Galaxy Nutritional Foods, Inc.

Management Discussion & Analysis

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

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of income and expense during the reporting periods presented. The Company's significant estimates include the allowance for doubtful accounts receivable, provision for obsolete inventory, and valuation of deferred taxes and warrants. Although the Company believes that these estimates are reasonable, actual results could differ from those estimates given a change in conditions or assumptions that have been consistently applied.

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

Valuation of Accounts Receivable and Chargebacks

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

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

Inventory

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

Deferred Taxes

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

Valuation of Non-Cash Compensation

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

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

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

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

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

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

NEW ACCOUNTING PRONOUNCEMENTS

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

In December 2003, the FASB issued a revised FASB Interpretation No. 46, "*Consolidation of Variable Interest Entities*"(FIN 46R), which clarifies how a business enterprise should evaluate whether it has a controlling interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN46R replaces FASB Interpretation No. 46, "*Consolidation of Variable Interest Entities*" which was issued in January 2003. The application of the requirements of FIN 46R did not have any impact on the Company's financial position or result of operations as the Company does not have any variable interests in variable interest entities.

MATERIAL FUTURE EVENTS

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

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

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

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

BUSINESS ENVIRONMENT

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

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

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

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

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

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

RESULTS OF OPERATIONS

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

FISCAL 2004 AS COMPARED TO FISCAL 2003

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

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

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

Through March 28, 2004, IRI (Information Resources Incorporated) scanner data, which measures retail grocery consumption, indicates that many of the major competitors in the conventional cheese slice, private label cheese slice and imitation cheese slice cheese segments have all experienced declining consumption versus the same period a year ago in terms of dollar sales. The range in declines is from 1% to 17% depending on the brand and consumer support (that is, advertising, promotion, and brand building efforts). Consumption in dollars of Veggie slices, the Company's major product line, was down approximately 10% in fiscal 2004 compared to fiscal 2003. Alternatively, Veggie consumption in dollars increased approximately 2% in shred form and 5% in chunk form during fiscal 2004 compared fiscal 2003. Management believes this data demonstrates that pressure on Veggie slice consumption is a function of usage occasion and not a result of overall consumer dissatisfaction with the Company's brand.

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

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

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

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

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

- The Company is shifting the emphasis and resource allocation of its marketing strategy from vendor promotions (retailer publications/flyers featuring price reductions and on-shelf temporary price reductions) to increase sales through consumer advertising (magazine, radio, event sponsorship, etc.) and consumer promotions (for example, on-pack "cents off" coupons, "cents off" coupons delivered via newspapers, in-store product sampling, product benefit communication at the point of purchase/shelf) while highlighting and communicating the benefits of the Company's products to meet the consumer demand for low carbohydrate and high protein products. This is a significant strategy shift and is based upon retail consumption data purchased from IRI (Information Resources Incorporated) that indicates increased sales potential from consumer focused marketing efforts versus similar dollars being spent toward price related vendor advertising and promotions.

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

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

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

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

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

Non-Cash Compensation Related to Options and Warrants

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

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

a. <u>*Notes Receivable for Common Stock*</u>
The Financial Accounting Standards Board issued Interpretation No. 44 ("FIN 44"), which clarifies the application of APB Opinion 25 relating to the accounting consequences of various modifications to fixed stock options. FIN 44 covers specific events that occurred after December 15, 1998 and was effective as of July 2, 2000. FIN 44 clarified that when an option is repriced, it is treated as a variable option and is marked to market each quarter. Accordingly, any increase

in the market price of the Company's common stock over the exercise price of the options that was not previously recorded is recorded as compensation expense at each reporting period. If there is a decrease in the market price of the Company's common stock compared to the prior reporting period, the reduction is recorded as compensation income. Compensation income is limited to the original base exercise price (the "Floor") of the options. In accordance with FIN 44, the underlying shares related to the $12,772,200 note receivable from the Company's founder, Angelo S. Morini, are treated as variable due to the nature of the note being non-interest bearing and non-recourse. The Floor for the underlying shares is $4.38 per share. There was no non-cash compensation expense or income related to these shares recorded during fiscal 2004 as the price of the Company's common stock at the beginning and end of the period was below the Floor. The Company recorded non-cash compensation income of $3,060,000 for fiscal 2003 based on the decrease in the market price of the Company's common stock from $5.43 at March 31, 2002 to $1.87 at March 31, 2003. The Company did not record any further non-cash compensation income once the stock price fell below the Floor of $4.38. Due to the volatility of the market price of its common stock, the Company is incapable of predicting whether this expense will increase or decrease in the future. If the Company's stock price is above the Floor of $4.38, a $0.01 increase or decrease in the Company's common stock price results in an expense or income, respectively, of $29,143.

b. Option and Warrant Repricing

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

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

c. Option and Warrant Issuances

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

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

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

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

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

FISCAL 2003 AS COMPARED TO FISCAL 2002

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

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

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

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

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

Non-Cash Compensation Related to Options and Warrants

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

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

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

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

General and administrative expenses decreased $1,777,624 (33%) during fiscal 2003, as compared to fiscal 2002. The decrease was due to a $798,000 decrease in bad debt expense and a $162,000 decrease in personnel costs along with a general reduction in standard administrative expenses due to cost cutting measures implemented at the end of fiscal 2002. Additionally, fiscal 2002 expenses were higher than fiscal 2003 due to $547,000 in unused advertising trade credits that the Company wrote off in the fourth quarter of fiscal 2002.

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

Interest expense decreased $670,876 (19%) from $3,594,091 in fiscal 2002 to $2,923,215 in fiscal 2003. On September 30, 1999, the Company entered into a $4,000,000 subordinated note payable with FINOVA Mezzanine. During fiscal 2003, this debt bore interest at a rate of 15.5% and included an original issuance discount of $786,900, which was amortized as interest expense over the term of the debt until September 30, 2002. In connection with FINOVA Mezzanine's warrant exercise and transfer of 815,000 shares of the Company's common stock, the Company agreed to guarantee the price at which the shares were sold to the public at $4.41 per share. The actual price received by FINOVA Mezzanine was

$3.25 per share and the difference of $945,400 was recorded as a debt discount and was amortized over the term until September 30, 2002. During the year ended March 31, 2003, interest expense decreased $205,000 because the above debt discounts were fully amortized. Additionally, interest expense decreased approximately $520,000 as a result of lower debt balances during fiscal 2003 compared to fiscal 2002. Loan fees amortized to interest expense increased approximately $54,000 during the year ended March 31, 2003 due to additional loan costs and the shortened loan periods. See "Debt Financing" below for further detail on the Company's outstanding debts and interest rates thereon.

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

Liquidity And Capital Resources

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

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

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

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

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

Debt Financing

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

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

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

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

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

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

In connection with the consolidations and extensions of the SouthTrust Bank loans as described above, the Company issued a warrant to purchase 100,000 shares of the Company's common stock to SouthTrust Bank on May 29, 2003. The warrant is exercisable until June 1, 2009 at an exercise price of $1.97 per share. In accordance with SFAS 123, the fair value of this warrant was estimated at $101,000 and will be amortized as non-cash compensation over 72 months beginning in May 2003.

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

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

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

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

Equity Financing

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

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

divided by,

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

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

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

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

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

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

Manufacturing; 1,111,112 shares of common stock sold at an aggregate sales price of $2,000,000 to Fromageries Bel S.A., a leading branded cheese company in Europe which signed a Master Distribution and Licensing Agreement effective May 22, 2003 with the Company. Sales to non-related parties under the Securities Purchase Agreements include: 138,889 shares of common stock sold at an aggregate sales price of $250,000 Apollo Capital Management Group; and 138,889 shares of common stock sold at an aggregate sales price of $250,000 Apollo MicroCap Partners, L.P.

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

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

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

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

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

A default by the Company in its obligations to redeem the Series A convertible preferred stock will also result in a default by the Company under the Textron Loan, which, in turn, will result in a default by the Company under the SouthTrust Loan. In the cases of the Textron Loan and the SouthTrust Loan, the lenders thereunder could exercise their respective rights under their loan documents to, among other things, declare a default under the loans, accelerate the outstanding indebtedness such that it would become immediately due and payable, and pursue foreclosure of the Company's assets which are pledged as collateral for such loans. In such event, it is unlikely that the Company would be able to continue as a going concern. The issue related to the Series A convertible preferred stock is a key item on the agenda of the Company's Board of Directors and substantial attention is being focused on resolving this issue during fiscal 2005.

Contractual Obligations And Commitments

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

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

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

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

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

Quantitative And Qualitative Disclosures About Market Risk

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

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

Controls And Procedures

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

Galaxy Nutritional Foods, Inc.
Fiscal 2004 Financial Results

Report of Independent Registered Public Accounting Firm

BDO

285 Peachtree Center Avenue, Suite 800, Atlanta, GA 30303

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

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

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

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

BDO Seidman, LLP

BDO Seidman, LLP

Atlanta, Georgia
June 16, 2004

GALAXY NUTRITIONAL FOODS, INC.

Balance Sheets

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

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.

Statements of Operations

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

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.

Statements of Stockholders' Equity

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

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.

Statements of Cash Flows

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

See accompanying notes to financial statements

Notes To Financial Statements

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business

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

Accounts Receivable

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

Inventories

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

Property and Equipment

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

Revenue Recognition

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

Shipping and Handling Costs

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

Stock Based Compensation

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

In December 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 148, "*Accounting for Stock Based Compensation—Transition and Disclosure—an Amendment to SFAS 123*." SFAS 148 provides two additional transition methods for entities that adopt the preferable method of accounting for stock based compensation. Further, the statement requires disclosure of comparable information for all companies regardless of whether, when, or how an entity adopts the preferable, fair value based method of accounting.

Effective April 1, 2003, the Company adopted the fair value method of recording compensation expense related to all stock options granted after March 31, 2003, in accordance with SFAS 123 and SFAS 148 (the prospective method, as defined by SFAS 148). Accordingly, the fair value of stock options as determined on the date of grant using the Black-Scholes option-pricing model, will be expensed over the vesting period of the related stock options. The negative impact on diluted earnings per share related to the issuance of employee stock options in fiscal 2004 was approximately $0.03.

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

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

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

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

Income Taxes

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

Net Income (Loss) per Common Share

Net income (loss) per common share is computed by dividing net income or loss by the weighted average shares outstanding. Diluted income (loss) per common share is computed on the basis of weighted average shares outstanding plus potential common shares which would arise from the exercise of stock options, warrants and conversion of the Series A convertible preferred stock.

Financial Instruments

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

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

Use of Estimates

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

Segment Information

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

Reclassifications

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

Recent Accounting Pronouncements

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

In December 2003, the FASB issued a revised FASB Interpretation No. 46, "*Consolidation of Variable Interest Entities*"(FIN 46R), which clarifies how a business enterprise should evaluate whether it has a controlling interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN46R replaces FASB Interpretation No. 46, "*Consolidation of Variable Interest Entities*" which was issued in January 2003. The application of the requirements of FIN 46R did not have any impact on the Company's financial position or result of operations as the Company does not have any variable interests in variable interest entities.

2) INVENTORIES

Inventories are summarized as follows:

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

3) **PREPAID EXPENSES AND OTHER**

Prepaid expenses are summarized as follows:

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

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

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

(4) **PROPERTY AND EQUIPMENT**

Property and equipment are summarized as follows:

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

(5) **LINE OF CREDIT AND NOTES PAYABLE**

Effective May 30, 2003, the Company obtained from Textron Financial Corporation ("Textron") a revolving credit facility (the "Textron Loan") in the maximum principal amount of $7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 (the "Loan Agreement"). The Textron Loan replaced the Company's asset-based credit facility with FINOVA Capital Corporation on May 30, 2003, which had an outstanding principal balance of $4,254,667 at the time of replacement. The Textron Loan is secured by the Company's inventory, accounts receivable and all other assets. Generally, subject to the maximum principal amount, which can be borrowed under the Textron Loan and certain reserves that must be maintained during the term of the Textron Loan, the amount available under the Textron Loan for borrowing by the Company from time to time is equal to the sum of (i) eighty-five percent (85%) of the net amount of its eligible accounts receivable plus (ii) sixty percent (60%) of the Company's eligible inventory not to exceed $3,500,000. Advances under the Textron Loan bear interest at a variable rate, adjusted on the first (1^{st}) day of each month, equal to the prime rate plus one and three-quarter percent (1.75%) per annum (5.75% at March 31, 2004) calculated on the average cash borrowings for the preceding month. The Textron Loan matures and all amounts are due and payable in full on May 26, 2006. However, in accordance with EITF 95-22, "*Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that involve both a Subjective Acceleration Clause and a Lock-Box Arrangement,*" the balance is reflected as current on the balance sheet. As of March 31, 2004, the outstanding principal balance on the Textron Loan was $4,605,277.

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

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

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

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

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

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

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

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

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

(6) COMMITMENTS AND CONTINGENCIES

Leases

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

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

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

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

Employment Agreements

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

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

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

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

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

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

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

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

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

Litigation

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

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

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

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

(7) CAPITAL STOCK

Employee Stock Purchase Plan

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

Stock Warrants

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

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

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

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

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

Stock Options

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

The following table summarizes information about plan stock option activity:

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

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

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

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

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

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

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

Reserved

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

Non-Cash Compensation Related to Options and Warrants

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

a. *Notes Receivable for Common Stock*

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

b. *Option and Warrant Repricing*

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

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

c. *Option and Warrant Issuances*

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

Series A Convertible Preferred Stock

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

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

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

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

On April 6, 2001, the Company recorded the initial carrying value of the preferred stock as $521,848. Each quarter the Company calculates an estimated redemption value of the remaining preferred stock and then calculates the difference between the initial carrying value and this estimated redemption value. The difference is then accreted over the redemption period (48 months beginning April 2001) using the straight-line method, which approximates the effective interest method. For the years ended March 31, 2004, 2003 and 2002, the Company recorded $1,340,943, $1,370,891, and $1,379,443, respectively, related to the accretion of the redemption value of preferred stock and the beneficial conversion feature of accrued dividends. As of March 31, 2004, the value of the remaining 43,894 shares of redeemable convertible preferred stock is $2,573,581.

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

Company's Series A Convertible Preferred Stock and upon the exercise of certain warrants held by the Series A Preferred Holders.

Common Stock Issuances

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

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

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

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

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

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

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

(8) INCOME TAXES

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

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

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

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

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

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

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

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

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

(9) RELATED PARTY TRANSACTIONS

Additional Morini Transactions

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

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

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

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

Other Related Party Transactions

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

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

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

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

(10) ECONOMIC DEPENDENCE

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

For the fiscal year ended March 31, 2004, the Company did not have any supplier that comprised more than 10% of raw material purchases. For the fiscal year ended March 31, 2003, the Company purchased approximately $2,23899,000 from one supplier totaling approximately 13% of raw material purchases for the fiscal year. For the fiscal year ended March 31, 2002, the Company purchased approximately $3,374,000 from one supplier totaling approximately 19% of raw material purchases for the fiscal year.

(11) EMPLOYEE BENEFIT PLAN

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

(12) SUPPLEMENTAL CASH FLOW INFORMATION

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

(13) EARNINGS PER SHARE

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

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

Potential conversion of the Series A convertible preferred stock for 1,522,658 shares, options for 4,742,201 shares and warrants for 1,242,856 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2004 as their effects were antidilutive. Potential conversion of the Series A convertible preferred stock for 2,013,831 shares, options for 4,652,146 shares and warrants for 742,856 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2003 as their effects were antidilutive. Potential conversion of the Series A convertible preferred stock for 769,034 shares, options for 2,809,384 shares and warrants for 490,878 shares have not been included in the computation of diluted net income (loss) per common share for the year ended March 31, 2002 as their effects were antidilutive.

(14) FOURTH QUARTER ADJUSTMENTS

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

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

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

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

(15) SCHEDULE OF VALUATION ACCOUNT

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

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

(16) QUARTERLY OPERATING RESULTS (UNAUDITED)

Unaudited quarterly operating results are summarized as follows:

2004	Three Months Ended (Unaudited) March 31	December 31	September 30	June 30
Net sales	$ 8,512,702	$ 9,638,571	$ 9,329,907	$ 8,695,781
Gross margin	2,745,256	2,922,821	2,999,930	2,644,665
Net income (loss)	614,430	(1,378,354)	(228,145)	(1,970,104)
Net income (loss) for common shareholders	906,277	(1,557,986)	(933,385)	(2,919,813)
Basic net income (loss) per common share	0.06	(0.10)	(0.06)	(0.21)
Diluted net income (loss) per common share	0.06	(0.10)	(0.06)	(0.21)
Stockholders' equity	8,226,481	7,497,656	8,404,579	9,191,983

2003	Three Months Ended (Unaudited) March 31	December 31	September 30	June 30
Net sales	$ 10,213,005	$ 9,755,729	$ 10,062,331	$ 9,977,704
Gross margin	3,222,414	2,949,866	3,015,101	2,741,200
Net income (loss)	(241,059)	(476,568)	732,245	1,019,510
Net income (loss) for common shareholders	70,755	(1,823,610)	541,545	610,233
Basic net income (loss) per common share	0.01	(0.15)	0.05	0.05
Diluted net income (loss) per common share	0.01	(0.15)	0.04	0.05
Stockholders' equity	6,440,346	6,470,626	7,111,328	7,062,553

Market For Common Equity And Related Stockholder Matters

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

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

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

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