41% to 45%	37% to 44%
Risk Free Interest Rate	3.38% to 4.12%	2.01% to 4.28%	1.71% to 5.03%
Expected Lives in Months	60 to 120	36 to 120	60 to 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:

Year Ended	<u>March 31, 2005</u>	<u>March 31, 2004</u>	<u>March 31, 2003</u>
Net loss to common stockholders as reported	\$ (4,261,855)	\$ (4,757,087)	\$ (2,530,390)
Add: Stock-based compensation expense included in reported net income	409,746	651,273	(1,021,117)
Deduct: Stock-based compensation expense determined under fair value based method for all awards	<u>(519,024)</u>	<u>(1,070,997)</u>	<u>(5,614,237)</u>
Pro forma net loss to common stockholders	<u>(4,371,133)</u>	<u>\$ (5,176,811)</u>	<u>\$ (9,165,744)</u>
Net loss per common share:			
Basic & diluted – as reported	<u>\$ (0.25)</u>	<u>\$ (0.32)</u>	<u>\$ (0.21)</u>
Basic & diluted – pro forma	<u>\$ (0.26)</u>	<u>\$ (0.35)</u>	<u>\$ (0.76)</u>

Income Taxes

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

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

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.

Financial Instruments

Statement of Financial Accounting Standards No. 107, “*Disclosures about Fair Value of Financial Instruments,*” requires disclosure of fair value information about financial instruments. Fair value estimates discussed herein are based upon certain market assumptions and pertinent information available to management as of March 31, 2005.

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

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expense during the reporting period. The Company’s significant estimates include the allowance for doubtful accounts receivable, which is made up of reserves for promotions, discounts and bad debts, provision for inventory obsolescence, valuation of deferred taxes, and valuation of stock options and warrants. Actual results could differ from those estimates.

Segment Information

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

Reclassifications

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

Recent Accounting Pronouncements

In 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. 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

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

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.

(2) **Schedule of Valuation Account**

	Balance at Beginning of Year	Charged to Costs and Expenses	Write-Offs, Retirements and Collections	Balance at End of Year
Year Ended March 31, 2003:				
Allowance for trade receivables	\$ 810,466	\$ 2,159,891	\$ (2,337,136)	\$ 633,221
Year Ended March 31, 2004:				
Allowance for trade receivables	\$ 633,221	\$ 2,433,458	\$ (2,433,679)	\$ 633,000
Year Ended March 31, 2005:				
Allowance for trade receivables	\$ 633,000	\$ 2,477,931	\$ (811,931)	\$ 2,299,000

In addition to reserving for potential uncollectible accounts, the Company uses its allowance for trade receivables account to estimate future credits that will be issued to customers for items such as discounts, rebates, sales promotions, coupons, slotting fees and spoils that relate to current period sales. For the years ended March 31, 2005, 2004 and 2003, the Company recorded an expense of \$1,609,134, \$59,908, and \$127,389, respectively related to bad debt. For the year ended March 31, 2005 the bad debt expense was approximately 3.3% of gross sales and for the years ended March 31, 2004 and 2003, it was less than 0.5% of gross sales.

(3) **Inventories**

Inventories are summarized as follows:

	<u>March 31, 2005</u>	<u>March 31, 2004</u>
Raw materials	\$ 1,451,588	\$ 1,786,586
Finished goods	2,359,882	2,846,257
Total	<u>\$ 3,811,470</u>	<u>\$ 4,632,843</u>

(4) **Prepaid Expenses and Other**

Prepaid expenses are summarized as follows:

	<u>March 31, 2005</u>	<u>March 31, 2004</u>
Employee advances	\$ 9,695	\$ 10,195
Prepaid commissions	--	47,322
Prepaid insurance	109,198	49,786
Other	100,699	158,998
Total	<u>\$ 219,592</u>	<u>\$ 266,301</u>

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(5) **Property and Equipment**

Property and equipment are summarized as follows:

	<u>Useful Lives</u>	<u>March 31, 2005</u>	<u>March 31, 2004</u>
Leasehold improvements	10-25 years	\$ 3,254,805	\$ 3,215,260
Machinery and equipment	5-20 years	28,139,177	27,113,145
Equipment under capital leases	7-10 years	923,255	1,808,810
Construction in progress		112,649	112,649
		32,429,886	32,249,864
Less accumulated depreciation and amortization		14,183,441	12,017,775
Property and equipment, net		<u>\$ 18,246,445</u>	<u>\$ 20,232,089</u>

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

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 (7.5% at March 31, 2005) calculated on the average cash borrowings for the preceding month. The initial term of the Textron loan ends on May 26, 2006, but this loan automatically renews for additional one-year periods unless terminated by our Company or Textron through a written notice 90-days prior thereto or as otherwise provided in the loan agreement. However, in accordance with EITF 95-22, “*Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that involve both a Subjective Acceleration Clause and a Lock-Box Arrangement,*” the balance is reflected as current on the balance sheet. As of March 31, 2005, the outstanding principal balance on the Textron Loan was \$5,458,479.

The Textron Loan Agreement contains certain financial and operating covenants. Due to the \$444,883 charge to operations related to the Separation and Settlement Agreement between the Company and Christopher J. New, its former Chief Executive Officer, the Company fell below the requirement for the adjusted tangible net worth and the fixed charge coverage ratio covenants for the quarter ended September 30, 2004. In a third amendment to the Textron Loan Agreement dated November 10, 2004, Textron agreed to change a definition in the loan covenants, the effect of which brought the Company back into compliance with both ratios.

As of March 31, 2005, the Company failed to comply with certain requirements and financial covenants in the Textron Loan Agreement. The Company fell below the fixed charge coverage ratio and the adjusted tangible net worth financial ratios primarily because of a large bad debt reserve and inventory write off related to one of its customers in March 2005 as detailed in Notes 2 and 16. On April 29, 2005, Textron also determined that the credit risk increased substantially enough to downgrade the Company’s accounts receivable with respect to such customer and deemed such accounts receivable as ineligible for purposes of calculating the Company’s borrowing base under the Textron Loan. This action by Textron placed the Company into an over-advance position with respect to the Textron Loan. As a result, effective as of April 29, 2005, the Company’s interest rate on the Textron Loan was increased from Prime plus 1.75% to Prime plus 4.75%.

On June 3, 2005, the Company 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, the Company’s interest rate would

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remain at Prime plus 4.75% on the Textron Loan 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 19 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% (7.75% as of June 16, 2005). In July 2005, Textron will review the Company's financial forecasts that reflect the subsequent events described in Note 19 and will evaluate whether any further amendments to the Textron Loan Agreement will be required.

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 loan was consolidated with the Company's March 2000 term loan with Wachovia Bank, 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. The balance outstanding on the term loan as of March 31, 2005 is \$8,241,985.

On June 30, 2005, the Company entered into a Loan Modification Agreement with Wachovia Bank, N.A. regarding its 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 is due on August 1, 2005. As required by the terms of the agreement, if the Company sells the equipment, the loan will be due and payable in full at the time of sale. Aggregate maturities of the Wachovia term loan payable over future years are as follows: 2006 - \$1,320,000 and 2007 - \$6,921,985.

The Wachovia term loan contains certain financial and operating covenants. The Company fell below the requirement for the tangible net worth covenant for the quarter ended March 31, 2005 and the requirement for the maximum funded debt to EBITDA ratio for the year ended March 31, 2005. Per the above Loan Modification Agreement, Wachovia agreed to waive compliance on the covenants for the periods ended March 31, 2005 and through the maturity of the loan on July 31, 2006.

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

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

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

On September 30, 1999, the Company obtained a \$4 million subordinated loan from FINOVA Mezzanine to finance additional working capital and capital improvement needs. This loan was paid in full as of May 30, 2003

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by the proceeds from the new loan from Wachovia Bank, as discussed above, and from the equity proceeds raised in the private placements in May 2003, as discussed in Note 9.

(7) **Accrued and Other Current Liabilities**

Accrued and other current liabilities are summarized as follows:

	<u>March 31, 2005</u>	<u>March 31, 2004</u>
Tangible personal property taxes	\$ 1,049,841	\$ 918,282
Warrant liability	740,000	664,898
Derivative liability	--	806,993
Accrued dividends on preferred stock	--	549,838
Other	340,365	344,180
Total	<u>\$ 2,130,206</u>	<u>\$ 3,284,191</u>

(8) **Commitments and Contingencies**

Leases

The Company leases its operating facilities and certain equipment under operating and capital leases, expiring at various dates through its fiscal year 2009. The following schedule presents the Company's obligations as of March 31, 2005, regarding (1) future minimum lease payments under capital leases, together with the present value of the net minimum lease payments and (2) future minimum rental payments required under operating leases that have initial or remaining terms in excess of one year:

	<u>Capital Leases</u>	<u>Operating Leases</u>
2006	\$ 203,756	\$ 547,737
2007	40,775	300,196
2008	36,209	266,778
2009	19,377	272,734
2010		91,769
Total net minimum lease payments	300,117	<u>\$ 1,479,214</u>
Less amount representing interest	<u>(20,738)</u>	
Present value of the net minimum lease payments	279,379	
Less current portion	<u>(194,042)</u>	
Long-term obligations under capital leases	<u>\$ 85,337</u>	

The total capitalized cost for equipment under capital lease is \$923,255 with accumulated depreciation of \$328,364 as of March 31, 2005.

Rental expense was approximately, \$1,055,000, \$1,088,000, and \$1,190,000 for the fiscal years ended March 31, 2005, 2004, 2003, respectively.

Employment Agreements

- *Angelo S. Morini*

In a Second Amended and Restated Employment Agreement effective October 13, 2003, Angelo S. Morini the Company's Founder, Vice-Chairman and President resigned from his positions with the Company as Vice Chairman and President and 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. Other material provisions of the agreement are as follows:

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1. For the term of the agreement, the Company shall cause Mr. Morini to be nominated for election to the Company's Board of Directors as a member of the slate of directors proposed by the Company in its proxy statement for any meeting of the Company's stockholders whereby directors shall be elected. Notwithstanding the foregoing, in the event Mr. Morini is not elected to the Board of Directors by the stockholders at any meeting of the Company's stockholders for which the proxy statement indicates Mr. Morini is nominated for election as a member of the slate of directors proposed by the Company, such obligations shall immediately cease.

2. The Company will obtain, and maintain in effect during the term of Mr. Morini's agreement, for the benefit of Mr. Morini (or reimburse Mr. Morini for the cost of) a two million dollar (\$2,000,000) term life insurance policy insuring Mr. Morini's life, the beneficiaries of which shall be designated by Mr. Morini.

3. Mr. Morini and the Company agreed that Mr. Morini and certain family members received advances from the Company of which \$167,603 was unreimbursed as of October 13, 2003, and (ii) the Company owed \$330,000 to Mr. Morini pursuant to a loan on March 28, 2002 to the Company. Mr. Morini and the Company agreed to offset the unreimbursed advances against the amounts owed by the Company, and, in repayment of the remainder of the amounts owed by the Company, the Company issued an aggregate of 55,087 shares of the Company's common stock to Mr. Morini (valued at approximately \$2.95 per share based on the average of the closing prices for the five trading days preceding the effective date of the Agreement).

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

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

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

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 the quarter ended December 31, 2003. The total estimated costs expensed under this agreement are \$1,830,329 of which \$1,292,575 remained unpaid but accrued (\$366,305 as short-term liabilities and \$926,270 as long-term liabilities) as of March 31, 2005. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

In the event that the \$12,772,200 loan is forgiven, the Company would show this amount as a forgiveness of debt in our Statement of Operations. In the event that Mr. Morini is unable to pay the loan when due and the Company

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forecloses on the shares, the Company will show 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 July 12, 2005 of \$2.03, the Company would show a loss of approximately \$6,850,000 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 effect 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. In addition to the compensation, the Company agreed that Mr. New's stock option rights under that certain Non-Qualified Stock Option Agreement dated December 5, 2002 (for 25,000 shares at an exercise price of \$1.67 per share) and that certain Non-Qualified Stock Option Agreement dated July 16, 2001 (for 100,000 shares at an exercise price of \$2.05 per share) will continue in full force and effect as if he was still employed by the Company. As of March 31, 2005, the remaining balance accrued was \$287,253 (\$220,218 in short-term liabilities and \$67,035 in long-term liabilities).

In connection with the modification of the stock options as described above, the Company recorded \$22,000 as additional non-cash compensation expense in the fiscal year ended March 31, 2005 pursuant to FIN 44 for modifications that renew or increase the life on existing options. The stock price on the date of the modification was \$2.15.

- *Michael E. Broll*

On July 8, 2004, Michael E. Broll, a member of the Company's Board of Directors, was appointed as the Chief Executive Officer upon the resignation of Mr. New. The Company entered into a one-year employment agreement with Mr. Broll pursuant to which Mr. Broll is entitled to receive an annual base salary of \$200,000 plus a performance bonus at the discretion of the Board, standard health benefits, a housing allowance of up to \$3,500 per month and an auto allowance of \$1,500 per month. The employment agreement renews automatically for one-year periods unless cancelled by either party ninety days prior to the end of the term. In the event Mr. Broll's employment is terminated without cause, he will be entitled to receive one year of his base salary as severance. Mr. Broll received a discretionary cash bonus of \$25,000 in the quarter ended March 31, 2005.

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

Litigation

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

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

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

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

(9) **Capital Stock**

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 on or after April 1, 2003 under the provisions of SFAS 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 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. 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, the Company calculates and records non-cash compensation related to its securities in the general and administrative line item in the Statements of Operations on two primary items:

a. Stock-Based Award Issuances

During the fiscal years ended March 31, 2005, 2004, and 2003, the Company recorded \$194,097, \$643,272 and \$153,238, respectively, as non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants. This expense was computed in accordance with SFAS No. 123 only for stock-based transactions awarded to consultants prior to April 1, 2003 and for all stock-based transactions awarded on or after April 1, 2003.

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

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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 March 31, 2005.

The Company recorded non-cash compensation expense of \$193,649 and \$8,001 related to these modified options for the years ended March 31, 2005 and March 31, 2004. There was no non-cash compensation expense recorded for the year ended March 31, 2003, as the market price of the Company's stock at the end of the period was less than the \$2.05 intrinsic value of the modified options.

In connection with a Separation and Settlement Agreement dated July 8, 2004 between the Company and Mr. New, the Company agreed that Mr. New's stock option rights under that certain Non-Qualified Stock Option Agreement dated December 5, 2002 (for 25,000 shares at an exercise price of \$1.67 per share) and that certain Non-Qualified Stock Option Agreement dated July 16, 2001 (for 100,000 shares at an exercise price of \$2.05 per share) would continue in full force and effect as if he were still employed by the Company. The stock price on the date of the modification was \$2.15. In accordance with FIN 44 for modifications that renew or increase the life on existing options, the Company recorded \$22,000 as additional non-cash compensation expense in the fiscal year ended March 31, 2005.

Employee Stock Purchase Plan

In January 1992, the Company's stockholders approved the 1991 Employee Stock Purchase Plan (the "1991 Purchase Plan"). The 1991 Purchase Plan provides for the sale of up to an aggregate of 85,714 shares of common stock to eligible employees. Up to 500 shares may be purchased by each eligible employee at the lesser of 85% of the fair market value of the shares on the first or last business day of the six-month purchase periods ending August 31 and February 28. Substantially all full-time employees are eligible to participate in the plan. During the year ended March 31, 2005, 18,894 shares were issued under this plan at prices of \$1.31 and \$1.23 per share. During the year ended March 31, 2004, 16,339 shares were issued under this plan at prices of \$1.49 and \$1.96 per share. During the year ended March 31, 2003, 9,880 shares were issued under this plan at prices of \$1.55 and \$2.80 per share. The weighted average exercise price of the shares issued were \$1.27, \$1.75, and \$1.99 per share for the fiscal years ended March 31, 2005, 2004 and 2003, respectively. As of March 31, 2005, there were 10,901 shares available for purchase under the 1991 Purchase Plan.

Stock Options

At March 31, 2005, the Company has three employee stock option plans, which were adopted in 1987, 1991, and 1996 and has granted additional non-plan stock options. Under the Company's stock option plans, qualified and nonqualified stock options to purchase up to 200,500 shares of the Company's common stock may be granted to employees and members of the Board of Directors. The maximum and typical term of options granted under the plans is ten years. Generally, options vest from zero to three years.

The Company estimated the fair value of all options issued during the periods using the Black-Scholes option-pricing model. This model uses the assumptions listed in Note 1 under Stock Based Compensation for each period. The estimated fair value is then recorded as a charge to non-cash compensation in the general and administrative line item in the Statement of Operations. During the fiscal years ended March 31, 2005 and 2004, the Company recorded \$150,763 and \$347,158, respectively, as non-cash compensation expense related to options that were issued to and vested by employees and directors. There was no non-cash compensation expense recorded during the year ended March 31, 2003, because the Company accounted for its stock-based employee and director compensation plans under the accounting provisions of APB No. 25 and all options were issued at market price on the date of the grant.

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The following table summarizes information about activity under all stock option plans:

	Shares	Weighted-Average Exercise Price per Share	Weighted-Average Fair Value of Options Granted
Balance, March 31, 2002	103,544	\$ 4.54	--
Granted – at market	25,858	4.37	\$2.51
Exercised	(1,000)	4.25	--
Forfeited or Expired	<u>(23,096)</u>	<u>2.43</u>	--
Balance, March 31, 2003	105,306	2.66	--
Granted – at market	914	2.90	\$1.65
Exercised	(7,911)	2.05	--
Forfeited or Expired	<u>(2,948)</u>	<u>4.96</u>	--
Balance, March 31, 2004	95,361	2.64	--
Granted – at market	63,930	1.28	\$0.77
Exercised	(13,893)	1.36	--
Forfeited or Expired	<u>(429)</u>	<u>19.25</u>	--
Balance, March 31, 2005	<u>144,969</u>	<u>\$ 2.11</u>	--

The Company has also made individual issuances of non-qualified, non-plan options. The following table summarizes information about non-plan stock option activity:

	Shares	Weighted-Average Exercise Price per Share	Weighted-Average Fair Value of Options Granted
Balance, March 31, 2002	2,705,840	3.93	--
Granted – at market	3,907,041	3.51	\$1.72
Forfeited or Expired	<u>(2,066,041)</u>	<u>2.06</u>	--
Balance, March 31, 2003	4,546,840	3.17	--
Granted – at market	400,000	2.73	\$0.77
Forfeited or Expired	<u>(300,000)</u>	<u>2.24</u>	--
Balance, March 31, 2004	4,646,840	3.19	--
Granted – at market	<u>270,000</u>	<u>1.69</u>	\$0.48
Balance, March 31, 2005	<u>4,916,840</u>	<u>\$ 3.02</u>	--

On September 30, 2003, the stockholders of the Company approved the issuance of 4,375,411 of these non-plan options of which 4,275,411 are still outstanding as of March 31, 2005.

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The following table summarizes information about plan and non-plan stock options outstanding and exercisable at March 31, 2005:

Range of Exercise Prices	Options Outstanding	Weighted- Average Remaining Life	Weighted- Average Exercise Price	Options Exercisable	Weighted- Average Remaining Life	Weighted- Average Exercise Price
\$1.20 – 1.99	383,573	6.3 years	\$ 1.60	283,573	6.9 years	\$ 1.62
2.00 – 2.99	1,745,333	3.9 years	2.11	1,739,333	3.9 years	2.11
3.00 – 3.99	1,921,198	4.4 years	3.41	1,921,198	4.4 years	3.41
4.00 – 4.99	576,716	4.9 years	4.29	501,716	4.7 years	4.27
5.00 – 5.99	432,797	2.3 years	5.20	432,797	2.3 years	5.20
6.00 – 10.28	2,192	3.2 years	8.39	2,192	3.2 years	8.39
	<u>5,061,809</u>			<u>4,880,809</u>		

Stock Warrants

At March 31, 2005, the Company had outstanding warrants to purchase the Company's common stock, which were issued in connection with sales consulting, financial consulting, and financing arrangements. Information relating to these warrants is summarized as follows:

Expiration Date	Number of Warrants	Exercise Price
August 2005	7,143	2.05
December 2005	81,500	3.90
January 2006	33,571	2.05
April 2006	100,000	1.70
July 2006	500,000	2.00
July 2006	10,000	5.00
January 2007	42,592	5.74
June 2007	30,000	2.05
June 2007	122,549	5.52
May 2008	50,000	2.05
August 2008	1,429	2.05
January 2009	1,429	2.05
June 2009	100,000	1.97
June 2009	153,000	2.05
October 2009	500,000	1.15
October 2009	50,000	1.20
October 2009	500,000	2.00
June 2012	2,143	2.05
	<u>2,285,356</u>	

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The Company estimates the fair value of all warrants issued during the periods using the Black-Scholes option-pricing model. This model uses the assumptions listed in Note 1 under Stock Based Compensation for each period. The estimated fair value is then recorded as a charge to non-cash compensation in the general and administrative line item in the Statement of Operations or as a charge to additional paid-in capital in Stockholders' Equity depending on the situation in which the warrant was issued. During the fiscal years ended March 31, 2005, 2004, and 2003, the Company granted warrants totaling 1,050,000, 700,000, and 264,692 shares, respectively, to non-employees and non-directors. During the fiscal years ended March 31, 2005, 2004, and 2003, the Company recorded \$468,334, \$296,114 and \$153,238, respectively, as non-cash compensation expense related to warrants that were issued to and vested by non-employees and non-directors.

Since the conversion of the Company's Series A convertible preferred stock could have resulted in a conversion into an indeterminable numbers of commons 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 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 as a liability. Any changes in the fair value of the securities after the initial valuation in April 2001 are marked to market during reporting periods. During the fiscal years ended March 31, 2005, 2004, and 2003, the Company recorded a loss/(gain) on the fair value of warrants of (\$443,937), \$242,835 and (\$1,174,355), respectively, related to the change in the fair value of the underlying warrants.

Reserved

At March 31, 2005, the Company has reserved common stock for future issuance under all of the above arrangements totaling 7,372,702 shares.

Series A Convertible Preferred Stock

In connection with a Stock Repurchase Agreement dated October 6, 2004, BH Capital Investments, LP and Excalibur Limited Partnership, the holders of the Company's Series A convertible preferred stock (the "Series A Preferred Holders"), converted 10,278 Series A convertible preferred shares into approximately 600,000 shares of common stock. The value of these converted Series A convertible preferred shares including accrued dividends was \$644,068. Simultaneously, the remaining 30,316 Series A convertible preferred shares held by the Series A Preferred Holders were acquired by the Company 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. As part of the transaction, the each former Series A Preferred Holder also received a warrant to purchase up to 250,000 shares of common stock at an exercise price of \$2.00 per share for a period of five years. The market price of the Company's common stock on October 6, 2004 was \$1.30. The fair value of the warrants is \$205,000.

On April 6, 2001, the Company received from 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, (\$62.66 at October 6, 2004), 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 13,578, 13,490 and 15,262 shares of the Series A convertible preferred stock plus accrued dividends, into 721,366, 459,908 and 624,936 shares of common stock, respectively, during the years ended March 31, 2005, 2004 and 2003, respectively. The conversion prices ranged from \$1.07 to \$1.75 based on the above formula.

The Series A Preferred Holders had the right to receive on any outstanding Series A convertible preferred stock a ten percent dividend on the shares, payable one year after the issuance of such preferred stock, and an eight

GALAXY NUTRITIONAL FOODS, INC.
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percent dividend for the subsequent three years thereafter, payable in either cash or shares of preferred stock. For the years ended March 31, 2005, 2004 and 2003, the Company recorded preferred dividends of \$82,572, \$201,791 and \$264,314, 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 years ended March 31, 2005, 2004 and 2003, the Company recorded \$319,500, \$1,256,019, and \$1,308,855, respectively, related to the accretion of the redemption value of preferred stock.

Common Stock Issuances

See Note 19 for additional information on stock issuances subsequent to March 31, 2005.

On October 6, 2004, the Company completed a private placement of its common stock, whereby it issued a total of 2,000,000 shares to an existing stockholder of the Company for aggregate gross proceeds to the Company of \$2,300,000. These proceeds were used to redeem the Company's Series A convertible preferred stock as discussed above. The purchase price of the shares was \$1.15 per share (95% of the prior 5-day trading closing stock price average). The stockholder also received a warrant to purchase up to 500,000 shares of the Company's common stock at an exercise price of \$1.15 per share for a period of five years. The shares are restricted securities that have not been registered under the Securities Act and may not be offered or sold in the United States absent registration or applicable exemptions and registration requirements.

In accordance with a registration rights agreement with the investor, the Company agreed to file and obtain effectiveness of a registration statement with the Securities and Exchange Commission ("SEC") within 180 days of closing to register the shares issued in the private placement and to include the shares underlying the warrant described above. The Company agreed that if a registration statement was not filed, or did not become effective within the defined period of time, then in addition to any other rights the investor may have, it would be required to pay certain liquidated damages of \$57,500 per month. 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 Company has received from the investor an extension of time until September 1, 2005 to have the registration statement declared effective by the SEC. Additionally, the investor waived all damages and remedies for failure to have an effective registration statement until September 1, 2005.

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, "*Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled in the Company's Own Stock,*" and EITF 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 reclassified the \$2,220,590 value of common stock subject to registration out of permanent equity and into temporary equity as of March 31, 2005.

Additionally, in accordance with EITF 00-19, and the terms of the above warrants, the fair value of the warrants were accounted for as a liability, with an offsetting reduction to the carrying value of the common stock. The warrant liability will be reclassified to equity upon the effective date of the registration statement. The fair value of the warrant on October 6, 2004, was estimated at \$315,000. On March 31, 2005, the fair value of the warrant was re-measured and estimated at \$740,000 (see Note 7). The increase of \$425,000 was reflected as a loss in the fair value of warrants line item in the Statement of Operations during the year ended March 31, 2005.

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In October 2003, pursuant to an employment contract, the Company issued 17,500 shares of its common stock with a total value of \$37,650 to a former employee for his services from January 2003 to July 2003. This expense was recorded as non-cash compensation during the fiscal year ended March 31, 2004.

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

Pursuant to seven Securities Purchase Agreements dated May 21, 2003, the Company issued a total of 2,138,891 shares of its common stock at a price per share equal to \$1.80 for aggregate gross proceeds to the Company of \$3,850,000. Sales to related parties under the Securities Purchase Agreements include: 555,556 shares of common stock sold at an aggregate sales price of \$1,000,000 to Frederick DeLuca, a greater than 5% stockholder; 55,556 shares of common stock sold at an aggregate sales price of \$100,000 to David H. Lipka, a Director of the Company; 83,333 and 55,556 shares of common stock sold at an aggregate sales price of \$150,000 and \$100,000, respectively, to Ruggieri of Windermere Family Limited Partnership and Ruggieri Financial Pension Plan, respectively, each an affiliate of John Ruggieri, the Company's former Vice President of Manufacturing; 1,111,112 shares of common stock sold at an aggregate sales price of \$2,000,000 to Fromageries Bel S.A., a leading branded cheese company in Europe which signed a Master Distribution and Licensing Agreement effective May 22, 2003 with the Company. Sales to non-related parties under the Securities Purchase Agreements totaled 277,778 shares of common stock sold at an aggregate sales price of \$500,000.

The Company used \$2,000,000 of the proceeds generated from these May 2003 private placements to pay down the balance of the Company's mezzanine loan from FINOVA Mezzanine Capital, Inc. The Company then applied the additional proceeds from the new loan from Wachovia Bank, as discussed in Note 6, to pay the remaining \$2,000,000 on the FINOVA Mezzanine loan. The Company utilized the remainder of the private placement proceeds for working capital and general corporate purposes.

In accordance with a warrant agreement dated September 30, 1999, the exercise price on 200,000 warrants still held by FINOVA Mezzanine on May 30, 2003, was reduced from \$3.41 to \$1.80 per share based on the sales price of the Company's common stock in May 2003. FINOVA Mezzanine exercised these warrants to purchase 200,000 shares of the Company's common stock on June 2, 2003. The Company received net proceeds of \$119,000 after a deduction of \$241,000 due to FINOVA Capital Corporation for waiver fees pursuant to a certain Amendment and Limited Waiver to Security Agreement dated June 26, 2002.

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

In accordance with Regulation D and pursuant to a certain common stock and Warrants Purchase Agreement dated June 28, 2002, the Company sold 367,647 shares of common stock on June 28, 2002 for \$4.08 (85% of an average market price) and issued warrants to purchase 122,549 shares of common stock at a price equal to \$5.52 per share to Stonestreet Limited Partnership. In connection with such sale, the Company issued 7,812 shares of common stock to Stonestreet Corporation and 4,687 shares of common stock to H&H Securities Limited in exchange for their services as finders. Per the terms of the agreement, the Company received net proceeds of \$930,000, after the repayment of a \$550,000 promissory note dated June 26, 2002 in favor of Excalibur Limited Partnership and payment of \$20,000 for Stonestreet Limited Partnership's costs and expenses related to the purchase of these shares of common stock.

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

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\$572,310.

(10) **Income Taxes**

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

March 31,	2005	2004
Deferred tax assets:		
Net operating loss carry forwards	\$14,732,000	\$14,207,000
Non-deductible reserves	1,033,000	198,000
Investment, alternative minimum and general business tax credits	80,000	86,000
Accrued employment contract	520,000	596,000
Other	983,000	635,000
<hr/>		
Gross deferred income tax assets	17,348,000	15,722,000
Valuation allowance	(13,191,000)	(11,816,000)
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Total deferred income tax assets	4,157,000	3,906,000
Deferred income tax liabilities:		
Depreciation and amortization	(4,157,000)	(3,906,000)
<hr/>		
Net deferred income tax assets	--	--

The valuation allowance increased by \$1,375,000, \$787,000, and \$1,037,000 for the years ended March 31, 2005, 2004, and 2003, respectively. The Company has recorded a valuation allowance to state its deferred tax assets at estimated net realizable value due to the uncertainty related to realization of these assets through future taxable income. In accordance with EITF 05-08, "Income Tax Consequences of Issuing Convertible Debt with a Conversion Feature," it is expected that temporary differences will arise for the differences in accounting for convertible debt with beneficial conversion features for book and tax purposes. Prior to EITF 05-08, the Company considered the bifurcated features to not result in bases differences. The Company believes that the adoption of this standard in fiscal 2006 will not have a significant impact on the financial position, results of operations or cash flows of the Company.

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

Years ended March 31,	2005	2004	2003
Federal income taxes at statutory rates	(34.0%)	(34.0%)	(34.0%)
Change in deferred tax asset valuation allowance	31.5%	26.6%	(93.4%)
Non deductible expenses:			
Non deductible compensation	--	--	93.7%
Imputed interest on note receivable	4.8%	7.0%	(18.8%)
Other	(2.3%)	0.4%	52.5%
<hr/>			
Income taxes (benefit) at effective rates	--	--	--

Unused net operating losses for income tax purposes, expiring in various amounts from 2008 through 2025, of approximately \$39,100,000 are available at March 31, 2005 for carry forward against future years' taxable income. Under Section 382 of the Internal Revenue Code, the annual utilization of this loss may be limited in the event there are changes in ownership.

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(11) **Earnings Per Share**

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

Years ended March 31,	2005	2004	2003
Net loss to common stockholders	\$(4,261,855)	\$(4,757,087)	\$(2,530,390)
Weighted average shares outstanding – basic & diluted	17,007,791	14,937,005	12,110,349
Basic & Diluted net loss per common share	\$ (0.25)	\$ (0.32)	\$ (0.21)

Options for 5,061,809 shares and warrants for 2,285,356 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2005 as their effects were antidilutive. Potential conversion of the Series A convertible preferred stock for 1,522,658 shares, options for 4,742,201 shares and warrants for 1,242,856 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2004 as their effects were antidilutive. Potential conversion of the Series A convertible preferred stock for 2,013,831 shares, options for 4,652,146 shares and warrants for 742,856 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2003 as their effects were antidilutive.

(12) **Supplemental Cash Flow Information**

Years ended March 31,	2005	2004	2003
Non-cash financing and investing activities:			
Purchase of equipment through capital lease obligations and term notes payable	\$ 82,583	\$ 55,672	\$ 94,763
Amortization of consulting and directors fees paid through issuance of common stock warrants	619,097	643,272	153,238
Reduction in accounts payable through issuance of notes payable	--	--	347,475
Reduction in accounts payable through issuance of common stock	--	37,650	839,158
Reduction in notes payable through issuance of common stock	--	162,424	--
Accrued preferred stock dividends	82,572	201,791	264,314
Accretion of discount on preferred stock	319,500	1,256,019	1,308,855
Cash paid for:			
Interest	767,001	1,396,419	2,349,002
Income taxes	--	--	51,037

(13) **Related Party Transactions**

Angelo S. Morini

In June 1999, in connection with an amended and restated employment agreement for Angelo S. Morini, the Company's Founder, the Company consolidated two full recourse notes receivable (\$1,200,000 from November 1994 and \$11,572,200 from October 1995) related to the exercise of 2,914,286 shares of the Company's common stock into a single note receivable in the amount of \$12,772,200 that is due on June 15, 2006. This 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 October 2003 Second Amended and Restated Employment Agreement between the Company and Mr. Morini (as detailed in Note 8), 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

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did not vote “FOR” in his capacity as a director or a stockholder.

In connection with the October 2003 Second Amended and Restated Employment Agreement, the Company issued an aggregate of 55,087 shares of the Company’s common stock to Mr. Morini (valued at approximately \$2.95 per share based on the average of the closing prices for the five trading days preceding the effective date of the Agreement) in order to repay \$162,397 of net advances that he had provided to the Company.

In October 2000, the Company obtained a \$1.5 million bridge loan from Wachovia Bank (as discussed in Note 6), which was guaranteed by Angelo S. Morini and secured by one million of his above-mentioned 2,914,286 shares of the Company’s common stock. These one million shares were returned to the Company when the loan was paid in full in February 2004.

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

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

Other Related Party Transactions

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

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

On May 22, 2003, the Company entered into a Master Distribution and Licensing Agreement with Fromageries Bel S.A. (“Bel”), a leading branded cheese company in Europe who is a greater than 5% stockholder in the Company. Under the agreement, the Company granted Bel exclusive distribution rights for the Company’s products in a territory comprised of the European Union States and to more than 21 other European countries and territories (the “Territory”). The Company also granted Bel the exclusive option during the term of the agreement to elect to manufacture the products designated by Bel for distribution in the Territory. The term of the agreement is ten years, provided that either of the parties may elect to terminate the agreement by delivery of notice to the other between March 24, 2007 and May 22, 2007, which termination shall be effective as of the first anniversary of the date of the notice of termination. Alternatively, the parties may mutually agree to continue operating under the agreement, to convert the agreement to a manufacturing and license agreement, or to terminate the agreement.

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A director of the Company was paid consulting fees totaling \$32,300 and \$77,520 for introductions into several large food service companies during the fiscal years ended March 31, 2004 and 2003, respectively. Another director of the Company was paid \$59,000 for his consulting services on marketing issues during each of the fiscal years ended March 31, 2005 and 2004.

(14) **Economic Dependence**

For the fiscal year ended March 31, 2005, the Company had one customer that accounted for approximately 12% of net sales. As of March 31, 2005, the customer owed the Company approximately \$1,550,000 or 22% of the Company's gross trade receivable balance. Additionally, the Company had approximately \$210,000 of inventory in stock as of March 31, 2005 related to this customer. Based on information that arose in April 2005 after the products were shipped, the Company determined that collection of the outstanding receivable balance and inventory amounts were in question as of March 31, 2005 and therefore, reserved 100% of these amounts in its reserve for trade receivables and inventory at year-end. We do not expect further sales to this customer after April 2005, but do expect that we will have another customer that will exceed 10% of our net sales in the fiscal year ending March 31, 2006.

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

For the fiscal year ended March 31, 2005, the Company purchased \$9,193,000 of products from four suppliers totaling approximately 55% of total raw material purchases for the fiscal year. For the fiscal year ended March 31, 2004, the Company did not have any supplier that comprised more than 10% of total raw material purchases. For the fiscal year ended March 31, 2003, the Company purchased approximately \$2,238,000 from one supplier totaling approximately 13% of raw material purchases for the fiscal year.

(15) **Employee Benefit Plan**

The Company has a 401(k) defined contribution plan covering all employees meeting certain minimum age and service requirements. The Company's matching contributions to the plan are determined by the Board of Directors. On August 1, 2003, the Company match was raised from 25% to a maximum of 50% of the employee's contribution up to 6% of the employee's compensation. Company contributions to the plan amounted to \$56,170, \$35,807 and \$21,820 for the fiscal years ended March 31, 2005, 2004 and 2003, respectively.

(16) **Fourth Quarter Adjustments**

During the fourth quarter of fiscal 2005, the Company recorded the following adjustments:

Bad debt on accounts receivable	\$ 1,605,783
Inventory write-offs	676,181

See Note 14 for a further explanation on the cause of a large portion of the large fourth quarter adjustments. In March 2005, the Company reviewed its inventory and wrote off the value of unsalable items that it would no longer use in production due to low margins, low volume, change in inventory formulas or loss of customer.

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

(17) **Restatement**

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 bifurcate 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

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issuer does not need to bifurcate 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 numbers of commons 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 bifurcated 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 has reflected an increase in additional paid-in-capital and accumulated deficit in the amount of \$1,703,246 as of March 31, 2005 and a derivative liability of \$806,993 for the year ended March 31, 2004 (See Note 7). For the years ended March 31, 2005, 2004, 2003 and 2002 the Company has restated net income to record a derivative benefit/(expense) of \$62,829, (\$94,269), (\$105,704) and (\$1,504,455), respectively related to the change in the fair value of the embedded derivative instruments.

Additionally, since the conversion of the Series A convertible preferred stock could have resulted in a conversion into an indeterminable numbers of commons 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 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 as a liability. 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 has reflected a decrease in additional paid-in-capital and accumulated deficit in the amount of (\$1,319,562) as of March 31, 2005 and a warrant liability of \$806,993 for the year ended March 31, 2004 (See Note 7). For the years ended March 31, 2005, 2004, 2003 and 2002, the Company has restated net income to record a gain/(loss) on the fair value of warrants of \$443,937, (\$242,835), \$1,174,355 and (\$55,895), respectively, related to the change in the fair values of the warrants.

In June 1999, in connection with an amended and restated employment agreement for Angelo S. Morini, the Company’s Founder, the Company consolidated two full recourse notes receivable (\$1,200,000 non-interest bearing from November 1994 and \$11,572,200 bearing interest at 7% from October 1995) related to the exercise of 2,914,286 shares of its common stock into a single non-recourse and non-interest bearing note receivable in the amount of \$12,772,200 that is due on June 15, 2006. This single consolidated note is secured by the 2,914,286 shares that were exercised. Due to the modification of the note terms from recourse to non-recourse, the Company accounted for the note as if it was a newly issued option per EITF 95-16, “*Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25,*” and due to the modification from interest bearing to non-interest bearing, the option was treated as variable and marked to market each period. The Company has now concluded that the interest and recourse features of the note receivable from Mr. Morini issued in June 1995 were non-substantive, and that the notes executed by Mr. Morini in favor of the Company in connection with the exercise of Mr. Morini’s options embodied the same attributes as those of the original option award. Although the 1999 note consolidation triggered a new measurement date, the award continued to include the same attributes associated with the original option, other than the term extension. Therefore, the revised consolidated note in June 1999 represented a fixed option award and should not have been marked to market during the reporting periods. For the years ended March 31, 2003, 2002 and 2001, the Company has restated net income to record a gain/(loss) related to non-cash compensation expense of (\$3,060,000), \$1,960,000, and \$1,100,000.

All of the above issues relate to accounting for securities that are reflected as income or expense through earnings as non-cash charges. These non-cash charges do not affect the Company’s revenues, cash flows from past or future operations, or its liquidity.

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

The following table summarizes the changes in the Statement of Operations as of March 31, 2005:

	<u>As Previously Reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Income (Loss) From Operations	(3,236,572)	425,000	(2,811,572)
Interest Expense	(1,129,977)	--	(1,129,977)
Gain/(Loss) on FV of Warrants	--	18,937	18,937
Derivative (Expense)/Benefit	--	62,829	62,829
Net Loss	(4,366,549)	506,766	(3,859,783)
Less:			
Preferred Stock Dividends	82,572	--	82,572
Preferred Stock Accretion to Redemption Value	203,605	115,895	319,500
Net Loss to Common Stockholders	(4,652,726)	390,871	(4,261,855)
Basic and Diluted Net Loss per Common Share	(0.27)	0.02	(0.25)

The following table summarizes the changes in the Statement of Operations as of March 31, 2004:

	<u>As Previously Reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Income (Loss) From Operations	(1,600,567)	--	(1,600,567)
Interest Expense	(1,361,606)	--	(1,361,606)
Gain/(Loss) on FV of Warrants	--	(242,835)	(242,835)
Derivative (Expense)/Benefit	--	(94,269)	(94,269)
Net Loss	(2,962,173)	(337,104)	(3,299,277)
Less:			
Preferred Stock Dividends	201,791	--	201,791
Preferred Stock Accretion to Redemption Value	1,340,943	(84,924)	1,256,019
Net Loss to Common Stockholders	(4,504,907)	(252,180)	(4,757,087)
Basic and Diluted Net Loss per Common Share	(0.30)	(0.02)	(0.32)

The following table summarizes the changes in the Statement of Operations as of March 31, 2003:

	<u>As Previously Reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Income (Loss) From Operations	4,017,343	(3,060,000)	957,343
Interest Expense	(2,923,215)	--	(2,923,215)
Other	(60,000)	--	(60,000)
Gain/(Loss) on FV of Warrants	--	1,174,355	1,174,355
Derivative (Expense)/Benefit	--	(105,704)	(105,704)
Net Income (Loss)	1,034,128	(1,991,349)	(957,221)
Less:			
Preferred Stock Dividends	264,314	--	264,314
Preferred Stock Accretion to Redemption Value	1,370,891	(62,036)	1,308,855
Net Loss to Common Stockholders	(601,077)	(1,929,313)	(2,530,390)
Basic and Diluted Net Loss per Common Share	(0.05)	(0.16)	(0.21)

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

The following table summarizes the changes in the Statement of Operations as of March 31, 2002:

	<u>As Previously Reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Income (Loss) From Operations	\$ (11,847,541)	\$ 1,960,000	\$ (9,887,541)
Interest Expense	(3,594,091)	--	(3,594,091)
Other	(57,520)	--	(57,520)
Gain/(Loss) on FV of Warrants	--	(55,895)	(55,895)
Derivative (Expense)/Benefit	--	(1,566,102)	(1,566,102)
Loss before Taxes	(15,499,152)	338,003	(15,161,149)
Income Tax Expense	(1,560,000)	--	(1,560,000)
Net Income (Loss)	(17,059,152)	338,003	(16,721,149)
Less:			
Preferred Stock Dividends	709,400	--	709,400
Preferred Stock Accretion to Redemption Value	1,379,443	(61,647)	1,317,796
Net Loss to Common Stockholders	\$ (19,147,995)	\$ 399,650	\$ (18,748,345)
Basic and Diluted Net Loss per Common Share	\$ (1.81)	\$ 0.03	\$ (1.78)

The following table summarizes the changes in the Statement of Operations as of March 31, 2001:

	<u>As Previously Reported</u>	<u>Adjustment</u>	<u>As Restated</u>
Income (Loss) From Operations	\$ (3,867,237)	\$ 1,100,000	\$ (2,767,237)
Interest Expense	(2,047,097)	--	(2,047,097)
Other	(25,000)	--	(25,000)
Income Tax Benefit	240,000	--	240,000
Cumulative Effect of Change in Accounting Policy	(786,429)	--	(786,429)
Net Income (Loss) to Common Stockholders	\$ (6,485,763)	\$ 1,100,000	\$ (5,385,763)
Basic and Diluted Net Loss per Common Share	\$ (0.69)	\$ 0.12	\$ (0.57)

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

Stockholders' equity, as previously stated	8,226,481	7,497,656	8,404,579	9,191,983
Adjustment	<u>(1,471,891)</u>	<u>(2,721,236)</u>	<u>(4,001,393)</u>	<u>(3,770,658)</u>
Stockholders' equity, as restated	<u>6,754,590</u>	<u>4,776,420</u>	<u>4,403,186</u>	<u>5,421,325</u>

(19) **Subsequent Events**

Warrant Exercises

In accordance with a warrant agreement dated April 10, 2003, the Company issued to Mr. Frederick DeLuca 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, 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.

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 at an exercise price of \$2.05 per share on June 26, 2002. Subsequently, 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 6 and the remaining proceeds from the warrant exercises will be used for working capital purposes as needed in the future.

Asset Sale and Outsourcing Arrangements

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

On June 30, 2005, the Company entered into an Outsourcing Supply Agreement (the "Outsourcing 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 Asset Purchase Agreement is scheduled to close on or about November 1, 2005. The closing is subject to the satisfaction of various conditions, including approval of the sale by the Company's stockholders and approval by the Company's lenders.

The Outsourcing Agreement is for an initial five-year period from the effective date of September 1, 2005 and is renewable at the Company's option for up to two additional five-year periods. On or before November 1, 2005, Schreiber will purchase the Company's remaining raw materials, ingredients and packaging at the Company's cost. Schreiber will bill the Company when it ships each order of finished products to the Company or its customers, based on a pre-determined price matrix.

The Outsourcing Agreement provides for a contingent short-fall payment obligation by the Company if a specified production level is not met during the second year of the Outsourcing Agreement. If a contingent short-fall payment is accrued after the second year, it may be reduced at the end of the third year if the production level during the third year exceeds the specified level of production. If the sale of the assets to Schreiber 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 Outsourcing Agreement at the end of the initial five-year period, there is a cancellation charge of \$1.5 million. If the Company does not exercise its option to renew the Outsourcing Agreement at the end of the second five-year period, there is a cancellation charge of \$750,000. If the sale of the assets to Schreiber 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 Company is currently reviewing the costs associated with these anticipated transactions and believes that they will have a material impact on the Company's financial position, results of operations, and cash flows during its fiscal year ending March 31, 2006.

Bank Loan Modification

On June 30, 2005, the Company entered into a Loan Modification Agreement with Wachovia Bank, N.A. regarding its 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 is due on August 1, 2005. As required by the terms of the agreement, if the Company sells the equipment as discussed above, the loan will be due and payable in full at the time of sale.

ITEM 9A. CONTROLS AND PROCEDURES.

As of March 31, 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.

Subsequent to the date of our evaluation, each of our Company's CEO and CFO considered the restatement of the selected financial data, the management's discussion and analysis of financial conditions and results of operations, and the restatement of the financial statements presented in Part II, Items 6, 7 and 8, respectively, included in this Form 10-K/A 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 are in the process of enhancing our internal control processes in order to be able to comprehensively review the accounting and disclosure implications of such transactions on a timely basis.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

Financial Statements

The following financial statement documents are filed as part of this Form 10-K/A:

Balance Sheets at March 31, 2005 and 2004
Statements of Operations for the years ended March 31, 2005, 2004, and 2003
Statement of Stockholders' Equity for the years ended March 31, 2005, 2004, and 2003
Statements of Cash Flows for the years ended March 31, 2005, 2004, and 2003
Notes to Financial Statements

Exhibits

The following Exhibits are filed as part of this Form 10-K/A:

<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 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.)
- * 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.)
- 23.1 BDO Seidman, LLP Consent Letter (*Filed herewith.*)
- 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 Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

GALAXY NUTRITIONAL FOODS, INC.
(Registrant)

Date: October 7, 2005

 /s/ Michael E. Broll
Michael E. Broll
Chief Executive Officer

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

Date: October 7, 2005

 /s/ Michael E. Broll
Michael E. Broll
Chief Executive Officer & Director
(Principal Executive Officer)

Date: October 7, 2005

 /s/ Salvatore J. Furnari
Salvatore J. Furnari
Chief Financial Officer & Vice President of Finance
(Principal Financial & Accounting Officer)

Date: October 7, 2005

 /s/ David H. Lipka
David H. Lipka
Director and Chairman of the Board

Date: October 7, 2005

 /s/ Joanne R. Bethlahmy
Joanne R. Bethlahmy
Director

Date: October 7, 2005

 /s/ Thomas R. Dyckman
Thomas R. Dyckman
Director

Date: October 7, 2005

 /s/ Charles L. Jarvie
Charles L. Jarvie
Director

Date: October 7, 2005

 /s/ Angelo S. Morini
Angelo S. Morini
Director

Date: October 7, 2005

 /s/ Patrice M.A. Videlier
Patrice M.A. Videlier
Director