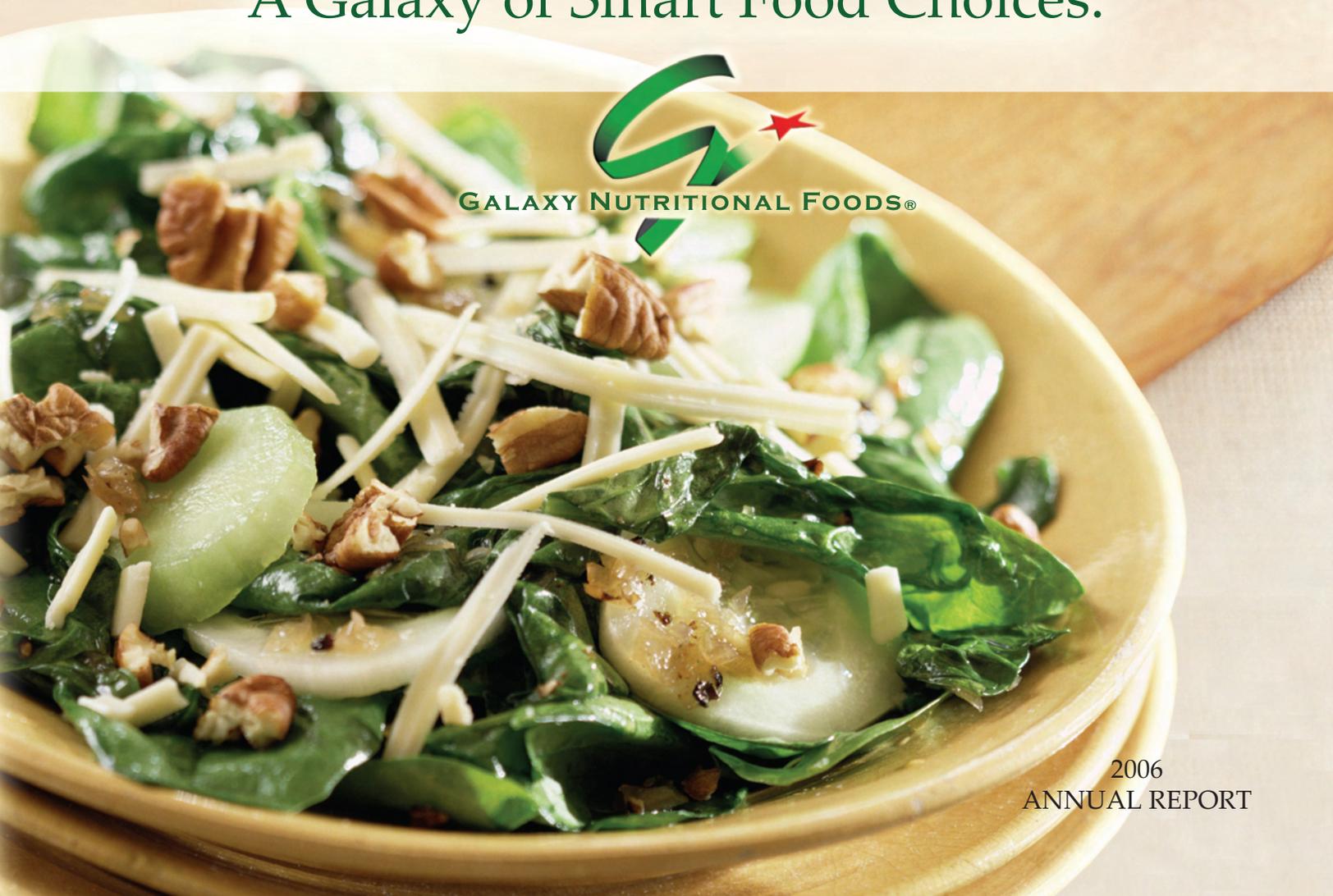




A Galaxy of Smart Food Choices.™



GALAXY NUTRITIONAL FOODS®

Table of Contents

| | |
|--|--------------------------|
| To Our Shareholders: | |
| From Our Chairman..... | i |
| From Our Chief Executive Officer | ii |
| Our Product Portfolio | iii |
| About Galaxy: | |
| Addressing Today’s Health Trends & Testimonials..... | iv |
| Forward Looking Information | 1 |
| Business..... | 2 - 3 |
| Risk Factors | 4 - 11 |
| Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities | 12 |
| Selected Financial Data..... | 13 |
| Managements Discussion and Analysis of Financial Conditions and Results of Operations | 14 - 36 |
| Quantitative and Qualitative Disclosures About Market Risk..... | 37 |
| Report of Registered Public Accounting Firm..... | 38 |
| Financial Statements | 39 - 42 |
| Notes to Financial Statements | 43 - 66 |
| Controls and Procedures..... | 67 |
| Board of Directors, Special Committees, Elected Officers & Senior Management | 68 |
| Corporate and Shareholder Information | <i>inside back cover</i> |
| Our Branded Products..... | <i>inside back cover</i> |

Letter from the Chairman of the Board

To our valued Galaxy Shareholders:

I am pleased to report that the Company's continuing efforts to operate within the bounds of proper corporate governance have been achieved in all respects, during Fiscal 2005 and Fiscal 2006.

Your Board of Directors continues to accept protection of the Company's interests and the rights of all Galaxy shareholders as its prime responsibility.

In Fiscal 2005 and Fiscal 2006, your Board of Directors has been an active participant in the review and approval of the Company's forward strategies and operating plan.

In Fiscal 2006, as one of our alternative strategies, we engaged Goldman Sachs to assist in testing the market to determine the value of our business at the market place. In this process, we received no attractive binding offer. Accordingly, we moved to our planned alternative strategy, which has as its objectives:

1. Eliminate sales with little or no margin, and concentrate our efforts on our proven brands;
2. Reduce overhead and operating costs;
3. Increase our profit margins;
4. Develop and continue to operate with a positive free cash flow;
5. Reinvest a portion of our free cash flow in our brands.

Having eliminated our long term debt in our arrangement with Schreiber Foods, Inc., we completed our manufacturing and distribution outsourcing project and now are receiving benefits in distribution and manufacturing.

In January 2006, two directors resigned from the Board of Directors, Charles Jarvie and Thomas Dyckman. The Board and its shareholders, thank Messrs. Jarvie and Dyckman for their service to Galaxy Nutritional Foods, Inc., and wish them well in their future.

As we move forward in 2007, we have satisfied \$1,200,000 of short term loans and refinanced these loans with convertible debt. In addition we have replaced our short term operating capital financing with a new \$3,500,000 working capital line with Systran Financial Services Corporation.

In May 2006, Galaxy began trading on the OTC Bulletin Board under the symbol GXYF after it was delisted from AMEX for not meeting certain minimum financial standards.

We have returned to profitability in the first quarter of our new fiscal year, exclusive of expenses that were primarily non-cash in nature. We intend to produce sustainable positive financial results, and are dedicated to achieving nothing short of the goals I have outlined.

David H. Lipka, Chairman
For the Galaxy Board of Directors



David H. Lipka,
Chairman of the Board

A handwritten signature in dark ink that reads "David H. Lipka".





Michael E. Broll,
Chief Executive Officer

A handwritten signature in black ink that reads "ME Broll". The signature is stylized and fluid.

ii

Letter from the Chief Executive Officer

Dear Shareholders and Associates of Galaxy Nutritional Foods:

As you can see in this Annual Report, Galaxy Nutritional Foods® experienced some serious challenges throughout Fiscal 2006. Our financial results fell short of our expectations due to a few key issues: operational costs associated with disposal activities and facilities shutdown; significant non-cash charges related to asset impairment charges and reserve on a non-recourse stockholder note; and necessary price increases which led to lower overall sales volume.

Despite some of our financial shortcomings, Galaxy made significant improvement in several areas. We launched four new products that garnered wide ranging customer support. We confirmed that targeted consumer media and marketing support has a very positive impact on our strategic goal to grow our household penetration. We also completed a total outsourcing of our supply chain (procurement, manufacturing and distribution) which will have positive gross margin impact for years to come.

As we move into Fiscal 2007, we have several positive forces working for us that we believe will lead to improved financial results.

First: We have already begun to see improved margins as a result of lower costs from our outsourcing partner.

Second: We have refined our marketing analysis which provides much improved direction on how and where to spend our consumer and trade promotional dollars. Our goal is to utilize the consumer spending to reverse the decline in our core brands.

Third: We are accelerating our research and development focus and resources to insure we have a pipeline of exciting new products. The second half of Fiscal 2007 will see the launch of new products targeting younger, health-conscious consumers.

I am very optimistic that Fiscal 2007 will bring a return to profitability and positive cash flow. We remain committed to delivering high quality, smart food choices. We endeavor to serve our shareholders responsibly and are extremely appreciative of your continued support.

Michael E. Broll, Chief Executive Officer
Galaxy Nutritional Foods, Inc.



Galaxy Nutritional Foods® Product Portfolio



Veggie Brand - #1 Cheese Alternative

You won't find this soy-based product in the dairy section because it has a logical home in produce. Veggie is an excellent source of calcium without cholesterol, saturated and trans fat or lactose. Veggie is available in slices, shreds, spreads and more and is a delicious and easy way to eat smarter sandwiches, salads and meals! Found in the produce section of grocery stores.



Rice Brand - Soy Free

Rice is an excellent source of calcium without cholesterol, trans fat or lactose. These rice-based products offer delicious cheese flavor in slices, shreds, blocks and more. Soy free Rice is found in the cheese alternative or dairy section of natural foods stores as well as in the natural section of traditional grocery stores.



Veggy Brand - Soy Based

Perfect for soy lovers, Veggy soy-based products are an excellent source of calcium without cholesterol, trans fat or lactose. You will find these delicious slices in a variety of mild to spicy flavors in the cheese alternative or dairy section of natural foods stores as well as in the natural section of traditional grocery stores.



Vegan Brand - Casein Free

Vegan products are 100% dairy and casein free and perfect for vegan diets or for those with dairy allergies. Available in slices, chunks and a grated parmesan flavor topping these soy-based products satisfy cheese cravings without the dairy. Look for Vegan products in the cheese alternative section of natural foods stores.



Wholesome Valley Organic Brand

Galaxy's Wholesome Valley is a great tasting cheese made without the use of antibiotics growth hormones or dangerous pesticides and chemicals. Wholesome Valley Organic products are found in the natural /organic sections of grocery and natural foods stores.



Galaxy Brand Super Stix - The Smart Grab-n-Go Snack is perfect snack for the entire family. These individually wrapped mozzarella flavor snack sticks are an excellent source of calcium and good source of protein. Like other Galaxy Nutritional Foods products, Super Stix have 0g saturated and trans fat per serving, are cholesterol free, always lactose free and found in produce.

Rice Vegan Brand Slices - Casein & Soy Free

New Rice Vegan slices are redefining non-dairy with great taste and melt. These casein and soy free products are a delicious addition to your favorite vegan sandwiches, salads and meals! The tastiest vegan in the Galaxy is found in the cheese alternative section of natural foods stores.



— GALAXY NUTRITIONAL FOODS® 2006 ANNUAL REPORT —
A Galaxy of Smart Food Choices™

About Galaxy

Galaxy Nutritional Foods develops and globally markets plant-based cheese and dairy alternatives, as well as processed organic cheese and cheese food to grocery and natural foods retailers, mass merchandisers and foodservice accounts. Veggie, the leading brand in the grocery cheese alternative category with 85% market share and the Company's top selling product group, is primarily merchandised in the produce section and provides calcium and protein without cholesterol, saturated fat or trans fat.¹

Galaxy is also a leader in the natural foods channel. Galaxy natural brands, have over 65% of the cheese alternative market share with popular brands including: Rice, Veggy and Vegan. In addition to cheese alternatives, Galaxy has the #4 organic cheese in the natural foods channel under the Wholesome Valley Organic brand.²

Galaxy Nutritional Foods has been dedicated to developing nutritious products to meet the taste and dietary needs of today's increasingly health conscious consumers since 1980 and continues to address growing health trends.

¹IRI 52-weeks ending June 18, 2006 ²SPINS 52-weeks ending June 17, 2006

| — GALAXY NUTRITIONAL FOODS® ADDRESSES HEALTH TRENDS — | | | | | |
|---|--------------------------------------|---|---|--|--|
| Galaxy's Core Brands: | | | | | |
| Key Health Trends: | Veggie® | Rice® | Veggy® | Vegan® | Wholesome Valley® |
| Traditional cheese is the #1 dietary source of saturated fat in the US. | 0g Saturated Fat per serving | Only 0.5g Saturated Fat per serving | 0g Saturated Fat per serving | 0g Saturated Fat per serving | Only 2.5g Saturated Fat per serving |
| 30 to 50 Million Americans are lactose intolerant. | Lactose Free | Lactose Free | Lactose Free | Lactose Free | Contains Lactose |
| 20% of the US has high cholesterol. | Cholesterol Free | Cholesterol Free | Cholesterol Free | Cholesterol Free | Only 3% Daily Value |
| 47% of Americans are keeping track of fat content. | 0g Trans & Saturated Fat per serving | 0g Trans & Only 0.5g Saturated Fat per serving | 0g Trans & Saturated Fat per serving | 0g Trans & Saturated Fat per serving | 0g Trans Fat & 2.5 Saturated Fat per serving |
| Healthier eating is women's #2 priority. | Excellent Source of Calcium | Excellent Source of Calcium & Preservative Free | Excellent Source of Calcium & Preservative Free | Excellent Source of Calcium, Preservative Free & Casein Free for Vegan Diets | USDA Organic & Good Source of Calcium |

— WHAT PEOPLE ARE SAYING ABOUT GALAXY'S PRODUCTS —

"Best of The Best...Veggie Slices are tasty."
- Phil Lempert, Food Editor "Today Show" 2/8/2006

"My cholesterol had gotten too high and I had to stop eating cheese... I decided to try Veggie Slices...
The taste is excellent and it melts like a dream."
- Consumer, Forest Park, IL

"I especially love your cheeses...I wasn't really a fan of healthy food but
as long as there are ingredients like this then I'm all for it. "
- Consumer, Flint, MI



FORWARD LOOKING INFORMATION

Information in this Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to enhance a reader's understanding of the financial condition, changes in financial condition and results of operations of our company. This MD&A is a supplement to and should be read in conjunction with our financial statements and notes thereto appearing elsewhere in this report. This Annual Report contains forward-looking statements within the meaning of the federal securities laws that relate to future events or our future financial performance. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs and certain assumptions made by our company. Words such as "anticipate," "expect," "intend," "plan," "believe," "seek," "project," "estimate," "may," "will," "could," "should," "potential," or "continue" or the negative or variations of these words or similar expressions are intended to identify forward-looking statements. Additionally, these forward-looking statements include, but are not limited to statements regarding:

- Improving cash flows from operations;
- Marketing our existing products and those under development;
- Our estimates of future revenue and profitability;
- Our expectations regarding future expenses, including cost of goods sold, delivery, selling, general and administrative, research and development expenses, and disposal costs;
- Our estimates regarding capital requirements and our needs for additional financing; and
- Competition in our market.

Although we believe that these forward-looking statements are reasonable at the time they are made, these statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially from our historical results and those expressed or forecasted in any forward-looking statements as a result of a variety of factors, including those set forth under "Risk Factors" and elsewhere in, or incorporated by reference into, this Annual Report. We are not required and undertake no obligation to publicly update or revise any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

BUSINESS

General

Galaxy Nutritional Foods, Inc. develops and globally markets plant-based cheese and dairy alternatives, as well as processed organic cheese and cheese food to grocery and natural foods retailers, mass merchandisers and food service accounts. Our overall strategy is to enhance the value of the Galaxy Nutritional Foods' brands by developing nutritious products that meet the taste and dietary needs of today's increasingly health conscious consumers. In this report, the terms "Company," "we," "us," or "our" means Galaxy Nutritional Foods, Inc.

Veggie, the leading brand in the cheese alternative category of the grocery channel and our top selling product group, is primarily merchandised in the produce section and provides calcium and protein without cholesterol, saturated fat or trans fat. In the natural foods channel, our brands include: Rice, Veggy, Vegan, and Wholesome Valley, which are primarily merchandised in the cheese alternative or dairy sections. We also have Galaxy imitation and private label products including processed slices and shreds. These products are primarily sold in the grocery, mass markets and food service channels.

We sell our products through leading grocery store chains including Publix, Kroger, Safeway, Albertson's, Wakefern, H.E. Butt and natural food stores including Whole Foods, Wild Oats and several independents. We seek to build core brand recognition and a broader consumer base through marketing, including product sampling and advertising programs to educate consumers on the benefits of healthier eating. Our strategy for the future is to continue our marketing efforts primarily in the retail market to capitalize on the continuing interest among consumers in eating foods low in cholesterol, saturated fat and trans fat. We believe that one of the leading contributors of cholesterol and saturated fat in the American diet is conventional cheese. By providing good tasting cheese alternatives in convenient forms and flavors, we believe that we will be able to attract an increasing number of consumers interested in improving their diet and eating habits.

Our Company was founded by Angelo S. Morini in 1972 under the original name of Fiesta Foods & Galaxy Foods in New Castle, Pennsylvania. In 1980, the name was changed to Galaxy Cheese Company and subsequently reincorporated under the laws of the State of Delaware in 1987. In June 1991, we moved from New Castle, Pennsylvania to Orlando, Florida and in November 2000 became Galaxy Nutritional Foods, Inc. to more clearly define our position in the food category.

Change in Operations

During the fiscal year ended March 31, 2006, we determined that our manufacturing capacity was significantly in excess of our requirements and that it would be advantageous to outsource manufacturing and distribution operations. On June 30, 2005, Galaxy Nutritional Foods, Inc. and Schreiber Foods, Inc., a Wisconsin corporation ("Schreiber"), entered into a Supply Agreement, whereby we agreed that Schreiber would become our sole source of supply for substantially all of our products. Schreiber is a privately held cheese manufacturing company whose primary business is contract manufacturing cheese, cheese alternative and other dairy products for many well-known companies and brands.

In November 2005, Schreiber began to deliver such products directly to our customers. The prices for such products are based on cost plus a processing fee as determined by the parties from time to time. Other material terms of the Supply Agreement are as follows:

- The initial term of the Supply Agreement is for a period of five years from the effective date of September 1, 2005 and is renewable at our option for up to two additional five-year periods (for a total term of up to fifteen years). If we do not exercise our first option to extend the term, then we will be obligated to pay Schreiber \$1,500,000. If we exercise our first option to extend the term, but

do not exercise our second option to extend the term, then we will be obligated to pay Schreiber \$750,000.

- The Supply Agreement provides for a contingent short-fall payment obligation by our Company if a specified production level is not met during the one-year period from September 1, 2006 to August 31, 2007. If a contingent short-fall payment is accrued after such one-year period, it may be reduced by the amount by which production levels in the one-year period from September 1, 2007 to August 31, 2008 exceeds the specified target level of production, if any.
- Schreiber is required to deliver products to our Company or our customers that are in compliance with our standards and specifications and all applicable laws. Schreiber will deliver all products within 10 business days of the effective date of such order, which is one business day after receipt of the order.
- We may not manufacture any products governed by the Supply Agreement during the term of the Supply Agreement.
- Schreiber may not manufacture our products or use any of our intellectual property other than pursuant to the terms of the Supply Agreement.

In November 2005, we sold all of our usable raw material inventory to Schreiber at our cost and transferred our finished goods inventory to Schreiber's facility. Our inventory balance as of March 31, 2006 consists primarily of certain stock levels of inventory we maintain at a public storage facility in Canada in order to distribute to our Canadian customers quickly and efficiently.

On December 8, 2005, we completed the sale of substantially all of our manufacturing and production equipment to Schreiber. This sale was approved by our stockholders at a Special Meeting held on December 5, 2005. The \$8,700,000 in proceeds was used to pay \$1,319,583 for tangible personal property taxes due primarily on the sold assets and \$7,374,299 to Beltway Capital Partners LLC (successor by assignment of Wachovia Bank, N.A.) for the termination of our term loan. The remaining proceeds balance of \$6,118 was used to reduce our asset-based line of credit from Textron Financial Corporation.

As a result of the above agreements, our Company eliminated its manufacturing and distribution operations and is now a branded marketing company that will continue to develop, market and sell our products. Additionally, we have eliminated the need to carry large amounts of inventory in order to manufacture our products prior to distribution to our customers. With the exception of inventory for samples and certain Canadian customers, we do not take possession of our inventory prior to its shipment from Schreiber to our customers.

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 sells to customers throughout the United States and 14 other countries.

RISK FACTORS

In addition to the other information in this Annual Report for the year ended March 31, 2006, the following are some of the factors as of August 11, 2006, that could cause our Company's actual results to differ materially from the expected results described in or underlying our Company's forward-looking statements. These factors should be considered carefully while evaluating our business and prospects. If any of the following risks actually occur, they could seriously harm our business, financial condition, results of operations or cash flows.

We have incurred significant losses.

We have incurred substantial losses in recent years and, as a result, have a stockholders deficit of \$3,591,259 as of June 30, 2006. Losses for the years ended March 31, 2006, 2005 and 2004 were \$24,148,553, \$3,859,783 and \$3,299,277, respectively. We received a report from our independent accountants relating to our audited financial statements as of March 31, 2006 containing a paragraph stating that because we were then in default of our notes payable, had suffered recurring losses from operations and at March 31, 2006 had deficiencies in working capital and equity, there was substantive doubt as to our ability to continue as a going concern. Our ability to continue as a going concern depended upon successfully obtaining sufficient cash resources to refinance our \$2.4 million of unsecured notes payable that matured on June 15, 2006 and obtaining positive cash flow from operations to sustain normal business operations.

Pursuant to a Note Purchase Agreement dated July 19, 2006, we issued a new unsecured convertible note for \$2,685,104.17 (the "Convertible Note") to Frederick A. DeLuca, a greater than 10% shareholder. The proceeds from the Convertible Note were used to repay or refinance \$2,400,000 in unsecured promissory notes that matured on June 15, 2006 (including one such note in the principal amount of \$1,200,000 owned by Mr. DeLuca) and a \$285,104.17 registration rights penalty owed to Mr. DeLuca. The Convertible Note accrues interest at 12.5% per annum. No interest or principal payments are required under the Convertible Note until its maturity in fifteen months on October 19, 2007. Principal, together with any accrued and unpaid interest, on the Convertible Note is convertible at any time prior to payment into shares of our common stock at a conversion price of \$0.35 per share. The market price of our common stock as quoted on the OTC on July 19, 2006 was \$0.28. As additional consideration for making the loan, we issued Mr. DeLuca a warrant (the "Warrant") to purchase up to 200,000 shares of our common stock at an exercise price equal to \$0.35 per share. The Warrant is fully vested and can be exercised on or before the expiration date of July 19, 2009.

Our current business plan eliminates certain low margin private label and Galaxy imitation business from our sales mix. The elimination of these low margin items and the elimination of excess overhead that was part of our former manufacturing operations should continue to result in higher gross margins with lower operating costs and produce positive cash flows from operations in fiscal 2007.

As a result of the successful refinancing of the \$2.4 million short-term notes and line of credit for our receivables financing and the positive cash flow that we are currently experiencing from operations, we believe that we have sufficient cash resources to meet our current liquidity needs.

Foreclosure on our note receivable will result in a material affect to our reported earnings.

In June 1999, in connection with an amended and restated employment agreement for Angelo S. Morini, our Founder, stockholder and a member of our Board of Directors, we consolidated two full-recourse notes receivable (\$1,200,000 from November 1994 and \$11,572,200 from October 1995) related to his purchase of 2,914,286 shares of our common stock into a single stockholder note receivable in the amount of \$12,772,200 that was due on June 15, 2006. This stockholder note receivable is non-interest bearing and non-recourse and is secured by the 2,914,286 shares of our common stock (the "Shares"). For the fiscal year ended March 31, 2006, we reserved \$10,120,200 against this stockholder note receivable under the

assumption that we would not be able to collect proceeds in excess of the \$2,652,000 value of the Shares as of such date. The value of the Shares was computed using the closing price of our common stock on March 31, 2006 of \$0.91 multiplied by the 2,914,286 shares.

On June 16, 2006, Mr. Morini failed to repay the non-recourse note obligation to our Company. On June 20, 2006, we delivered notice to Mr. Morini that we intended to exercise our rights to the Shares and retain all the Shares in full satisfaction of his obligations under the stockholder note receivable. On July 6, 2006, Mr. Morini consented to our acceptance of the Shares in full satisfaction of his obligations under the stockholder note receivable. As a result, we are in the process of canceling the Shares along with an additional 30,443 treasury shares. Our total number of issued and outstanding shares of common stock is now 17,109,894 shares. Based upon the \$0.42 closing price of our common stock as quoted on the OTC Bulletin Board on June 16, 2006, the Shares have an approximate value of \$1,224,000. Accordingly, we will recognize an additional expense of \$1,428,000 in the first quarter of fiscal 2007 in order to record the additional decline in the value of the Shares from its \$2,652,000 value as of March 31, 2006.

Although this expense resulted in a material loss to our operations, it does not have any affect on the balance sheet since the stockholder note receivable was already shown as a reduction to Stockholders' Equity (Deficit).

We depend on one supplier to manufacture and distribute all of our products to our customers.

Pursuant to a Supply Agreement dated June 30, 2005 between our Company and Schreiber Foods, Inc. ("Schreiber"), since November 2005, we depend solely on Schreiber to manufacture and distribute all of our products to our customers. We will rely solely on Schreiber to produce our products at prices that are competitive in the market, to maintain the quality of our products, and to supply our customers with the products they order on a timely basis. If Schreiber is unable to deliver its services according to the negotiated terms of the Supply Agreement for any reason, including the deterioration of its financial condition or over-commitment of its resources, we may lose customers and we may be required to purchase outsourcing services from another source at a higher price. Either of these occurrences will likely reduce our profits or result in a reduction in sales of our products.

We may be required to pay substantial penalties under our Supply Agreement and may not have the ability to do so.

The initial term of the Supply Agreement with Schreiber is for a period of five years from the effective date of September 1, 2005 and is renewable at our option for up to two additional five-year periods (for a total term of up to fifteen years). If we do not exercise our first option to extend the term, then we will be obligated to pay Schreiber \$1,500,000. If we exercise our first option to extend the term, but do not exercise our second option to extend the term, then we will be obligated to pay Schreiber \$750,000.

Additionally, the Supply Agreement provides for a contingent short-fall payment obligation by our Company if a specified production level is not met during the one-year period from September 1, 2006 to August 31, 2007. If a contingent short-fall payment is accrued after such one-year period, it may be reduced by the amount by which production levels in the one-year period from September 1, 2007 to August 31, 2008 exceeds the specified target level of production, if any. The short-fall payment is based on formula that calculates the payment as follows: $((\text{required pounds shipped} - \text{actual pounds shipped}) / \text{required pounds shipped}) * \$8,700,000$. Thus, if we did not purchase any products from Schreiber during between September 1, 2006 and August 31, 2008, the payment could be as high as \$8,700,000.

In either event, we may not have the ability to pay the required penalty and Schreiber may use its contractual rights in order to collect and may cease production and shipment of our products. Such an action would have a material adverse affect on the liquidity and financial condition of the Company and it is unlikely that we would be able to continue as a going concern.

Delisting of our common stock may make it more difficult for investors to sell shares, may potentially lead to future market declines and may increase our costs related to registration statements.

On April 20, 2006, we received a letter from AMEX, notifying us that it intended to proceed with the filing of an application with the Securities and Exchange Commission to strike our common stock from listing and registration on the Exchange. We did not appeal this determination by AMEX and on May 5, 2006, AMEX suspended trading in our common stock and submitted an application to the Securities and Exchange Commission to strike our common stock from listing and registration on AMEX.

Since May 8, 2006, our common stock is now traded in the over-the-counter market on what is commonly referred to as the OTC Bulletin Board. As a result, an investor could find it more difficult to dispose of or to obtain accurate quotations as to the market value of our securities. The delisting may make trading our shares more difficult for investors, potentially leading to further declines in our share price. Among other consequences, delisting from AMEX may cause difficulty in obtaining future financing.

In addition, we are no longer eligible to use short form registration statements with the respect to the sale of our securities. This could substantially increase our costs of registering securities in the future and make it more expensive and difficult to maintain the effectiveness of certain currently effective registration statements involving selling stockholders of our Company. Although most of these stockholders would be eligible to sell their shares over the public markets pursuant to Rule 144, in the event we are not able to timely maintain the effectiveness of such registration statements, we may be held liable for damages suffered by such selling stockholders.

Our common stock may become subject to certain “Penny Stock” rules which may make it a less attractive investment.

Since the trading price of our common stock is less than \$5.00 per share, trading in our common stock would be subject to the requirements of Rule 15g-9 of the Exchange Act if our net tangible assets fall below \$2 million. Under Rule 15g-9, brokers who recommend penny stocks to persons who are not established customers and accredited investors, as defined in the Exchange Act, must satisfy special sales practice requirements, including requirements that make and individualized written suitability determination for the purchaser and receive the purchaser’s written consent prior to the transaction. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 also requires additional disclosures in connection with any trades involving penny stock, including the delivery, prior to any penny stock transaction, of a disclosure schedule explaining the penny stock market and the risks associated with that market. Such requirements may severely limit the market liquidity of our common stock and the ability of investors in our equity securities to sell their securities in the secondary market. For all of these reasons, an investment in our equity securities may not be attractive to our potential investors.

As of September 30, 2005, we had a material weakness in our internal control over financial reporting, and we might find other material weaknesses in the future which may adversely affect our ability to provide timely and reliable financial information and satisfy our reporting obligations under federal securities laws.

As of September 30, 2005, we did not maintain effective controls over the completeness and accuracy relating to the accounting and disclosure for complex and non-standard stockholders’ equity transactions. Specifically, we did not have effective controls over accounting for our Series A convertible preferred stock during the periods from April 2001 through October 2004 and other mark-to-market securities, including warrants and shares exercised through a note receivable, during the periods from March 2001 through June 2005. This control deficiency resulted in the restatement of our financial statements for the fiscal years ended March 31, 2005, 2004, 2003, 2002 and 2001, and the restatement of the quarterly data for the first quarter ended June 30, 2005. Our management therefore determined that this control deficiency constituted a “material weakness” in our internal control over financial reporting relating to the accounting and disclosure for complex and non-standard stockholders’ equity transactions.

To address our material weakness related to the accounting and disclosure for complex and non-standard stockholders' equity transactions, we have enhanced our internal control processes in order to be able to comprehensively review the accounting and disclosure implications of such transactions on a timely basis. As part of the enhancement, we have subscribed to additional outside research materials and will consult with additional outside consultants to confirm our understanding of complex transactions, as necessary.

We might find other material weaknesses in our internal control over financial reporting in future periods. To the extent that any significant or material weaknesses exist in our internal control over financial reporting, such weaknesses may adversely affect our ability to provide timely and reliable financial information necessary for the conduct of our business and satisfaction of our reporting obligations under federal securities laws.

We may not be able to implement Section 404 of the Sarbanes-Oxley Act on a timely basis.

The Securities and Exchange Commission (the "SEC"), as directed by Section 404 of The Sarbanes Oxley Act, adopted rules generally requiring each public company to include a report of management on the company's internal controls over financial reporting in its annual report on Form 10-K that contains an assessment by management of the effectiveness of the company's internal controls over financial reporting. In addition, the company's independent registered accounting firm must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. This requirement will first apply to our annual report on Form 10-K for the fiscal year ending March 31, 2008.

We have not yet developed a Section 404 implementation plan. We have in the past discovered, and may in the future discover, areas of our internal controls that need improvement. How companies should be implementing these new requirements including internal control reforms to comply with Section 404's requirements and how independent auditors will apply these requirements and test companies' internal controls, is still reasonably uncertain.

We expect that we will need to hire and/or engage additional personnel and incur incremental costs in order to complete the work required by Section 404. There can be no assurance that we will be able to complete a Section 404 plan on a timely basis. Our liquidity position in fiscal 2007 and fiscal 2008 may also impact our ability to adequately fund our Section 404 efforts.

Additionally, upon completion of a Section 404 plan, we may not be able to conclude that our internal controls over financial reporting are effective, or in the event that we conclude that our internal controls are effective, our independent accountants may disagree with our assessment and may issue a report that is qualified. This could subject our Company to regulatory scrutiny and a loss of public confidence in our internal controls. Any failure to implement required new or improved controls, or difficulties encountered in their implementation, could negatively affect our operating results or cause us to fail to meet our reporting obligations.

We lack an operating history as a branded marketing company and we may not be successful.

There can be no assurance that we will be successful as a branded marketing company. While we have marketed our products ourselves in the past, we lack an operating history as solely a branded marketing company for investors to evaluate our business and prospects. We have limited meaningful historical financial data upon which to plan future operating expenses. Accordingly, we face risks and uncertainties relating to our ability to successfully implement our strategy. Investors must consider the risks, expenses, difficulties and uncertainties frequently encountered by companies in their early stage of transition. Failure to accurately forecast our revenues and future operating expenses could cause quarterly fluctuations in our operating results, including cash flows, and may result in further volatility of or a decline in our stock price.

We are subject to borrowing restrictions under our primary credit facility.

On June 23, 2006, we entered into a Receivables Purchase Agreement with Systran Financial Services Corporation, a subsidiary of Textron Financial Corporation (“Systran”), whereby Systran will provide financing to our Company through advances against certain trade receivable invoices due to our Company (the “Systran Advance”). The Systran Agreement is secured by our accounts receivable and all other assets. Generally, subject to a maximum principal amount of \$3,500,000 which can be borrowed under the Systran Agreement, the amount available for borrowing is equal to 85% of our eligible accounts receivable invoices less a dilution reserve and any required fixed dollar reserves, which Systran may increase or decrease at its sole discretion. The dilution and fixed dollar reserves have been initially set at 7% and \$100,000, respectively. Advances under the Systran Agreement bear interest at a variable rate equal to the prime rate plus 1.5% per annum (9.5% on June 23, 2006).

The initial term of the Systran Agreement ends on June 23, 2009 and may renew automatically for consecutive twelve-month terms unless terminated sooner. The Systran Agreement may be accelerated in the event of certain defaults by our Company including among other things, a default in our payment and/or performance of any obligation to Systran or any other financial institution, creditor, or bank; and any change in the conditions, financial or otherwise, of our Company which reasonably causes Systran to deem itself insecure. In such an event, interest on our borrowings would accrue at the greater of twelve percent per annum or the variable rate of prime plus 1.5% and we would be liable for an early termination premium ranging from 1% to 3% of the maximum principal amount available under the Systran Agreement.

There is no guarantee that Systran will maintain or lower the current reserves on our borrowing availability. Additionally, we may experience future credit tightening by Systran by virtue of reserves they may require, receivables they may deem ineligible or other rights they have under the Systran Agreement. Such restrictions would adversely affect our cash flows.

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

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

A private investor owns a large percentage of the outstanding shares, which could materially limit the ownership rights of investors.

As of August 11, 2006, Frederick DeLuca, a private investor, owned approximately 23% of our outstanding common stock and held warrants and a convertible note which, if exercised with accrued and unpaid interest on the convertible note as of such date and assuming the exercise of no other outstanding options or warrants, would give him ownership of approximately 48% of our outstanding common stock. Investors who purchase common stock in our Company may be unable to elect any specific members of the board of directors or exercise significant control over us or our business as a result of Mr. DeLuca’s ownership. Additionally, Mr. DeLuca may be able to exercise significant influence over our policies and Board composition.

Stockholders may experience further dilution.

We have a substantial number of outstanding options, warrants and a convertible note to acquire shares of common stock. As of August 11, 2006, we have a total of 14,064,784 shares reserved for issuance upon exercise of options, warrants and a convertible note that we have granted. Of this total, 7,927,665 are exercisable securities that are “in the money.” “In the money” generally means that the current market price of the common stock is above the exercise price of the shares subject to the option, warrant or note conversion. The issuance of common stock upon the exercise of these options and warrants or note conversion could adversely affect the market price of the common stock or result in substantial dilution to our existing stockholders. In addition, any future securities issuances by our Company, could result in the issuance, or potential issuance, of a significant amount of equity securities that will cause substantial dilution to our stockholders, particularly given the current low trading price of our common stock.

The facility lease for our corporate headquarters is set to expire in November 2006 and we have not secured a new location.

We entered into a lease agreement for the corporate headquarters with Anco Company, a Florida general partnership, on November 13, 1991. The lease expires in November 2006, unless renewed pursuant to terms mutually agreeable to the landlord and our Company. We are currently searching for new office space for our corporate headquarters. However, we can make no assurances that we will be able to find and move to a new location prior to November 2006 or that we will be able to renew our existing lease on terms acceptable to us. In the event that we are not successful, we may be subject to higher than normal lease rates or possible disruption of normal business operations.

Rising interest rates could negatively affect our results of operations.

The interest rates of most of our outstanding debts fluctuate based upon changes in the prime rate. Increases in the prime rate will result in an increase in our cost of funds, and would negatively affect our results of operations. We are anticipating future increases in interest rates during the fiscal year ending March 31, 2007. We have not entered into any derivative instruments such as interest rate swap or hedge agreements to manage our exposure to rising interest rates.

Competition in our industry is intense.

Competition in the natural food segment of the food industry is intense. We believe that as consumers become more interested in healthy food alternatives the competition in our markets will increase substantially. Therefore, the effectiveness of our advertising, marketing and promotional programs and the financial resources necessary for their implementation is an important part of our sales growth plan.

In the retail cheese market, we compete with large national and regional manufacturers of conventional, organic, and imitation cheese products. Competitors such as Kraft, Borden’s and ConAgra, among others are well established and have significantly more brand name recognition, marketing personnel, and cash resources at their disposal. Within the retail cheese alternative niche market, there are a number of additional competitors such as Tree of Life, Tofutti Brands, Inc., Yves (a subsidiary of Hain Celestial Group), Follow Your Heart, and Melissa’s. Like our product lines, these competitors offer dairy and cheese alternatives to grocery and natural foods stores. In addition, their offerings are similar to ours in that they have comparable perceived benefits and are distributed or positioned in the same retail shelf space as our products.

In the food service markets, our substitute and imitation cheese products compete with other numerous substitute and imitation cheese products, as well as with conventional cheeses.

While we believe that we are superior to the competition in our niche and that the breadth and depth of our product lines make it difficult for our smaller competitors to have a significant impact on our market leading share in the cheese alternative category, our competitors may succeed in developing new or enhanced products, which are better than our products. These companies may also prove to be more successful than us in marketing and selling these products. We cannot assure you that we will be able to compete successfully

with any of these companies or achieve a greater market share than we currently possess. Increased competition as to any of our products or services could result in price reductions, reduced margins, and loss of market share, which could negatively affect our business, prospects, results of operations and financial condition.

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

There could be a decrease in demand for our products as consumers' tastes, preferences, shopping behavior, and overall evaluation of health benefits change over time. Historically, this was demonstrated in the change in consumer eating habits with the publicly recognized trend toward low-carbohydrate diets, which led to decreased consumption of items such as bread and our complementary product of cheese alternative slices. Additionally, the number of consumers shopping in the retail grocery and natural foods stores continues to shift with the national expansion of Wal-Mart superstores and other similar superstores which include extensive grocery operations. Additionally, with the growth in the aging population of U.S. consumers, there could be price pressure on our products due to the fixed income nature of this population segment.

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

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

We rely on the protection of our trademarks, and the loss of a trademark would negatively impact the products associated with the trademark.

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

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

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

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

We, like any other seller of food products, face the risk of exposure to product liability claims in the event that our manufacturer's quality control procedures fail and the consumption of our products causes injury or illness. In July 2006, we initiated a voluntary product recall on one of our Vegan products after we discovered that the product produced by a sub-manufacturer may contain traces of undeclared milk ingredients. The recall was limited to our Vegan Parmesan Flavor Soy Topping with expiration codes between April 2007 and May 2007 of which we had sold approximately \$65,000. With respect to product liability claims, our insurance may not continue to be available at a reasonable cost, or, if available, may not be adequate to cover liabilities. We generally seek contractual indemnification and insurance coverage from parties supplying us products, but this indemnification or insurance coverage is limited, as a practical matter, to the creditworthiness of the indemnifying party, and their carriers, if any, as well as the limits of any insurance provided by suppliers. If we do not have adequate insurance or contractual indemnification available, product liability claims relating to defective products could have a material adverse effect on our financial condition, results of operations and cash flows.

MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

From August 1999 to May 5, 2006, our common stock, \$.01 par value per share, was traded on the American Stock Exchange ("AMEX") under the symbol "GXY". The following table sets forth the high and low closing sales prices of our common stock during each quarter as reported by AMEX for the fiscal years ended March 31, 2006 and 2005:

| Period | High Closing Sales Price | Low Closing Sales Price |
|----------------------------------|--------------------------|-------------------------|
| 2006 Fiscal Year, quarter ended: | | |
| June 30, 2005 | \$2.53 | \$1.85 |
| September 30, 2005 | \$2.10 | \$1.61 |
| December 31, 2005 | \$1.91 | \$1.23 |
| March 31, 2006 | \$1.42 | \$0.85 |
| 2005 Fiscal Year, quarter ended: | | |
| June 30, 2004 | \$2.45 | \$1.90 |
| September 30, 2004 | \$2.15 | \$1.24 |
| December 31, 2004 | \$1.98 | \$1.16 |
| March 31, 2005 | \$2.83 | \$1.80 |

On April 20, 2006, we received a letter from AMEX, notifying us that it intended to proceed with the filing of an application with the Securities and Exchange Commission to strike our common stock from listing and registration on the Exchange. We did not appeal this determination by AMEX and on May 5, 2006, AMEX suspended trading in our common stock and submitted an application to the Securities and Exchange Commission to strike our common stock from listing and registration on AMEX. Commencing May 8, 2006, we began trading under the symbol "GXYP" in the over-the-counter market on what is commonly referred to as the OTC Bulletin Board.

Holders

On July 13, 2006, there were approximately 616 stockholders of record for our common stock. This does not reflect persons or entities that hold our common stock in nominee or "street" name through various brokerage firms.

Dividends

We have not paid any dividends with respect to our common stock and do not expect to pay dividends on our common stock in the foreseeable future. It is the present policy of our Board of Directors to retain future earnings to finance the growth and development of our 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 our Company. See Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of our current capital position.

SELECTED FINANCIAL DATA

| | Fiscal Years Ended March 31, | | | | |
|---|------------------------------|--------------|--------------|--------------|--------------|
| | (1) 2006 | (1) 2005 | (1) 2004 | 2003 | (2) 2002 |
| Net sales | \$37,775,862 | \$44,510,487 | \$36,176,961 | \$40,008,769 | \$42,927,104 |
| Reserve on stockholder note receivable ⁽³⁾ | (10,120,200) | -- | -- | -- | -- |
| Cost of disposal activities ⁽³⁾ | (1,646,490) | -- | -- | -- | -- |
| Impairment of fixed assets ⁽³⁾ | (7,896,554) | -- | -- | -- | -- |
| Employment contract expense ⁽³⁾ | -- | (444,883) | (1,830,329) | -- | -- |
| Income tax benefit (expense) | -- | -- | -- | -- | (1,560,000) |
| Net income (loss) | (24,148,553) | (3,859,783) | (3,299,277) | (957,221) | (16,721,149) |
| Net income (loss) to common stockholders | (24,148,553) | (4,261,855) | (4,757,087) | (2,530,390) | (18,748,345) |
| Net income (loss) per common share – basic & diluted | (1.23) | (0.25) | (0.32) | (0.21) | (1.78) |
| Total assets ⁽⁴⁾ | 5,250,070 | 27,769,666 | 29,961,816 | 33,325,334 | 36,115,051 |
| Long-term obligations | 597,184 | 8,000,627 | 9,740,094 | 10,170,195 | 12,511,461 |
| Redeemable Convertible Preferred Stock | -- | -- | 2,573,581 | 2,324,671 | 2,156,311 |

- (1) See Material Historical Events under *Business Environment* for a summary of the major events during the fiscal years ended March 31, 2006, 2005 and 2004.
- (2) In addition to the line items detailed above, the net loss for fiscal year ended March 31, 2002 included approximately \$5.4 million in accounts receivable and inventory write-downs, non-cash compensation expense of approximately \$400,000, approximately \$1 million in fixed asset disposals and unused trade credit write-offs, and approximately \$2.4 in non-cash interest, derivative and fair value expenses.
- (3) See *Results of Operations* below for a detailed description of these items.
- (4) Total assets decreased by approximately \$22,500,000 from March 31, 2005 to March 31, 2006 as a result of our reduction in inventory and equipment related to the outsourcing of our manufacturing and distribution functions and the sale of substantially all of our manufacturing equipment.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following information in this Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to enhance a reader's understanding of the financial condition, changes in financial condition and results of operations of our Company. This MD&A is a supplement to and should be read in conjunction with our Financial Statements and notes thereto contained. Terms such as "fiscal 2007", "fiscal 2006", "fiscal 2005" or "fiscal 2004" refer to our fiscal years ending March 31, 2007, 2006, 2005 and 2004, respectively.

This MD&A contains the following sections:

- Basis of Presentation; Going Concern
- Business Environment
- Critical Accounting Policies
- Results of Operations
- Liquidity and Capital Resources
- Contractual Obligations
- Recent Accounting Pronouncements

Basis Of Presentation; Going Concern

We have incurred substantial losses in recent years and, as a result, have a stockholders deficit of \$3,591,259 as of June 30, 2006. Losses for the years ended March 31, 2006, 2005 and 2004 were \$24,148,553, \$3,859,783 and \$3,299,277, respectively. Additionally, we received a report from our independent accountants relating to our audited financial statements as of March 31, 2006 containing a paragraph stating that because we were then in default of our notes payable, had suffered recurring losses from operations and at March 31, 2006 had deficiencies in working capital and equity, there was substantive doubt as to our ability to continue as a going concern. Our ability to continue as a going concern depended upon successfully obtaining sufficient cash resources to refinance our \$2.4 million of unsecured notes payable that matured on June 15, 2006 and obtaining positive cash flow from operations to sustain normal business operations.

Our current business plan eliminates certain low margin private label and Galaxy imitation business from our sales mix. The elimination of these low margin items and the elimination of excess overhead that was part of our former manufacturing operations should continue to result in higher gross margins with lower operating costs and produce positive cash flows from operations in fiscal 2007.

As a result of the successful refinancing of the \$2.4 million short-term notes and line of credit for our receivables financing and the positive cash flow that we are currently experiencing from operations, we believe that we have sufficient cash resources to meet our current liquidity needs. Therefore, our financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America assuming that we will continue on a going concern basis. This assumes the realization of assets and the satisfaction of liabilities in the normal course of business.

Business Environment

General

Galaxy Nutritional Foods, Inc. (our "Company") is principally engaged in developing and globally marketing plant-based cheese and dairy alternatives, as well as processed organic cheese and cheese food to grocery and natural foods retailers, mass merchandisers and foodservice accounts. Veggie, the leading brand in the grocery cheese alternative category and our Company's top selling product group, is primarily merchandised

in the produce section and provides calcium and protein without cholesterol, saturated fat or trans-fat. Other popular brands include: Rice, Veggy, Vegan, and Wholesome Valley. We are dedicated to developing nutritious products to meet the taste and dietary needs of today's increasingly health conscious consumers. Our company headquarters are located in Orlando, Florida.

In fiscal 2006, we determined that the manufacturing capacity was significantly in excess of our requirements and that it would be advantageous to outsource manufacturing and distribution operations. On June 30, 2005, Galaxy Nutritional Foods, Inc. and Schreiber Foods, Inc., a Wisconsin corporation ("Schreiber"), entered into a Supply Agreement, whereby we agreed that Schreiber would become our sole source of supply for substantially all of our products. In November 2005, Schreiber began to deliver such products directly to our customers.

On December 8, 2005, we completed the sale of substantially all of our manufacturing and production equipment to Schreiber for \$8,700,000 in cash pursuant to an Asset Purchase Agreement dated June 30, 2005. Our Company has now converted from a manufacturing company into a branded marketing company that will continue to develop, market and sell our products.

Cheese Alternative Category

We are the market leader within our cheese alternative category niche, but in being so, the category increases or decreases partly as a result of our marketing and pricing efforts. We believe that the greatest source of future growth in the cheese alternative category will come through consumers shifting to cheese alternatives from natural cheese. Our strategy is to broaden the consumer base to include younger, less price sensitive consumers seeking products with overall health and nutrition attributes. Historically, our products and marketing efforts appealed to older consumers purchasing cheese alternatives for specific dietary concerns.

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

In fiscal 2006, we launched a regional consumer marketing campaign to educate conventional cheese users on the benefits and location of Galaxy branded products. The campaign drivers included traditional consumer advertising, price based promotions, secondary placement and event marketing.

The consumer focused advertising included a 30 second TV commercial in key markets on major networks including Food Network, Lifetime, Travel Channel, Oxygen and USA during September 2005 and January 2006. Price based promotions included a cents off coupon in free standing inserts distributed in major regional newspapers in September 2005 and January 2006. We also tested secondary placement with select retailers in Florida, Los Angeles and Chicago. Event marketing included sponsorship of the Komen Race for the Cure in New York and Houston. This provided an opportunity to educate women on the benefits of cheese alternatives and introduce them to our brands with samples, coupons and product information.

The fiscal 2006 marketing campaign provided valuable insight as to what types of marketing efforts produced short-term and long-term benefits for brand recognition and accomplished our goal to broaden the consumer base within the cheese alternative category. We are using the results from fiscal 2006, to focus the fiscal 2007 marketing campaign as we enter the year as a branded marketing company.

Historical Summary

Fiscal 2006

During fiscal 2006, we entered into a Supply Agreement with Schreiber, whereby we agreed we would cease our manufacturing and distribution operations and that Schreiber would become our sole source of supply for substantially all of our products. In November 2005, Schreiber began to deliver such products directly to our customers. On December 8, 2005, we completed the sale of substantially all of our manufacturing and production equipment to Schreiber for \$8.7 million. Additionally, during fiscal 2006, we secured \$2.4 million in short-term unsecured notes for working capital purposes. As a result of these transactions in fiscal 2006, we reduced our total assets by nearly \$20 million, incurred \$9.5 million in expenses (of which approximately \$8 million is a non-cash expense) and reduced our liabilities by over \$11 million compared to fiscal 2005.

Fiscal 2005

During fiscal 2005, we redeemed the remaining 30,316 Series A convertible preferred shares that were outstanding as of October 6, 2004 for \$2,279,688. The cash for the redemption was obtained through an equity financing (see *Equity Financing* under Liquidity and Capital Resources for further details). In early fiscal 2005, we made the decision to take on a few additional private-label manufacturing contracts at lower margins in order to utilize some of our excess production capacity. One of the new contract customers accounted for 12% of our sales during fiscal 2005, which attributed to 65% of the increase in sales over fiscal 2004. In the fourth quarter of fiscal 2005, we reserved nearly \$1,550,000 in accounts receivable and \$210,000 in inventory related to this customer due to questionable collectibility. See Del Sunshine LLC under *Fiscal 2006* for further details. Also during fiscal 2005, we experienced a sharp increase in our cost of goods sold primarily as a result of a 32% (or nearly \$2.7 million) increase in the price of casein, our primary ingredient used in production. Only a portion of this overall increase could be passed on to our customers. Additionally, the price increase cannot be implemented immediately.

Fiscal 2004

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

Recent Material Developments

Outsourcing Effect

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

Some of the effects of the transaction are as follows:

- We are solely a branded marketing company without any manufacturing and distribution functions.
- In December 2005, we ceased to use the manufacturing portion of our main leased facility in Orlando, Florida where our administrative offices are located, but we plan to stay in this location through the end of our lease in November 2006. If the lease is not terminated sooner, future lease payments due on this facility are approximately \$267,000 for the balance of the term. Effective April 15, 2006 through October 31, 2006, we entered into a sublease agreement for a portion of our

unused manufacturing facility and parking spaces whereby we expect to receive approximately \$83,901 in rental income to offset our lease payment obligations in fiscal 2007.

- In December 2005, we abandoned our distribution facility that had a lease termination date of July 31, 2009. Effective July 31, 2006, we entered into a lease termination agreement with our landlord, CLP Industrial Properties, regarding our unused leased distribution facilities whereby the landlord released us from \$1,068,869 in future payment obligations from August 1, 2006 through July 31, 2009 under the terms of our current operating lease, in exchange for a termination fee of \$228,859.
- We eliminated 104 employee positions related to the manufacturing and distribution of our products and created 2 new employee positions. We now maintain 30 full time positions.
- We used the proceeds from the sale of our manufacturing equipment to reduce a substantial portion of our outstanding debt and liabilities. Repayment of these liabilities will result in annual interest savings in excess of \$800,000.
- We will no longer have the carrying value of inventory nor need to use asset based financing to support the production of inventory. In the recent past, we averaged 50 to 60 days of sales in inventory.
- We anticipate substantial savings on delivery charges related to the distribution of our products to our customers. In the first quarter of fiscal 2007, delivery expenses amounted to 3% of net sales compared to 6% of net sales in the first quarter of fiscal 2006.
- We anticipate substantial savings on costs of goods sold and improved gross margins as a result of reduced overhead and lower material costs. In the first quarter of fiscal 2007, gross margin was approximately 35% of net sales compared to 23% of net sales in the first quarter of fiscal 2006.

Debt Refinancing

On June 23, 2006, we entered into a Receivables Purchase Agreement with Systran Financial Services Corporation, a subsidiary of Textron Financial Corporation (“Systran”), whereby Systran will provide financing to our Company through advances against certain trade receivable invoices due to our Company (the “Systran Agreement”). On June 23, 2006, Systran advanced \$2,379,262 under the Systran Agreement of which \$1,839,086 was used to pay in full and terminate our obligations under our line of credit with Textron Financial Corporation, which was to terminate on June 27, 2006.

Pursuant to a Note Purchase Agreement dated July 19, 2006, we issued a new unsecured convertible note for \$2,685,104 (the “Convertible Note”) to Frederick A. DeLuca, a greater than 10% shareholder. The proceeds from the Convertible Note were used to repay or refinance \$2,400,000 in unsecured promissory notes that matured on June 15, 2006 (including one such note in the principal amount of \$1,200,000 owned by Mr. DeLuca) and a \$285,104 registration rights penalty owed to Mr. DeLuca.

See *Debt Financing* under Liquidity and Capital Resources for additional information on the above refinancing.

Del Sunshine LLC

Pursuant to an oral contract manufacturing and distribution arrangement among our Company, Del Sunshine LLC (“Del”), a Delaware limited liability company, and Non-Dairy Specialty Foods, LLC (“Non-Dairy”), a Nevada limited liability company and affiliate of Del, we began manufacturing certain private label products for Del and delivering them directly to Del’s customers, including Del’s major customer, Wal-Mart, Inc. in April 2004. These private label products were produced using label and packaging trademarks owned by

Del. Sales to Del accounted for 12% of our sales during fiscal 2005, which attributed to 65% of the increase in sales over fiscal 2004.

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

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

The effectiveness of the Trademark License Agreement and the Assignment of Accounts Receivable Agreement was conditioned upon Del providing us with proof, satisfactory to us, that (a) Del would be transferring to us under the Assignment of Accounts Receivable Agreement accounts receivable and purchase orders in excess of \$400,000 and (b) that Wal-Mart, Inc. would consent to the transactions contemplated under both agreements. Del has not satisfied either of the foregoing conditions and we do not believe that it is likely that Del will be able to satisfy the conditions in the future. Although we waived the conditions as they relate to the Trademark License Agreement, we did not waive them with respect to the Assignment of Accounts Receivable Agreement. Currently, we are exploring our options in addressing the issues with Del related to the effectiveness and continuation of the Assignment of Accounts Receivable Agreement and Del's payment of our account receivable. On or about June 15, 2006, we ceased selling products under Del's trademarks and we allowed the Trademark License Agreement to expire according to its terms on September 30, 2005.

In the fourth quarter of fiscal 2005, we reserved nearly \$1,550,000 in accounts receivable and wrote off \$210,000 in inventory related to Del based upon our determination in April 2005 that collection from Del was questionable as of March 31, 2005. During the first quarter of fiscal 2006, we accrued approximately \$40,000 in royalties under the Trademark License Agreement and offset them against the receivable owed to us by Del. During the year ended March 31, 2006, we recorded approximately \$279,000 in additional bad debt related to Del. As of March 31, 2006, all amounts owed by Del have been written off as uncollectible.

Measurements of Financial Performance

We focus on several items in order to measure our performance. We are working towards obtaining positive trends in the following areas:

- Operating cash flow
- Gross margin in dollars and % of gross sales
- Operating income excluding certain employment contract expenses, non-cash compensation related to stock based transactions, disposal costs and fixed asset impairment charges
- EBITDA excluding certain employment contract expenses and non-cash compensation related to stock based transactions, disposal costs and fixed asset impairment charges
- Liquidity
- Key financial ratios (such as accounts receivable and accounts payable turnover ratios)

Critical Accounting Policies

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

Management has discussed the selection of critical accounting policies and estimates with our Board of Directors and the Board of Directors has reviewed our disclosure relating to critical accounting policies and estimates in this annual report on Form 10-K. Our significant accounting policies are described in Note 1 to our financial statements for fiscal 2006. The critical accounting policies used by management and the methodology for its estimates and assumptions are as follows:

Valuation of Accounts Receivable and Chargebacks

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

Based on the age of the receivable, cash collection history and past dilution in the receivables, we make an estimate of our anticipated bad debt, anticipated future authorized deductions due to current period activity and anticipated collections on non-authorized amounts that customers have currently deducted on past invoices. Based on this analysis, we reserved \$1,769,000 and \$2,299,000 for known and anticipated future credits and doubtful accounts at March 31, 2006 and 2005, respectively. We believe that this estimate is reasonable, but there can be no assurance that our estimate will not change given a change in economic conditions or business conditions within the food industry, our individual customer base or our Company. Actual bad debt expense increased from 1% of gross sales during fiscal 2004 to 3% of gross sales during fiscal 2005 due to the \$1,550,000 reserve for Del Sunshine as described under *Material Historical Events*, but it decreased back to 1% of gross sales during fiscal 2006.

Valuation of Stockholder Note Receivable

We evaluated the collection of the \$12,772,200 stockholder note receivable that was due on June 15, 2006 from Angelo S. Morini, our Founder, stockholder and a member of our Board of Directors. This stockholder note receivable is non-recourse and is secured only by 2,914,286 shares of our common stock. During our evaluation, among other things, we considered the current value of the 2,914,286 shares of our common stock and the remaining time before the stockholder note was due to be paid. Due to the uncertainty that the value of these shares would exceed the stockholder note value prior to its maturity, we reserved \$10,120,200 during the fiscal year ended March 31, 2006 for the difference between the \$2,652,000 share value and the \$12,772,200 loan value as of such date. The value of the shares was computed using the closing price of our common stock on March 31, 2006 of \$0.91 multiplied by the 2,914,286 shares.

On June 16, 2006, Mr. Morini failed to repay the non-recourse note obligation to our Company and we subsequently reacquired the 2,914,286 shares. Based upon the \$0.42 closing price of our common stock as quoted on the OTC Bulletin Board on June 16, 2006, the shares have an approximate value of \$1,224,000. Accordingly, we will recognize an additional expense of \$1,428,000 in the first quarter of fiscal 2007 in

order to record the additional decline in the value of the shares from its \$2,652,000 value as of March 31, 2006.

Inventory

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

Deferred Taxes

Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. We have reserved our net deferred tax assets in full.

Valuation of Non-Cash Compensation

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

Effective April 1, 2003, we adopted the fair value recognition provisions of Statement of Financial Accounting Standard (“SFAS”) No. 123, “*Accounting for Stock-Based Compensation*,” and apply SFAS No. 148, “*Accounting for Stock-Based Compensation – Transition and Disclosure*,” prospectively to all employee awards granted on or after April 1, 2003. Awards from our plans vest over periods ranging from immediate to five years. Therefore, the cost related to stock-based compensation included in the determination of net income for the periods is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS No. 123. The fair value of the stock-based award (including, but not limited to, restricted stock awards, stock option grants, and warrant issuances) is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related award. The difference between the proforma and reported net loss per common share related to the issuance of employee stock options during the years ended March 31, 2006, 2005 and 2004 ranged from nearly zero to \$0.03.

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

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

| Fiscal Years Ended | March 31, 2006 | March 31, 2005 | March 31, 2004 |
|--------------------------|----------------|----------------|----------------|
| Dividend Yield | None | None | None |
| Volatility | 11% to 46% | 45% to 46% | 41% to 45% |
| Risk Free Interest Rate | 3.35% to 4.30% | 3.38% to 4.12% | 2.01% to 4.28% |
| Expected Lives in Months | 1 to 120 | 60 to 120 | 36 to 120 |

In addition to non-cash compensation expense related to new stock-based transactions, prior to March 31, 2006, we also record non-cash compensation expense in accordance with the Financial Accounting Standards Board (“FASB”) Interpretation No. 44 (“FIN 44”) related to modifications of fixed stock options or awards granted to employees or directors that were granted prior to April 1, 2003 and accounted for under the accounting provisions of APB No. 25.

FIN 44 states that when an option is repriced or there are items that effectively reduce the price of an option, it is treated as a variable option that is marked to market each quarter. Accordingly, any increase in the market price of our common stock over the exercise price of the option that was not previously recorded is recorded as compensation expense at each reporting period. If there is a decrease in the market price of our common stock compared to the prior reporting period, the reduction is recorded as compensation income to reverse all or a portion of the expense recognized in prior periods. Compensation income is limited to the original base exercise price (the intrinsic value) of the options. Each period we may record non-cash compensation expense or income related to our analysis on approximately 3.5 million option shares. Assuming that the stock price exceeds the intrinsic value on all the variable option shares, a \$0.01 increase or decrease in our common stock price resulted in an expense or income, respectively, of approximately \$35,000. Effective April 1, 2006, we will adopt SFAS No. 123R at which time this variable accounting treatment will be discontinued.

Disposal Costs

We have recorded accruals in connection with the asset sale and outsourcing arrangements with Schreiber. These accruals include estimates pertaining to employee termination costs and abandonment of excess equipment and facilities and other potential costs. Actual costs may differ from these estimates or our estimates may change. In accordance with SFAS No. 146, “*Accounting for Costs Associated with Exit or Disposal Activities*,” costs associated with restructuring activities are recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. Given the significance and complexity of these activities, and the timing of the execution of such activities, the accrual process involves periodic reassessments of estimates made at the time the original decisions were made, including evaluating estimated employment terms, contract cancellation charges and real estate market conditions for sub-lease rents. We will continually evaluate the adequacy of the remaining liabilities under our restructuring initiatives. Although we believe that these estimates accurately reflect the costs of our activities, actual results may differ, thereby requiring us to record additional provisions or reverse a portion of such provisions. If we do not sublease our facilities, our estimate of excess facility expenses will increase.

Results Of Operations

| 12 Months Ending March 31, | 2006 | 2005 | 2004 | 2006-2005 | 2005-2004 | 2006-2005 | 2005-2004 | 2006 | 2005 | 2004 |
|----------------------------|------------------|------------------|-------------------|------------------|--------------------|--------------|---------------|--------------|--------------|--------------|
| | | | | \$ | \$ | % | % | % of | % of | % of |
| | | | | Change | Change | Change | Change | Sales | Sales | Sales |
| Net Sales | 37,775,862 | 44,510,487 | 36,176,961 | (6,734,625) | 8,333,526 | -15.1% | 23.0% | 100.0% | 100.0% | 100.0% |
| Cost of Goods Sold | 28,142,732 | 34,736,594 | 24,864,289 | (6,593,862) | 9,872,305 | -19.0% | 39.7% | 74.5% | 78.0% | 68.7% |
| Gross Margin | 9,633,130 | 9,773,893 | 11,312,672 | (140,763) | (1,538,779) | -1.4% | -13.6% | 25.5% | 22.0% | 31.3% |

Sales

For the fiscal years ended March 31, 2006, 2005 and 2004, our gross sales were \$41,492,717, \$48,421,384 and \$40,041,371, respectively. The following chart sets forth the percentage of gross sales derived from our product brands during the fiscal years ended March 31, 2006, 2005 and 2004:

**Percentage of Gross Sales
Fiscal Years Ended March 31,**

| Brand | 2006 | 2005 | 2004 |
|----------------------------------|-------------|-------------|-------------|
| Veggie | 52.5% | 46.5% | 59.9% |
| Private Label, Imitation & Other | 31.1% | 35.4% | 22.4% |
| Rice | 7.8% | 6.6% | 7.9% |
| Veggy | 3.8% | 4.7% | 6.2% |
| Wholesome Valley Organic | 2.8% | 5.0% | 1.1% |
| Vegan | 2.0% | 1.8% | 2.5% |

Net sales, after discounts, returns and allowances, in fiscal 2006 decreased 15% from net sales in fiscal 2005 due to a decline in private label sales volume to Wal-Mart. Prior to fiscal 2006, we produced certain private label products for Del Sunshine who then sold the product to Wal-Mart. In fiscal 2006, we began selling these products directly to Wal-Mart instead of through Del Sunshine (See Del Sunshine LLC under *Recent Material Developments* for further details). During fiscal 2006, combined sales to Wal-Mart and Del Sunshine accounted for approximately 7% of gross sales, compared to nearly 14% of gross sales in fiscal 2005. This decrease in sales accounted for 8% of the sales decline in fiscal 2006.

The remaining 7% decrease in sales was due to overall consumer resistance to the multiple price increases we implemented in late fiscal 2005 and early fiscal 2006 to offset our rising production costs. We statistically linked the majority of the reduction in sales of our Veggie Slices to average unit price and plan to implement more effective price promotions in fiscal 2007.

Net sales for fiscal 2005 increased by 23% over net sales for fiscal 2004 primarily due to increased sales in private label and Wholesome Valley® Organic products. During fiscal 2005, we had one new private label customer that accounted for approximately 12% of gross sales. This customer accounted for nearly 65% of the increase in fiscal 2005 sales. However, we are no longer selling to this customer due to a shift in sales between customers as discussed above.

During fiscal 2007, we plan to reduce marginally profitable private label and Galaxy imitation sales and as a result, improve our gross margins. We anticipate that our sales in fiscal 2007 will decline next year due to our specific focus to eliminate marginally profitable private label and other products.

Cost of Goods Sold

Cost of goods sold decreased from 78% of net sales in fiscal 2005 to 74% of net sales in fiscal 2006. This four percentage point decrease in cost of goods sold was primarily due to the reduced production overhead through the outsourcing of our manufacturing operations since November 2005 as discussed under *Recent Material Developments*.

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

The principal raw material used by our Company is casein, which accounted for approximately 35% and 47% of our raw material purchases in fiscal 2006 and fiscal 2005, respectively. As casein is a significant component of our product formulation, we were vulnerable to short-term and long-term changes in casein pricing, which at times has been volatile.

We experienced a 32% increase in average casein prices in fiscal 2005 compared to average casein prices in fiscal 2004, which resulted in an increase in cost of goods of approximately \$2.7 million. In fiscal 2006, we continued to experience high casein prices, the averages of which were approximately 30% higher than the average prices for fiscal 2005. In October 2005, the prices of casein began to decline. Schreiber, our outsourcing manufacturer, is now responsible for securing these ingredients, but fluctuations in casein prices will be passed on directly to us when we purchase the finished product from them. In order to offset the high casein costs, we incorporated alternative formula modifications in some of our products. We also passed along some of the increased costs to our customers during fiscal 2005 and will implement additional price increases as appropriate. However, these price increases often cannot be passed on to the customers at the same time or in proportion to the increase in our costs and therefore, we experience lower margins on the sales of our products.

Gross Margin

Despite the sharp decline in sales, gross margin dollars in fiscal 2006 was only slightly lower than fiscal 2005 due to the elimination of the private label sales to Wal-Mart and the elimination of our high fixed overhead in the fourth quarter of fiscal 2006. In the fourth quarter of fiscal 2006, our gross margin averaged 34% compared to the annual fiscal 2006 average of 26%. Private label and imitation sales consist primarily of products that generate high sales volumes but lower gross margins.

In fiscal 2007, we expect our gross profit percentage to improve over the fiscal 2006 levels despite the reduction in sales levels due to the elimination of certain low margin private label and Galaxy imitation business and the reduction in excess overhead. Our anticipated higher margin sales combined with our lower overhead burden, should produce higher gross margins in dollars and as a percentage of sales.

EBITDA

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

EBITDA, a non-GAAP measure:

| 12 Months Ending March 31, | | | | 2006-2005 | 2005-2004 | 2006-2005 | 2005-2004 | 2006 | 2005 | 2004 |
|--|-------------|-------------|-------------|----------------------|----------------------|---------------------|---------------------|-----------------------|-----------------------|-----------------------|
| | 2006 | 2005 | 2004 | \$ Change | \$ Change | % Change | % Change | % of Sales | % of Sales | % of Sales |
| Gross Margin | 9,633,130 | 9,773,893 | 11,312,672 | (140,763) | (1,538,779) | -1.4% | -13.6% | 25.5% | 22.0% | 31.3% |
| Operating Expenses: | | | | | | | | | | |
| Selling | 5,571,097 | 5,148,426 | 4,981,996 | 422,671 | 166,430 | 8.2% | 3.3% | 14.7% | 11.6% | 13.8% |
| Delivery | 2,251,318 | 2,307,166 | 1,877,682 | (55,848) | 429,484 | -2.4% | 22.9% | 6.0% | 5.2% | 5.2% |
| Employment contract expense ⁽²⁾ | - | 444,883 | 1,830,329 | (444,883) | (1,385,446) | -100.0% | -75.7% | 0.0% | 1.0% | 5.1% |
| General and administrative, including \$926,263, \$409,746 and \$651,273 non-cash stock compensation ⁽¹⁾ | 4,750,624 | 4,380,436 | 3,954,303 | 370,188 | 426,133 | 8.5% | 10.8% | 12.6% | 9.8% | 10.9% |
| Research and development | 321,016 | 309,054 | 260,410 | 11,962 | 48,644 | 3.9% | 18.7% | 0.8% | 0.7% | 0.7% |
| Reserve on stockholder note receivable ⁽²⁾ | 10,120,200 | - | - | 10,120,200 | - | 100.0% | 0.0% | 26.8% | 0.0% | 0.0% |
| Cost of disposal activities ⁽²⁾ | 1,646,490 | - | - | 1,646,490 | - | 100.0% | 0.0% | 4.4% | 0.0% | 0.0% |

| | | | | | | | | | | |
|---|--------------|-------------|-------------|--------------|-------------|---------|---------|--------|-------|-------|
| Impairment of fixed assets ⁽²⁾ | 7,896,554 | - | - | 7,896,554 | - | 100.0% | 0.0% | 20.9% | 0.0% | 0.0% |
| (Gain)Loss on disposal of assets | (3,628) | (4,500) | 8,519 | 872 | (13,019) | -19.4% | -152.8% | 0.0% | 0.0% | 0.0% |
| Total operating expenses | 32,553,671 | 12,585,465 | 12,913,239 | 19,968,206 | (327,774) | 158.7% | -2.5% | 86.2% | 28.3% | 35.7% |
| Loss from Operations⁽³⁾ | (22,920,541) | (2,811,572) | (1,600,567) | (20,108,969) | (1,211,005) | 715.2% | 75.7% | -60.7% | -6.3% | -4.4% |
| Other Income (Expense), Net | | | | | | | | | | |
| Interest expense, net | (1,616,743) | (1,129,977) | (1,361,606) | (486,766) | 231,629 | 43.1% | -17.0% | -4.3% | -2.5% | -3.8% |
| Derivative income (expense) | - | 62,829 | (94,269) | (62,829) | 157,098 | -100.0% | -166.6% | 0.0% | 0.1% | -0.3% |
| Gain (loss) on FV of warrants | 388,731 | 18,937 | (242,835) | 369,794 | 261,772 | 1952.8% | -107.8% | 1.0% | 0.0% | -0.7% |
| Total | (1,228,012) | (1,048,211) | (1,698,710) | (179,801) | 650,499 | 17.2% | -38.3% | -3.3% | -2.4% | -4.7% |
| NET LOSS | (24,148,553) | (3,859,783) | (3,299,277) | (20,288,770) | (560,506) | 525.6% | 17.0% | -63.9% | -8.7% | -9.1% |
| Interest expense, net | 1,616,743 | 1,129,977 | 1,361,606 | 486,766 | (231,629) | 43.1% | -17.0% | 4.3% | 2.5% | 3.8% |
| Depreciation | 1,517,287 | 2,172,566 | 2,205,053 | (655,279) | (32,487) | -30.2% | -1.5% | 4.0% | 4.9% | 6.1% |
| EBITDA, a non-GAAP measure | (21,014,523) | (557,240) | 267,382 | (20,457,283) | (824,622) | 3671.2% | -308.4% | -55.6% | -1.3% | 0.7% |

- (1) In our calculation of key financial measures, we exclude the non-cash compensation related to stock-based transactions because we believe that this item does not accurately reflect our current on-going operations. Many times non-cash compensation is calculated based on fluctuations in our stock price, which can skew the financial results dramatically up and down. The market price of our common shares is outside our control and typically does not reflect our current operations.
- (2) In our calculation of key financial measures, we exclude the employment contract expenses related to Angelo S. Morini and Christopher J. New, the reserve on stockholder note receivable, disposal costs and fixed asset impairment charges because we believe that these items do not reflect expenses related to our current on-going operations. See below for a detailed description of these items.
- (3) Operating Loss has increased due the increase in non-cash stock compensation expense as discussed below under general and administrative, and certain non-standard expenses such as the reserve on stockholder note receivable, disposal costs and fixed asset impairment charges related to the Asset Purchase Agreement and the Supply Agreement with Schreiber as discussed under *Recent Material Developments*.

Selling

Selling expense is partly a function of sales through variable costs such as brokerage commissions and promotional costs along with certain fixed costs for employee salaries and benefits and marketing campaigns. We have experienced increased selling expenses each fiscal year primarily due to the increase in marketing efforts. During fiscal 2006, we increased our television costs by \$296,000 and implemented a new television marketing campaign. Additionally, we paid over \$100,000 for a subscription service that enables us to obtain detailed information about product sales during the year. During fiscal 2005, we increased our marketing costs by approximately \$190,000 over fiscal 2004, but shifted our marketing efforts from trade promotions to consumer advertising. The large consumer advertising costs were primarily related to a strategic television campaign, which was undertaken to promote our Veggie products during the second and third quarter of fiscal 2005.

We expect fixed selling expenses for advertising and market research in fiscal 2007 to be nearly the same level as in fiscal 2006, but with a more focused use of funds. We sell our products through our internal sales force and an independent broker network.

Delivery

Delivery expense is primarily a function of sales, and has remained consistent at approximately 5% of net sales. In fiscal 2006, delivery expense increased to 6% of net sales due to higher fuel prices and surcharges charged by our transportation companies. In November 2005, Schreiber began to deliver our products

directly to our customers pursuant to the Supply Agreement between our Company and Schreiber dated June 30, 2005. After the outsourcing of the distribution function, our delivery expense decreased. In the fourth quarter of fiscal 2006, delivery expenses amounted to 4% of net sales compared to 6% of net sales for the prior three quarters.

Due to our Supply Agreement, we anticipate additional savings on delivery charges related to the distribution of our products to our customers in fiscal 2007 as compared to fiscal 2006.

Employment Contract Expense

In connection with a Separation and Settlement Agreement dated July 8, 2004 between our Company and Christopher J. New (as further described under Item 11), we accrued and expensed \$444,883 as the two-year cost of this agreement under employment contract expense in the second quarter of fiscal 2005. As of March 31, 2006, the remaining balance unpaid and accrued balance reflected in short-term liabilities was \$67,809.

In October 2003, our Company and Angelo S. Morini entered into a Second Amended and Restated Employment Agreement (as further described under Item 11). In connection with this agreement, we accrued and expensed the five-year cost of this agreement as employment contract expense in the third quarter of fiscal 2004. The total estimated costs expensed under this agreement are \$1,830,329 of which \$925,982 remained unpaid and accrued (\$366,305 as short-term liabilities and \$559,677 as long-term liabilities) as of March 31, 2006. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

General and administrative

During fiscal 2006, general and administrative expenses increased approximately \$370,000 compared to fiscal 2005 primarily due to increases of approximately \$517,000 in additional non-cash compensation related to stock-based transactions, as detailed below, \$285,000 in liquidated damages related to a registration rights agreement as discussed below under *Equity Financing*, \$130,000 additional director and officer insurance costs due to higher coverages and increased premiums, \$237,000 in consulting fees for our outsourcing and sale arrangements, and \$448,000 in additional professional fees for legal and audit services due to our additional review of strategic alternatives (including the potential sale of our Company that was abandoned in April 2006) and SEC filings during fiscal 2006. These increases were reduced by a decrease of nearly \$1.2 million in bad debt expense from fiscal 2005 as discussed under *Recent Material Developments*.

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

Excluding the effects of non-cash compensation related to stock-based transactions, we anticipate that in fiscal 2007, general and administrative expenses will decrease on an annual basis due to the non-recurrence of the highly intensive consulting, legal and audit services related to major contracts, review of strategic alternatives and additional SEC filings that were required in fiscal 2006. Additionally, we do not anticipate the reoccurrence of liquidated damages related to stock registration that were incurred in fiscal 2006.

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

| 12 Months Ending March 31, | 2006 | 2005 | 2004 | 2006-2005 | 2005-2004 | 2006-2005 | 2005-2004 |
|---|-------------|-------------|-------------|------------------|------------------|------------------|------------------|
| | | | | \$ | \$ | % | % |
| | | | | Change | Change | Change | Change |
| Stock-based award issuances | 1,118,819 | 194,097 | 643,272 | 924,722 | (449,175) | 476.4% | -69.8% |
| Option modifications under APB 25 awards | (192,556) | 215,649 | 8,001 | (408,205) | 207,648 | -189.3% | 2595.3% |
| Non-cash compensation related to stock based transactions | 926,263 | 409,746 | 651,273 | 516,517 | (241,527) | 126.1% | -37.1% |

Effective April 1, 2003, we elected to record compensation expense measured at fair value for all stock-based award transactions on or after April 1, 2003 under the provisions of SFAS 123. Prior to April 1, 2003, we only recorded the fair value of stock-based awards granted to non-employees or non-directors under the provisions of SFAS 123. The fair value of the stock-based award is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related award. Prior to April 1, 2003, we accounted for our stock-based employee and director compensation plans under the accounting provisions of APB No. 25 as interpreted by FASB Interpretation No. 44 ("FIN 44"). Any modifications of fixed stock options or awards granted to employees or directors originally accounted for under APB No. 25 may result in additional compensation expense under the provisions of FIN 44. FIN 44 covers specific events that occurred after December 15, 1998 and was effective as of July 1, 2000.

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

a. Stock-Based Award Issuances

During the fiscal years ended March 31, 2006, 2005 and 2004, we recorded \$1,118,819, \$194,097, and \$643,272, respectively, as non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants.

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

On October 11, 2002, we repriced all outstanding options granted to employees prior to October 11, 2002 (4,284,108 shares at former prices ranging from \$2.84 to \$10.28) to the market price of \$2.05 per share. Prior to the repricing modification, the options were accounted for as a fixed award under APB No. 25. In accordance with FIN 44, the repricing of the employee stock options requires additional compensation expense to be recognized and adjusted in subsequent periods for changes in the price of our common stock that are in excess of the \$2.05 stock price on the date of modification (additional intrinsic value). If there is a decrease in the market price of our common stock compared to the prior reporting period, the reduction is recorded as compensation income to reverse all or a portion of the expense recognized in prior periods. Compensation income is limited to the original base exercise price (the intrinsic value) of the options. This variable accounting treatment for these modified stock options began with the quarter ended December 31, 2002 and such variable accounting treatment was to continue until the related options were cancelled, expired or exercised. Effective April 1, 2006, we will adopt SFAS No. 123R at which time this variable accounting treatment will be discontinued. We recorded non-cash compensation (income) expense of (\$192,556), \$193,649 and \$8,001 related to these modified options for the fiscal years ended March 31, 2006, 2005 and 2004. There are 3,494,091 outstanding modified stock options remaining as of March 31, 2006.

In connection with a Separation and Settlement Agreement dated July 8, 2004 between our Company and Mr. New (as further described under Item 11), we agreed that Mr. New's stock option rights under that

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

Reserve on stockholder note receivable

In June 1999, in connection with an amended and restated employment agreement for Angelo S. Morini, our Founder, stockholder and a member of our Board of Directors, we consolidated two full-recourse notes receivable (\$1,200,000 from November 1994 and \$11,572,200 from October 1995) related to his purchase of 2,914,286 shares of our common stock into a single stockholder note receivable in the amount of \$12,772,200 that was due on June 15, 2006. This stockholder note receivable is non-interest bearing and non-recourse and is secured by the 2,914,286 shares of our common stock (the “Shares”). For the fiscal year ended March 31, 2006, we reserved \$10,120,200 against this stockholder note receivable under the assumption that we would not be able to collect proceeds in excess of the \$2,652,000 value of the Shares as of such date. The value of the Shares was computed using the closing price of our common stock on March 31, 2006 of \$0.91 multiplied by the 2,914,286 shares.

Although this expense resulted in a material loss to our operations, it does not have any affect on the balance sheet since the stockholder note receivable was already shown as a reduction to Stockholders’ Equity (Deficit).

On June 16, 2006, Mr. Morini failed to repay the non-recourse note obligation to our Company and we subsequently reacquired the 2,914,286 shares. Based upon the \$0.42 closing price of our common stock as quoted on the OTC Bulletin Board on June 16, 2006, the Shares have an approximate value of \$1,224,000. Accordingly, we will recognize an additional expense of \$1,428,000 in the first quarter of fiscal 2007 in order to record the additional decline in the value of the Shares from its \$2,652,000 value as of March 31, 2006.

Cost of disposal activities

We are accounting for the costs associated with the Schreiber transactions in accordance with SFAS No. 146, “Accounting for Costs Associated with an Exit or Disposal Activity,” because the arrangements are planned and controlled by management and materially change the manner in which our business will be conducted. In accordance with SFAS No. 146, costs associated with disposal activities should be reported as a reduction of income from operations. For the fiscal year ended March 31, 2006, we incurred and reported \$1,646,490 as Costs of Disposal Activities in the Statement of Operations. As of March 31, 2006, all 104 employee positions related to the manufacturing and distribution of our products had been eliminated. The remaining employee termination costs are expected to be paid in fiscal 2007. In December 2005, we abandoned our distribution facility and the production portion of our administrative facility and accrued \$396,197 related to abandonment of these facilities. This amount was calculated as the present value of the remaining lease rentals, reduced by the estimated market value of sublease rentals. If we do not sublease these facilities, the actual loss will exceed this estimate. Other exit costs consist primarily of legal and professional fees related to the disposal activities.

A summary of the disposal costs recognized for the fiscal year ended March 31, 2006 is as follows:

| | Employee Termination Costs | Excess Facilities | Other Exit Costs | Total |
|-------------------------|---|------------------------------|-----------------------------|--------------|
| Disposal Costs Incurred | \$ 451,002 | \$ 518,479 | \$ 677,009 | \$ 1,646,490 |

We anticipate that in future periods, there will be additional disposal costs related to professional fees, contract cancellation charges and higher lease abandonment charges to reflect the cost of abandoned facilities that were not subleased during the period.

Impairment of property and equipment and loss on sale of assets

In light of the Schreiber transactions discussed above under *Recent Material Developments*, we determined that it is more likely than not that a majority of our fixed assets related to production activities would be sold or disposed prior to the end of their useful life. In accordance with SFAS No. 144, “*Accounting for the Impairment or Disposal of Long-Term Assets*,” we wrote down the value of our assets to their estimated fair values in June 2005. We estimated the fair value based on the \$8,700,000 sales price to Schreiber and the anticipated sales price related to any other assets to be held for sale plus future cash flows related to the assets from July 1, 2005 until the end of production in November 2005. Based on this estimate, we recorded an impairment of property and equipment of \$7,896,554 in order to reflect a net fair value of our equipment in June 2005.

All assets continued to be used and depreciated under Property and Equipment until the sale of substantially all of our production machinery and equipment on December 8, 2005. For the fiscal year ended March 31, 2006, we recorded a \$3,628 gain on the sale of assets related to the remaining value of assets sold or abandoned after production ceased in December 2005.

We have reclassified our remaining assets available for sale as Assets Held for Sale in the Balance Sheet and expect to sell these remaining assets by September 2006. We have estimated the fair value of these assets to be \$61,950. Any difference between the actual proceeds received and this estimated fair value will be recognized as a gain or loss on the sale of assets in the period that they are sold.

Other Income and Expense

Interest expense increased approximately \$487,000 or 43% in fiscal 2006. The increase was primarily the result of increased amortization related to loan costs and debt discounts. The amortization of loan costs increased by approximately \$242,000 due to additional loan fees charged by our lenders and due to the acceleration of the loan fee amortization on the Beltway loan that was paid in full in December 2005, as further described under *Debt Financing*. Additionally, pursuant to several Note and Warrant Purchase Agreements, as further described under *Debt Financing*, we issued warrants to purchase up to 600,000 shares of our common stock. We recorded the \$444,731 initial fair value of the warrants as a discount to debt. In fiscal 2006, we amortized \$317,752 of this non-cash debt discount that is being amortized from September 2005 through June 2006 and is included in interest expense. Due to average lower debt balances in fiscal 2006 as compared to fiscal 2005, our additional interest expense related to debt securities declined in excess of \$73,000.

Several of our loans and default provisions accrue interest based on a variable prime plus rate. Due to the increases in the prime rate (currently at 8%), we will experience higher interest rates in fiscal 2007 as compared to fiscal 2006 (in which prime averaged 6.7%). However, we anticipate that our interest expense will decrease nearly 50% in fiscal 2007, despite the higher interest rates, due to lower debt balances and the completion of the non-cash debt discount amortization in June 2006 as discussed above.

Interest expense decreased \$231,629 or 17% in fiscal 2005. The decrease in fiscal 2005 compared to fiscal 2004 resulted primarily due to the elimination of interest on a mezzanine loan from FINOVA Mezzanine Capital that was recorded in the first two months of fiscal 2004 and lower lender fees charged on our debt facilities in fiscal 2005.

Derivative income/expense represents the adjustment for the change in the fair value of the embedded derivative in our Series A convertible preferred stock, which met the criteria for bifurcation and separate accounting under SFAS No. 133. The fair value of the embedded derivative was computed based on several

factors including the underlying value of our common stock at the end of each period. For the fiscal years ended March 31, 2005 and 2004, we recorded a derivative income/(expense) of \$62,829 and (\$94,269), respectively, related to the change in the fair value of the embedded derivative instruments. There was no income or expense in fiscal 2006 because the Series A convertible preferred stock was partially converted and the remaining shares redeemed in the third quarter of fiscal 2005.

Since the conversion of our Series A convertible preferred stock could have resulted in a conversion into an indeterminable number of common shares, we determined that under the guidance in paragraph 24 of EITF 00-19, "Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled in the Company's Own Stock," we were prohibited from concluding that we had sufficient authorized and unissued shares to net-share settle any warrants or options issued to non-employees. Therefore, we reclassified to a liability the fair value of all warrants and options issued to non-employees that were outstanding during the period that the Series A convertible preferred stock was outstanding from April 2001 to October 2004. Additionally, in accordance with EITF 00-19, if a contract requires settlement in registered shares, then we may be required to record the value of the securities as a liability and/or temporary equity. Any changes in the fair value of the securities based on the Black-Scholes pricing model after the initial valuation are marked to market during reporting periods. During the fiscal years ended March 31, 2006, 2005 and 2004, we recorded a gain/(loss) on the fair value of warrants of \$388,731, 18,937 and (\$242,835), respectively, related to the change in the fair values of the warrants.

Liquidity And Capital Resources

Future Capital Needs

Our current business plan eliminates certain low margin private label and Galaxy imitation business from our sales mix. The elimination of these low margin items and the elimination of excess overhead that was part of our former manufacturing operations should continue to result in higher gross margins with lower operating costs and produce positive cash flows from operations in fiscal 2007. With the reduction in overall debt and property taxes, we expect to see annual interest savings in excess of \$800,000 in fiscal 2007. Additionally, we anticipate improved gross margins to provide over \$1 million in additional cash in fiscal 2007.

As a result of the successful refinancing of the \$2.4 million short-term notes and credit available for our receivables financing and the positive cash flow that we are currently experiencing from operations, we believe that we have sufficient cash resources to meet our current liquidity needs.

Cash Flows from Operating Activities and Investing Activities

| | | | | 2006-2005 | 2005-2004 | 2006-2005 | 2005-2004 |
|--|-------------|-------------|-------------|---------------|---------------|---------------|---------------|
| | | | | \$ | \$ | % | % |
| 12 Months Ending March 31, | 2006 | 2005 | 2004 | Change | Change | Change | Change |
| Cash from (used in) operating activities | (436,678) | 779,746 | 2,236,350 | (1,216,424) | (1,456,604) | -156.0% | -65.1% |
| Cash from (used in) investing activities | 8,547,933 | (65,002) | (231,778) | 8,612,935 | 166,776 | -13250.3% | -72.0% |
| Cash used in financing activities | (8,237,157) | (602,641) | (1,556,491) | (7,634,516) | 953,850 | 1266.8% | -61.3% |
| Net increase (decrease) in cash | (125,902) | 112,103 | 448,081 | (238,005) | (335,978) | -212.3% | -75.0% |

On December 8, 2005, we completed the sale of substantially all of our manufacturing and production equipment to Schreiber. This sale was approved by our stockholders at a Special Meeting held on December 5, 2005. The \$8,700,000 in proceeds was used to pay \$1,319,583 for tangible personal property taxes due primarily on the sold assets and \$7,374,299 to Beltway Capital Partners LLC (successor by assignment of Wachovia Bank, N.A.) for the termination of our term loan. The remaining proceeds balance of \$6,118 was used to reduce our asset-based line of credit from Textron Financial Corporation.

Cash from operating activities declined during fiscal 2006 due to higher operating expenses and the disposal costs as described under *Results of Operations*.

During fiscal 2005 and fiscal 2004, we achieved positive cash flow from operations. This was achieved mainly through higher sales volumes in fiscal 2005 and improved margins on sales fiscal 2004. In fiscal 2005, we noted a 65% decrease in cash from operating activities compared to fiscal 2004. This was primarily attributable to an approximate 17% increase in net accounts receivable associated with our increase in sales. This increase in cash used was offset by further reductions in inventory levels and increases in accounts payable. We are continually reviewing our collection practices, payment terms to vendors and inventory levels in order to maximize cash flow from operations.

Cash used in investing activities primarily relates to our purchases and sales of office and manufacturing equipment in each fiscal year. In fiscal 2006, we received over \$8.8 million in proceeds from the sale of the majority of our assets as a result of the discontinuance of our manufacturing operations. We do not anticipate any large capital expenditures during fiscal 2007.

In fiscal 2007, we expect to see improved cash from operations due to improved gross margin on sales and a reduction in overhead costs. These improved operating cash flows will be used to reduce certain related party notes payable as discussed under “*Equity Financing*” below and to continue our focused marketing investment in our branded products.

Cash Flows Used In Financing Activities

| 12 Months Ending March 31, | 2006 | 2005 | 2004 |
|---|--------------------|------------------|--------------------|
| Net borrowings (payments) on line of credit and bank overdrafts | (3,539,477) | 853,202 | (1,485,893) |
| Issuances of debt | 2,400,000 | - | 2,000,000 |
| Payments of debt and capital leases | (8,767,323) | (1,417,103) | (6,226,625) |
| Issuances of stock | 1,669,643 | 2,240,948 | 4,156,027 |
| Redemption of preferred stock | - | (2,279,688) | - |
| Cash used in financing activities | <u>(8,237,157)</u> | <u>(602,641)</u> | <u>(1,556,491)</u> |

During fiscal 2006, we used the proceeds received from the sale of our manufacturing equipment as discussed above, and proceeds received from certain related parties to pay in full our term loan to Beltway Capital Partners LLC (successor by assignment of Wachovia Bank, N.A.) and reduce our asset-based line of credit from Textron Financial Corporation. See “*Debt Financing and Equity Financing*” below for further details.

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

During fiscal 2004, we refinanced all of our credit facilities that were in existence at the end of fiscal 2003. This refinancing was accomplished through the payment of \$4,000,000 to FINOVA Mezzanine by renewing and increasing our loan with Wachovia Bank by \$2,000,000 and through \$3,850,000 in private placement equity financings. Additionally, we replaced FINOVA Capital Corporation with Textron Financial Corporation as our new asset based lender. This financial restructuring improved our operations and financial

position and reduced interest expense nearly \$1.6 million during fiscal 2004. The remaining proceeds from the refinancing were used for operations and to further reduce our accounts payable and debt balances.

Debt Financing

Line of Credit

On May 27, 2003, we obtained from Textron Financial Corporation (“Textron”) a revolving credit facility (the “Textron Loan”) with a maximum principal amount of \$7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 and subsequent amendments (the “Textron Loan Agreement”). The Textron Loan was secured by our inventory, accounts receivable and all other assets. Advances under the Textron Loan bore interest at a variable rate equal to the prime rate plus 1.75% per annum (9.5% at March 31, 2006) calculated on the average cash borrowings for the preceding month. We paid down the Textron Loan over \$3.5 million in fiscal 2006.

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

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

Due to the cost of disposal activities and impairment of property and equipment during fiscal 2006, we fell below the requirements in the fixed charge coverage ratio and the adjusted tangible net worth calculation from June 30, 2005 through September 30, 2005. Effective October 1, 2005, we executed a Fifth Amendment to the Textron Loan Agreement that provided a waiver for the defaults in the fixed charge coverage ratio and the adjusted tangible net worth requirements, in addition to certain over-advances on the Textron Loan, during the periods from June 2005 through September 2005. The Fifth Amendment amended and replaced several financial covenants, allowed eligibility for borrowing on inventory until December 31, 2005 and provided that the Textron Loan would expire at the end of the initial term on May 26, 2006. Additionally, Textron consented to the sale of our manufacturing equipment to Schreiber and terminated their liens on those assets. In exchange for the waiver and amendments, we paid a fee of \$50,000, and paid additional administrative fees as follows: \$5,000 on February 1, 2006, \$10,000 on March 1, 2006, \$15,000 on April 1, 2006 and \$20,000 May 1, 2006.

On May 26, 2006, we executed a Sixth Amendment to the Textron Loan Agreement. The Sixth Amendment provided for an extension of the Textron Loan from May 26, 2006 until June 27, 2006 and reduced the maximum principal amount which could be borrowed under the Textron Loan to \$3,000,000. In exchange for the amendment and extension, we paid a fee of \$10,000.

On June 23, 2006, we entered into a Receivables Purchase Agreement with Systran Financial Services Corporation, a subsidiary of Textron Financial Corporation (“Systran”), whereby Systran will provide financing to our Company through advances against certain trade receivable invoices due to our Company (the “Systran Agreement”). The Systran Agreement is secured by our accounts receivable and all other assets. Generally, subject to a maximum principal amount of \$3,500,000 which can be borrowed under the Systran Agreement, the amount available for borrowing is equal to 85% of our eligible accounts receivable invoices less a dilution reserve and any required fixed dollar reserves. The dilution and fixed dollar reserves

have been initially set at 7% and \$100,000, respectively. Advances under the Systran Agreement bear interest at a variable rate equal to the prime rate plus 1.5% per annum (9.5% on June 23, 2006). We paid a one-time closing fee of \$35,000 and are also obligated to pay a \$1,500 monthly service fee. The initial term of the Systran Agreement ends on June 23, 2009 and may renew automatically for consecutive twelve-month terms unless terminated sooner.

On June 23, 2006, Systran advanced \$2,379,262 under the Systran Agreement of which \$1,839,086 was used to pay in full and terminate our obligations under our line of credit with Textron Financial Corporation which was to terminate on June 27, 2006.

Term Notes Payable

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

On June 30, 2005, we entered into a Loan Modification Agreement with Wachovia regarding our term loan. The agreement modified the following terms of the loan: 1) the loan was to mature and be payable in full on July 31, 2006 instead of June 1, 2009; 2) the principal payments were to remain at \$110,000 per month with accrued interest at Wachovia’s Base Rate plus 1% instead of increasing to \$166,250 on July 1, 2005 as provided by the terms of the promissory note evidencing the loan; and 3) all covenants related to our tangible net worth, total liabilities to tangible net worth, and maximum funded debt to EBITDA ratios were waived and compliance was not required by us through the intended maturity date of the loan on July 31, 2006. In connection with the agreement, we paid \$60,000, of which \$30,000 was paid upon execution of the agreement and \$30,000 was paid on August 1, 2005.

In September 2005, Wachovia assigned this term loan to Beltway Capital Partners LLC. As discussed under the Schreiber Transactions in *Recent Material Developments* above, this loan was paid in full upon the sale of the equipment to Schreiber on December 8, 2005. Beltway received proceeds of \$7,374,299 of which \$7,361,985 was for principal and \$12,314 was for interest and associated closing costs.

Related Party Notes Payable

Pursuant to a Note and Warrant Purchase Agreement dated September 12, 2005, we received \$1,200,000 as a loan from Mr. Frederick A. DeLuca, a greater than 10% shareholder. In October 2005, pursuant to several Note and Warrant Purchase Agreements dated September 28, 2005, we received a \$600,000 loan from Conversion Capital Master, Ltd., a \$485,200 loan from SRB Greenway Capital (Q.P.), L.P., a \$69,600 loan from SRB Greenway Capital, L.P. and a \$45,200 loan from SRB Greenway Offshore Operating Fund, L.P. The combined total of these loans is \$2,400,000. The loans are evidenced by unsecured promissory notes (the “Notes”) held by the above referenced parties (the “Note Holders”). The Notes required monthly interest-only payments at 3% above the bank prime rate of interest per the Federal Reserve Bank and matured on June 15, 2006. In consideration for the Notes and in accordance with an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, we issued to Mr. DeLuca, Conversion Capital Master, Ltd., SRB Greenway Capital (Q.P.), L.P., SRB Greenway Capital, L.P., and SRB Greenway Offshore Operating Fund, L.P., warrants to purchase up to 300,000 shares, 150,000 shares, 121,300 shares, 17,400 shares, and 11,300 shares, respectively, of our common stock at an exercise price equal to \$1.53 (95% of the lowest closing price of our common stock in the sixty calendar days immediately preceding October 17, 2005). The warrants fully vested on October 17, 2005 and can be exercised on or before the expiration date of October 17, 2008. Also in consideration for the Notes, we granted the Note Holders “piggy back” registration rights with respect to the shares underlying the warrants. These shares were registered on December 30, 2005.

We recorded the \$444,731 initial fair value of the warrants, upon their issuance, as a discount to debt. This discount is being amortized from September 2005 through June 2006. We amortized \$317,752 in fiscal 2006. As of March 31, 2006, the outstanding principal balance of \$2,400,000 on the Notes less the remaining debt discount was \$2,273,021.

Since the exercise price for the warrants was not fixed until October 17, 2005, we revalued the warrants on October 17, 2005 and calculated a fair value of \$396,000. The \$48,731 difference between the initial \$444,731 value of the warrants and the value of the warrants on October 17, 2005 was recorded as a gain on fair value of warrants in the Statement of Operations.

We did not have the short-term liquidity to pay our related party Note Holders on the \$2.4 million Notes that matured on June 15, 2006 in accordance with their original terms. We received a letter on June 20, 2006 from all the Note Holders, other than Mr. DeLuca, notifying the Company that its failure to pay the amounts due and owing on the maturity date constitutes a default under \$1.2 million of the Notes held by those Note Holders. Pursuant to the terms of the Notes, since we did not cure the default within 10 days after receipt of the notice of default, we were obligated to pay interest at the default rate of 8% above the Prime Rate beginning July 1, 2006. We amortized the final \$126,979 of debt discount costs related to the above transaction in the three months ended June 30, 2006.

Pursuant to a Note Purchase Agreement dated July 19, 2006, we issued a new unsecured convertible note for \$2,685,104 (the "Convertible Note") to Mr. DeLuca. The proceeds from the Convertible Note were used to repay or refinance the above mentioned \$2.4 million Notes that matured on June 15, 2006 and a \$285,104 registration rights penalty owed to Mr. DeLuca. The Convertible Note accrues interest at 12.5% per annum. No interest or principal payments are required under the Convertible Note until its maturity in fifteen months on October 19, 2007. Principal, together with any accrued and unpaid interest, on the Convertible Note is convertible at any time prior to payment into shares of our common stock at a conversion price of \$0.35 per share. The market price of our common stock as quoted on the OTC on July 19, 2006 was \$0.28. As additional consideration for making the loan, we issued Mr. DeLuca a warrant (the "Warrant") to purchase up to 200,000 shares of our common stock at an exercise price equal to \$0.35 per share. The Warrant is fully vested and can be exercised on or before the expiration date of July 19, 2009. In July 2006, we recorded the \$18,000 fair value of the Warrant as a discount to debt that will be amortized from July 2006 through October 2007.

Equity Financing

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

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

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

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

In accordance with a registration rights agreement dated October 6, 2004 with Mr. Frederick DeLuca, we agreed that within 180 days we would file with the Securities and Exchange Commission (“SEC”) and obtain effectiveness of a registration statement that included 2,000,000 shares issued in a private placement and 500,000 shares related to a stock purchase warrant. Per the terms of the agreement, if a registration statement was not filed, or did not become effective within 180 days, then in addition to any other rights Mr. DeLuca may have, we would be required to pay certain liquidated damages. We filed a registration statement on Form S-3 on March 14, 2005. However, the registration was not declared effective until December 30, 2005. Mr. DeLuca granted an extension of time to have the registration statement declared effective by the SEC and waived all damages and remedies for failure to have an effective registration statement until September 1, 2005. From September 2, 2005 through December 29, 2005, we accrued liquidated damages of \$285,104 (2.5% times the product of 2,500,000 registerable shares and the share price of \$1.15 per share every thirty days).

Contractual Obligations

We lease our operating facilities and certain equipment under operating and capital leases, expiring at various dates through fiscal year 2010. In addition, we have several loan obligations as described in detail above. The table below summarizes the principal balances of our obligations for indebtedness and lease obligations as of March 31, 2006 in accordance with their required payment terms:

| Contractual Obligations | Payments due by fiscal period | | | | |
|--|-------------------------------|---------------------|---------------------|-------------------|--------------|
| | Total | 2007 | 2008-2009 | 2010-2011 | Thereafter |
| Textron credit facility ⁽¹⁾ | \$ 1,919,002 | \$ 1,919,002 | \$ -- | \$ -- | \$ -- |
| Related party notes payable | 2,400,000 | 2,400,000 | -- | -- | -- |
| Interest on debt facilities ⁽²⁾ | 84,134 | 84,134 | -- | -- | -- |
| Contractual employment agreements | 993,791 | 434,114 | 559,677 | -- | -- |
| Capital Lease Obligations ⁽³⁾ | 63,227 | 23,498 | 39,729 | -- | -- |
| Operating Lease Obligations ⁽⁴⁾ | 1,549,873 | 679,934 | 747,116 | 122,823 | -- |
| Total | <u>\$ 7,010,027</u> | <u>\$ 5,540,682</u> | <u>\$ 1,346,522</u> | <u>\$ 122,823</u> | <u>\$ --</u> |

(1) In accordance with EITF 95-22, “*Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that involve both a Subjective Acceleration Clause and a Lock-Box Arrangement*,” the \$1,919,002 balance owed to Textron is reflected as current on the balance sheet and in the above schedule.

(2) The Textron credit facility bears interest at prime plus 1.75% and the related party notes payable bear interest at prime plus 3%. Interest is estimated assuming that the credit facility balance will remain unchanged, all obligations are paid when due and that the prime rate will remain at its level on March 31, 2006 of 7.75%.

(3) Includes the principal and interest portion of capital lease payments to be paid.

- (4) Effective April 15, 2006 through October 31, 2006, we entered into a sublease agreement for a portion of some of our unused manufacturing and parking space whereby we expects to receive approximately \$83,901 in rental income to offset our lease payment obligations in fiscal 2007.

In addition to the foregoing contractual obligations, we have several contingent obligations under our Supply Agreement with Schreiber that could be material and adverse to us as follows:

The initial term of the Supply Agreement dated June 30, 2005 between our Company and Schreiber is for a period of five years from the effective date of September 1, 2005 and is renewable at our option for up to two additional five-year periods (for a total term of up to fifteen years). If we do not exercise our first option to extend the term, then we will be obligated to pay Schreiber \$1,500,000. If we exercise our first option to extend the term, but do not exercise our second option to extend the term, then we will be obligated to pay Schreiber \$750,000.

Additionally, the Supply Agreement provides for a contingent short-fall payment obligation by our Company if a specified production level is not met during the one-year period from September 1, 2006 to August 31, 2007. If a contingent short-fall payment is accrued after such one-year period, it may be reduced by the amount by which production levels in the one-year period from September 1, 2007 to August 31, 2008 exceeds the specified target level of production, if any. The short-fall payment is based on formula that calculates the payment as follows: $((\text{required pounds shipped} - \text{actual pounds shipped}) / \text{required pounds shipped}) * \$8,700,000$. Thus, if we did not purchase any products from Schreiber during between September 1, 2006 and August 31, 2008, the payment could be as high as \$8,700,000.

On May 22, 2003, we entered into a Master Distribution and Licensing Agreement with Fromageries Bel S.A., (“Bel”) a leading branded cheese company in Europe who is a greater than 5% stockholder in our Company. Under the agreement, we granted Bel exclusive distribution rights for our products in a territory comprised of the European Union States and to more than 21 other European countries and territories (the “Territory”). We also granted Bel the exclusive option during the term of the agreement to elect to manufacture the products designated by Bel for distribution in the Territory. The term of the agreement was ten years. The parties could mutually agree to continue operating under the agreement, to convert the agreement to a manufacturing and license agreement, or to terminate the agreement. This agreement was terminated effective July 1, 2005, pursuant to a Termination, Settlement and Release Agreement signed on July 22, 2005. In accordance with the termination agreement, we received \$150,000 from Fromageries Bel S.A.

Recent Accounting Pronouncements

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

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “*Share-Based Payment*” (“SFAS No. 123R”), which addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for (a) equity instruments of the company or (b) liabilities that are based on the fair value of the company’s equity instruments or that may be settled by the issuance of equity instruments. SFAS No. 123R supercedes APB Opinion No. 25 and amends SFAS No. 95, “*Statement of Cash Flows.*” Under SFAS No. 123R, companies are required to record compensation expense for all share-based payment award transactions measured at fair value as determined by an option valuation model.

Currently, we use the Black-Scholes pricing model to calculate the fair value of our share-based transactions. This statement is effective for fiscal years beginning after June 15, 2005. Since we currently recognize compensation expense at fair value for share-based transactions in accordance with SFAS No. 123, we do not anticipate adoption of this standard will have a significant impact on our financial position, results of operations, or cash flows.

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

In May 2005, the FASB issued SFAS No. 154, “*Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and SFAS No. 3.*” SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and a change required by an accounting pronouncement when the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application of changes as if the new accounting principle had always been used. SFAS No. 154 is effective for fiscal years beginning after December 15, 2005. We believe that the adoption of this standard will not have a significant impact on our financial position, results of operations or cash flows.

In February 2006, the FASB issued SFAS No. 155, “*Accounting for Certain Hybrid Financial Instruments – An Amendment of FASB Statements No. 133 and 140.*” SFAS No. 155 provides entities with relief from having to separately determine the fair value of an embedded derivative that would otherwise be required to be bifurcated from its host contract in accordance with SFAS No. 133. It also allows an entity to make an irrevocable election to measure such a hybrid financial instrument at fair value in its entirety, with changes in fair value recognized in earnings. SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring for fiscal years beginning after September 15, 2006. We believe that the adoption of this standard will not have a significant impact on our financial position, results of operations or cash flows.

Changes in Accountants

On July 18, 2006, the Board selected Cross, Fernandez & Riley, LLP (“CFR”), an independent member of the BDO Seidman Alliance network of firms, as the new independent accountant to audit the registrant’s financial statements. Certain employees of CFR were previously contracted by BDO Seidman, LLP (our former independent accountant) to perform audit work on the Company for the fiscal years ended March 31, 2006 and 2005. Approximately 55% and 75% of the total hours spent by the auditors in carrying out the audit of the Company’s financial statements for the fiscal years ended March 31, 2006 and 2005, respectively, were spent by CFR. All audit work conducted by CFR was reviewed by BDO Seidman. Other than communications in connection with the audit work performed by CFR for these periods and prior to July 18, 2006, there were no discussions between the Company and CFR regarding the application of accounting principles to specific completed or contemplated transactions, or the type of audit opinion that might be rendered on the Company’s financial statements. Furthermore, other than communications in connection with the audit work performed by CFR, no written or oral advice was provided by CFR that was an important factor considered by the Company in reaching a decision as to any accounting, auditing or financial reporting issue. Other than in connection with the audit work for the fiscal years ended March 31, 2006 and 2005, the Company has not consulted with CFR regarding any matter that was either the subject of a disagreement (as defined in paragraph (a)(1)(iv) of Item 304 of Regulation S-K and the related instructions to this item) or a reportable event (as described in paragraph (a)(1)(v) of Item 304 of Regulation S-K).

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk results primarily from fluctuations in interest rates. The interest rates on our outstanding debts as of March 31, 2006, to Textron and our related party Note Holders 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, 2006 with respect to our debt as of such date would increase or decrease interest expense and hence reduce or increase the net income of our Company by approximately \$43,200 per year or \$10,800 per quarter.

Our sales during the fiscal years ended March 31, 2006, 2005 and 2004, which were denominated in a currency other than U.S. Dollars, were less than 5% of gross sales and no net assets were maintained in a functional currency other than U. S. Dollars during such periods. Therefore, while we believe that the effects of changes in foreign currency exchange rates have not historically been significant to our operations or net assets, we are unable to forecast the effects that foreign currency exchange rates may have on our future operations.

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Registered Public Accounting Firm



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, 2006 and 2005 and the related statements of operations, stockholders' equity (deficit) and cash flows for each of the three years in the period ended March 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Galaxy Nutritional Foods, Inc. as of March 31, 2006 and 2005 and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company is in default of its notes payable, has suffered recurring losses from operations and, at March 31, 2006, has deficiencies in working capital and equity that raise substantive doubt as to its ability to continue as a going concern. Management's plan in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

BDO Seidman, LLP

BDO Seidman, LLP

Atlanta, Georgia
July 13, 2006

GALAXY NUTRITIONAL FOODS, INC.
Balance Sheets

| | Notes | MARCH 31, 2006 | MARCH 31, 2005 |
|--|---------------|-------------------|-------------------|
| ASSETS | | | |
| CURRENT ASSETS: | | | |
| Cash | | \$ 435,880 | \$ 561,782 |
| Trade receivables, net of allowance for doubtful accounts of \$1,769,000 and \$2,299,000 | 2 | 4,018,806 | 4,644,364 |
| Inventories | 3 | 273,528 | 3,811,470 |
| Prepaid expenses and other | | 70,717 | 219,592 |
| Total current assets | | 4,798,931 | 9,237,208 |
| PROPERTY AND EQUIPMENT, NET | 4,9,10 | 226,349 | 18,246,445 |
| ASSETS HELD FOR SALE | 4,10 | 61,950 | -- |
| OTHER ASSETS | | 162,840 | 286,013 |
| TOTAL | | \$ 5,250,070 | \$ 27,769,666 |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | | |
| CURRENT LIABILITIES: | | | |
| Line of credit | 5 | \$ 1,919,002 | \$ 5,458,479 |
| Accounts payable | | 2,665,963 | 3,057,266 |
| Accrued disposal costs | 9 | 480,404 | -- |
| Accrued and other current liabilities | 6 | 542,811 | 2,130,206 |
| Related party notes payable | 5 | 2,273,021 | -- |
| Current portion of accrued employment contracts | 7 | 434,114 | 586,523 |
| Current portion of term notes payable | 5 | -- | 1,320,000 |
| Current portion of obligations under capital leases | 7 | 20,231 | 194,042 |
| Total current liabilities | | 8,335,546 | 12,746,516 |
| ACCRUED EMPLOYMENT CONTRACTS , less current portion | 7 | 559,677 | 993,305 |
| TERM NOTES PAYABLE , less current portion | 5 | -- | 6,921,985 |
| OBLIGATIONS UNDER CAPITAL LEASES , less current portion | 7 | 37,507 | 85,337 |
| Total liabilities | | 8,932,730 | 20,747,143 |
| COMMITMENTS AND CONTINGENCIES | 7,9 | -- | -- |
| TEMPORARY EQUITY: | | | |
| Common stock, subject to registration, \$.01 par value; 2,000,000 shares issued and outstanding | 6 | -- | 2,220,590 |
| STOCKHOLDERS' EQUITY (DEFICIT): | | | |
| Common stock, \$.01 par value; authorized 85,000,000 shares; 20,054,623 and 16,411,474 shares issued | | 200,546 | 164,115 |
| Additional paid-in capital | | 71,345,556 | 65,838,227 |
| Accumulated deficit | | (72,456,301) | (48,307,748) |
| | | (910,199) | 17,694,594 |
| Less: Notes receivable arising from the exercise of stock options | 7 | (2,652,000) | (12,772,200) |
| Treasury stock, 30,443 shares, at cost | | (120,461) | (120,461) |
| Total stockholders' equity (deficit) | | (3,682,660) | 4,801,933 |
| TOTAL | | \$ 5,250,070 | \$ 27,769,666 |

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
Statements of Operations

| Fiscal Years Ended March 31, | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|------------------------|-----------------------|-----------------------|
| NET SALES | \$ 37,775,862 | \$ 44,510,487 | \$ 36,176,961 |
| COST OF GOODS SOLD | <u>28,142,732</u> | <u>34,736,594</u> | <u>24,864,289</u> |
| Gross margin | <u>9,633,130</u> | <u>9,773,893</u> | <u>11,312,672</u> |
| OPERATING EXPENSES: | | | |
| Selling | 5,571,097 | 5,148,426 | 4,981,996 |
| Delivery | 2,251,318 | 2,307,166 | 1,877,682 |
| Employment contract expense-general and administrative (Note 7) | -- | 444,883 | 1,830,329 |
| General and administrative, including \$926,263, \$409,746 and \$651,273 non-cash compensation related to stock based transactions (Note 8) | 4,750,624 | 4,380,436 | 3,954,303 |
| Research and development | 321,016 | 309,054 | 260,410 |
| Reserve on stockholder note receivable (Note 7) | 10,120,200 | -- | -- |
| Cost of disposal activities (Note 9) | 1,646,490 | -- | -- |
| Impairment of equipment (Note 10) | 7,896,554 | -- | -- |
| (Gain) loss on disposal of assets (Note 10) | <u>(3,628)</u> | <u>(4,500)</u> | <u>8,519</u> |
| Total operating expenses | <u>32,553,671</u> | <u>12,585,465</u> | <u>12,913,239</u> |
| LOSS FROM OPERATIONS | <u>(22,920,541)</u> | <u>(2,811,572)</u> | <u>(1,600,567)</u> |
| OTHER INCOME (EXPENSE): | | | |
| Interest expense | (1,616,743) | (1,129,977) | (1,361,606) |
| Derivative income (expense) | -- | 62,829 | (94,269) |
| Gain (loss) on fair value of warrants (Note 8) | 388,731 | 18,937 | (242,835) |
| Total other income (expense) | <u>(1,228,012)</u> | <u>(1,048,211)</u> | <u>(1,698,710)</u> |
| NET LOSS | \$ (24,148,553) | \$ (3,859,783) | \$ (3,299,277) |
| Less: | | | |
| Preferred Stock Dividends (Note 8) | -- | 82,572 | 201,791 |
| Preferred Stock Accretion to Redemption Value (Note 8) | <u>--</u> | <u>319,500</u> | <u>1,256,019</u> |
| NET LOSS TO COMMON STOCKHOLDERS | <u>\$ (24,148,553)</u> | <u>\$ (4,261,855)</u> | <u>\$ (4,757,087)</u> |
| BASIC AND DILUTED NET LOSS PER COMMON SHARE (Note 12) | <u>\$ (1.23)</u> | <u>\$ (0.25)</u> | <u>\$ (0.32)</u> |

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

| | Common Stock | | Additional Paid-In Capital | Accumulated Deficit | Notes Receivable for Common Stock | Treasury Stock | Total |
|---|--------------|------------|-------------------------------|------------------------|---|-------------------|----------------|
| | Shares | Par Value | | | | | |
| Balance at March 31, 2003 | 12,761,685 | \$ 127,617 | \$ 59,018,430 | \$ (41,148,688) | \$ (12,772,200) | \$ (120,461) | \$ 5,104,698 |
| Exercise of options | 7,911 | 79 | 16,138 | -- | -- | -- | 16,217 |
| Exercise of warrants | 200,000 | 2,000 | 358,000 | -- | -- | -- | 360,000 |
| Issuance of common stock under employee stock purchase plan | 16,339 | 163 | 28,364 | -- | -- | -- | 28,527 |
| Issuance of common stock | 2,211,478 | 22,115 | 3,929,242 | -- | -- | -- | 3,951,357 |
| Conversion of preferred stock | 459,908 | 4,599 | 794,921 | -- | -- | -- | 799,520 |
| Fair value of stock-based transactions | -- | -- | 491,308 | -- | -- | -- | 491,308 |
| Non-cash compensation related to variable securities | -- | -- | 8,001 | -- | -- | -- | 8,001 |
| Dividends on preferred stock | -- | -- | (201,791) | -- | -- | -- | (201,791) |
| Accretion of discount on preferred stock | -- | -- | (503,970) | -- | -- | -- | (503,970) |
| Net loss | -- | -- | -- | (3,299,277) | -- | -- | (3,299,277) |
| Balance at March 31, 2004 | 15,657,321 | 156,573 | 63,938,643 | (44,447,965) | (12,772,200) | (120,461) | 6,754,590 |
| Exercise of options | 13,893 | 139 | 18,717 | -- | -- | -- | 18,856 |
| Issuance of common stock under employee stock purchase plan | 18,894 | 189 | 23,813 | -- | -- | -- | 24,002 |
| Costs associated with issuance of common stock | -- | -- | (22,500) | -- | -- | -- | (22,500) |
| Conversion of preferred stock | 721,366 | 7,214 | 840,215 | -- | -- | -- | 847,429 |
| Fair value of stock-based transactions | -- | -- | 83,224 | -- | -- | -- | 83,224 |
| Non-cash compensation related to variable securities | -- | -- | 215,649 | -- | -- | -- | 215,649 |
| Dividends on preferred stock | -- | -- | (82,572) | -- | -- | -- | (82,572) |
| Accretion of discount on preferred stock | -- | -- | 823,038 | -- | -- | -- | 823,038 |
| Net loss | -- | -- | -- | (3,859,783) | -- | -- | (3,859,783) |
| Balance at March 31, 2005 | 16,411,474 | \$ 164,115 | \$ 65,838,227 | \$ (48,307,748) | \$ (12,772,200) | \$ (120,461) | \$ 4,801,933 |
| Exercise of options | 2,250 | 22 | 2,858 | -- | -- | -- | 2,880 |
| Exercise of warrants | 1,130,000 | 11,300 | 1,257,700 | -- | -- | -- | 1,269,000 |
| Issuance of common stock under employee stock purchase plan | 10,899 | 109 | 15,344 | -- | -- | -- | 15,453 |
| Transfer of common stock from temporary equity | 2,500,000 | 25,000 | 2,577,900 | -- | -- | -- | 2,602,900 |
| Fair value of stock-based transactions | -- | -- | 1,846,083 | -- | -- | -- | 1,846,083 |
| Non-cash compensation related to variable securities | -- | -- | (192,556) | -- | -- | -- | (192,556) |
| Reserve on stockholder note receivable | -- | -- | -- | -- | 10,120,200 | -- | 10,120,200 |
| Net loss | -- | -- | -- | (24,148,553) | -- | -- | (24,148,553) |
| Balance at March 31, 2006 | 20,054,623 | \$ 200,546 | \$ 71,345,556 | \$ (72,456,301) | \$ (2,652,000) | \$ (120,461) | \$ (3,682,660) |

See accompanying notes to financial statements

GALAXY NUTRITIONAL FOODS, INC.
Statements of Cash Flows

| Fiscal Years Ended March 31, | 2006 | 2005 | 2004 |
|--|--------------------|-------------------|--------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: (Note 13) | | | |
| Net Loss | \$ (24,148,553) | \$ (3,859,783) | \$ (3,299,277) |
| Adjustments to reconcile net loss to net cash from (used in) operating activities: | | | |
| Depreciation and amortization | 1,517,287 | 2,172,566 | 2,205,053 |
| Amortization of debt discount and financing costs | 675,886 | 116,522 | 236,321 |
| Provision for promotional deductions and losses on trade receivables (Note 2) | 1,485,266 | 1,666,000 | (221) |
| Provision for loss on stockholder note receivable (Note 7) | 10,120,200 | -- | -- |
| Derivative (income) expense | -- | (62,829) | 94,269 |
| (Gain) loss on fair value of warrants | (388,731) | (18,937) | 242,835 |
| Non-cash compensation related to stock-based transactions (Note 8) | 926,263 | 409,746 | 651,273 |
| (Gain) loss on disposal of assets (Note 10) | 7,892,926 | (4,500) | 8,519 |
| (Increase) decrease in: | | | |
| Trade receivables | (859,708) | (2,346,166) | 999,049 |
| Inventories | 3,537,942 | 821,373 | 661,657 |
| Prepaid expenses and other | 148,875 | 46,709 | 189,012 |
| Increase (decrease) in: | | | |
| Accounts payable | (391,303) | 1,790,920 | (1,426,143) |
| Accrued and other liabilities | (953,028) | 48,125 | 1,674,003 |
| NET CASH FROM (USED IN) OPERATING ACTIVITIES | (436,678) | 779,746 | 2,236,350 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchase of property and equipment | (294,236) | (104,339) | (221,585) |
| Proceeds from sale of equipment | 8,842,169 | 4,500 | -- |
| (Increase) decrease in other assets | -- | 34,837 | (10,193) |
| NET CASH FROM (USED IN) INVESTING ACTIVITIES | 8,547,933 | (65,002) | (231,778) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Decrease in book overdrafts | -- | -- | (1,151,276) |
| Net borrowings (payments) on line of credit | (3,539,477) | 853,202 | (334,617) |
| Borrowings on term notes payable | 2,400,000 | -- | 2,000,000 |
| Repayments on term notes payable | (8,241,985) | (1,140,000) | (1,572,760) |
| Repayments on subordinated note payable | -- | -- | (4,000,000) |
| Financing costs for long term debt | (303,697) | (37,500) | (288,230) |
| Principal payments on capital lease obligations | (221,641) | (239,603) | (365,635) |
| Proceeds from exercise of common stock options | 2,880 | 18,856 | 16,217 |
| Proceeds from exercise of common stock warrants, net of costs | 1,651,310 | -- | 360,000 |
| Proceeds from issuance of common stock under employee stock purchase plan | 15,453 | 24,002 | 28,527 |
| Proceeds from issuance of common stock, net of costs | -- | 2,198,090 | 3,751,283 |
| Redemption of preferred stock | -- | (2,279,688) | -- |
| NET CASH FROM (USED IN) FINANCING ACTIVITIES | (8,237,157) | (602,641) | (1,556,491) |
| NET INCREASE (DECREASE) IN CASH | (125,902) | 112,103 | 448,081 |
| CASH, BEGINNING OF YEAR | 561,782 | 449,679 | 1,598 |
| CASH, END OF YEAR | \$ 435,880 | \$ 561,782 | \$ 449,679 |

See accompanying notes to financial statements.

GALAXY NUTRITIONAL FOODS, INC. NOTES TO FINANCIAL STATEMENTS

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

Nature of Business and Going Concern

Galaxy Nutritional Foods, Inc. (the "Company") is principally engaged in developing and globally marketing plant-based cheese and dairy alternatives, as well as processed organic cheese and cheese food to grocery and natural foods retailers, mass merchandisers and foodservice accounts. The Company is dedicated to developing nutritious products to meet the taste and dietary needs of today's increasingly health conscious consumers. These products are sold throughout the United States and internationally to customers in the retail and food service markets. The Company's headquarters are located in Orlando, Florida.

During fiscal 2006, the Company transitioned its manufacturing and distribution operations to an outside supplier. In November 2005, Schreiber Foods, Inc., a Wisconsin corporation ("Schreiber"), began manufacturing and distributing substantially all of the Company's products in accordance with a Supply Agreement that was signed on June 30, 2005. The prices for such products are based on cost plus a processing fee as determined by the parties from time to time. Additionally, in December 2005, the Company sold substantially all of its manufacturing and production equipment to Schreiber for \$8,700,000 in cash pursuant to an Asset Purchase Agreement dated June 30, 2005.

The Company has incurred substantial losses in recent years and, as a result, has a stockholders deficit of \$3,682,660 as of March 31, 2006. Losses for the years ended March 31, 2006, 2005 and 2004 were \$24,148,553, \$3,859,783 and \$3,299,277, respectively. The Company's ability to continue as a going concern depends upon successfully obtaining sufficient cash resources to refinance its \$2.4 million of unsecured related party notes payable that matured on June 15, 2006 (See Note 5) and obtaining positive cash flow from operations to sustain normal business operations. The accompanying financial statements have been prepared on a going concern basis, which assumes continuity of operations and realization of assets and liabilities in the ordinary course of business. The financial statements do not include any adjustments that might result if the Company was forced to discontinue its operations.

The Company's current business plan eliminates certain low margin private label and Galaxy imitation business from its sales mix. The elimination of these low margin items and the elimination of excess overhead that was part of the Company's former manufacturing operations should result in higher gross margins with lower operating costs in fiscal 2007 and produce positive cash flows from operations. However, the expected improvement in cash flows from operations will not be sufficient to repay the short-term notes without additional financing. Management is currently negotiating with the existing note holders and other parties regarding extending the maturity of the notes, refinancing the notes and/or converting all or a portion of the notes into equity. There can be no assurance that the Company will be successful in its business plan, its negotiations with the existing note holders and other parties or that the terms of any such refinancing or conversions will not result in the issuance, or potential issuance, of a significant amount of equity securities that will cause substantial dilution to the Company's stockholders. If the Company is not successful in refinancing the \$2.4 million in short-term notes or in otherwise entering into a financing, sale, or business transaction that infuses sufficient cash resources into the Company in the near future, any collection actions by the existing note holders could have a material adverse effect on the liquidity and financial condition of the Company or its ability to secure additional financing.

Cash

Periodically, the Company maintains cash in financial institutions in excess of amounts insured by the federal government. The Company has not experienced any losses on such accounts.

Accounts Receivable

Accounts receivable are customer obligations due under normal trade terms. The Company evaluates the collectibility of its accounts receivable using 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. Prior to November 2005, the cost elements included in inventories were direct material costs, direct labor and overhead allocations. Material cost consisted of the cost of ingredients and packaging that go into the production of the item. Labor consisted of the wages for those employees directly making the item. Overhead was applied to inventory units based on the normal capacity of the production facilities and consisted of factory overhead costs such as indirect labor, benefits, supplies, repairs, depreciation and utilities expended during the production process. As of March 31, 2006, the cost elements included in inventories only consist of direct material costs.

Property and Equipment

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

Revenue Recognition

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

Marketing and Advertising

The Company expenses the production costs of advertising the first time the advertising takes place and expenses slotting fees and direct response advertising costs in the period incurred. Advertising expense was approximately \$1,331,000, \$1,539,000 and \$910,000 during the fiscal years ended March 31, 2006, 2005 and 2004, respectively.

Shipping and Handling Costs

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

Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standard ("SFAS") No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*," the Company evaluates the carrying value of long-lived assets when circumstances indicate the carrying value of those assets may not be fully recoverable. The Company evaluates recoverability of long-lived assets held for use by comparing the net carrying value of an asset group to the estimated undiscounted cash flows (excluding interest) during the remaining life of the asset group. If such an evaluation indicates that the future undiscounted cash flows of certain long-lived asset groups are not sufficient to recover the carrying value of such asset groups, the assets are then adjusted to their fair values. The Company recorded an impairment of property and equipment in the first quarter of fiscal 2006 as discussed more fully in Note 10.

Disposal Costs

The Company has recorded accruals in connection with the asset sale and outsourcing arrangements with Schreiber. These accruals include estimates pertaining to employee termination costs and abandonment of excess equipment and facilities and other potential costs. Actual costs may differ from these estimates or the Company's estimates may change. In accordance with SFAS No. 146, "*Accounting for Costs Associated with Exit or Disposal Activities*," costs associated with restructuring activities are recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. Given the significance and complexity of these activities, and the

timing of the execution of such activities, the accrual process involves periodic reassessments of estimates made at the time the original decisions were made, including evaluating estimated employment terms, contract cancellation charges and real estate market conditions for sub-lease rents. The Company will continually evaluate the adequacy of the remaining liabilities under its restructuring initiatives. Although the Company believes that these estimates accurately reflect the costs of its activities, actual results may differ, thereby requiring the Company to record additional provisions or reverse a portion of such provisions.

Stock Based Compensation

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

Effective April 1, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," and applies SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure," prospectively to all employee awards granted on or after April 1, 2003. These standards require the Company to provide pro-forma information regarding net income (loss) and earnings (loss) per share amounts as if compensation cost for all the Company's employee and director stock-based awards had been determined in accordance with the fair value method prescribed in SFAS No. 123. Awards from the Company's plans vest over periods ranging from immediate to five years. Therefore, the cost related to stock-based compensation included in the determination of net income for the periods is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS No. 123.

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

| Fiscal Years Ended | March 31, 2006 | March 31, 2005 | March 31, 2004 |
|--------------------------|----------------|----------------|----------------|
| Dividend Yield | None | None | None |
| Volatility | 11% to 46% | 45% to 46% | 41% to 45% |
| Risk Free Interest Rate | 3.35% to 4.30% | 3.38% to 4.12% | 2.01% to 4.28% |
| Expected Lives in Months | 1 to 120 | 60 to 120 | 36 to 120 |

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

| Fiscal Years Ended | March 31, 2006 | March 31, 2005 | March 31, 2004 |
|--|---------------------|--------------------|-----------------------|
| Net loss to common stockholders as reported | \$ (24,148,553) | \$ (4,261,855) | \$ (4,757,087) |
| Add: Stock-based compensation expense included in reported net income | 926,263 | 409,746 | 651,273 |
| Deduct: Stock-based compensation expense determined under fair value based method for all awards | (966,456) | (519,024) | (1,070,997) |
| Pro forma net loss to common stockholders | <u>(24,188,746)</u> | <u>(4,371,133)</u> | <u>\$ (5,176,811)</u> |
| Net loss per common share: | | | |
| Basic & diluted – as reported | <u>\$ (1.23)</u> | <u>\$ (0.25)</u> | <u>\$ (0.32)</u> |
| Basic & diluted – pro forma | <u>\$ (1.23)</u> | <u>\$ (0.26)</u> | <u>\$ (0.35)</u> |

Net Income (Loss) per Common Share

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

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, reserve on stockholder note receivable, provision for obsolete inventory, valuation of deferred taxes, valuation of compensation expense on options and warrants, and accruals for disposal costs. 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 sells to customers throughout the United States and 14 other countries.

Recent Accounting Pronouncements

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

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

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

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

In February 2006, the FASB issued SFAS No. 155, *"Accounting for Certain Hybrid Financial Instruments – An Amendment of FASB Statements No. 133 and 140."* SFAS No. 155 provides entities with relief from having to separately determine the fair value of an embedded derivative that would otherwise be required to be bifurcated from its host contract in accordance with SFAS No. 133. It also allows an entity to make an irrevocable election to measure such a hybrid financial instrument at fair value in its entirety, with changes in fair value recognized in

earnings. SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring for fiscal years beginning after September 15, 2006. The Company believes that the adoption of this standard will not have a significant impact on its financial position, results of operations or cash flows.

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.

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, 2006.

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

(2) Schedule of Valuation Account

| | Balance at Beginning of Year | Charged to Costs and Expenses | Write-Offs, Retirements and Collections | Balance at End of Year |
|------------------------------------|------------------------------------|-------------------------------------|---|---------------------------|
| Fiscal Years Ended March 31, 2004: | | | | |
| Allowance for trade receivables | \$ 633,221 | \$ 2,433,458 | \$ (2,433,679) | \$ 633,000 |
| Fiscal Years Ended March 31, 2005: | | | | |
| Allowance for trade receivables | \$ 633,000 | \$ 2,477,931 | \$ (811,931) | \$ 2,299,000 |
| Fiscal Years Ended March 31, 2006: | | | | |
| Allowance for trade receivables | \$ 2,299,000 | \$ 4,087,750 | \$ (4,617,750) | \$ 1,769,000 |

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 fiscal years ended March 31, 2006, 2005 and 2004, the Company recorded an expense of \$427,271, \$1,609,134, and \$59,908, respectively related to bad debt. For those years, the bad debt expense was approximately 1.1%, 3.6% and 0.2% of net sales, respectively.

(3) Inventories

Inventories are summarized as follows:

| | March 31, 2006 | March 31, 2005 |
|----------------|-------------------|---------------------|
| Raw materials | \$ 38,986 | \$ 1,451,588 |
| Finished goods | 234,542 | 2,359,882 |
| Total | <u>\$ 273,528</u> | <u>\$ 3,811,470</u> |

(4) **Property and Equipment**

Property and equipment are summarized as follows:

| | <u>Useful Lives</u> | <u>March 31, 2006</u> | <u>March 31, 2005</u> |
|--|---------------------|-----------------------|-----------------------|
| Leasehold improvements | 10-25 years | \$ 89,079 | \$ 3,254,805 |
| Machinery and equipment | 3-20 years | 1,034,447 | 28,139,177 |
| Equipment under capital leases | 7-10 years | -- | 923,255 |
| Construction in progress | | -- | 112,649 |
| | | <u>1,123,526</u> | <u>32,429,886</u> |
| Less accumulated depreciation and amortization | | <u>897,177</u> | <u>14,183,441</u> |
| Property and equipment, net | | <u>\$ 226,349</u> | <u>\$ 18,246,445</u> |

The Company has reclassified its remaining fixed assets available for sale as Assets Held for Sale in the Balance Sheet and expects it will sell these remaining assets by September 2006. The Company has estimated the fair value of these assets to be \$61,950. Any difference between the actual proceeds received and this estimated fair value will be recognized as a gain or loss on the sale of assets in the period that they are sold.

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

Line of Credit

On May 27, 2003, the Company obtained from Textron Financial Corporation (“Textron”) a revolving credit facility (the “Textron Loan”) with a maximum principal amount of \$7,500,000 pursuant to the terms and conditions of a Loan and Security Agreement dated May 27, 2003 and subsequent amendments (the “Textron Loan Agreement”). The Textron Loan is secured by the Company’s inventory, accounts receivable and all other assets. Generally, subject to the maximum principal amount which can be borrowed under the Textron Loan and certain reserves that must be maintained during the term of the Textron Loan, the amount available under the Textron Loan for borrowing by the Company from time to time is equal to the sum of (i) 85% of the net amount of its eligible accounts receivable plus (ii) until December 31, 2005, 60% of the Company’s eligible inventory not to exceed \$3,500,000. After December 31, 2005, there was no borrowing available on inventory since it is not produced or held by the Company. Advances under the Textron Loan bear interest at a variable rate, adjusted on the first (1st) day of each month, equal to the prime rate plus 1.75% per annum (9.50% at March 31, 2006) calculated on the average cash borrowings for the preceding month. As of March 31, 2006, the outstanding principal balance on the Textron Loan was \$1,919,002.

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

On June 16, 2005, the Company used a portion of the proceeds from the warrant exercises described in Note 8 to satisfy the \$750,000 over-advance with Textron. In connection with the satisfaction of the over-advance, the Company agreed to immediately terminate Textron’s obligation to permit any over-advances under the Textron Loan, which obligation was to expire on July 31, 2005. With the termination of the over-advance facility, the interest rate on the Textron Loan returned to its prior level of Prime plus 1.75%.

Due to the cost of disposal activities and impairment of property and equipment (as discussed in Notes 9 and 10), the Company fell below the requirements in the fixed charge coverage ratio and the adjusted tangible net worth calculation from June 30, 2005 through September 30, 2005. Effective October 1, 2005, the Company executed a Fifth Amendment to the Textron Loan Agreement that provided a waiver for the defaults in the fixed charge coverage ratio and the adjusted tangible net worth requirements, in addition to certain over-advances on the Textron Loan, during the periods from June 2005 through September 2005. The Fifth Amendment amended and replaced several financial covenants, allowed eligibility for borrowing on inventory until December 31, 2005 and provides that the Textron Loan would expire at the end of the initial term on May 26, 2006. Additionally, Textron

consented to the sale of the Company's manufacturing equipment to Schreiber and the terminated their liens on those assets. In exchange for the waiver and amendments, the Company immediately paid a fee of \$50,000, and paid additional administration fees as follows: \$5,000 on February 1, 2006, \$10,000 on March 1, 2006, \$15,000 on April 1, 2006 and \$20,000 May 1, 2006.

On May 26, 2006, the Company executed a Sixth Amendment to the Textron Loan Agreement. The Sixth Amendment provided for an extension of the Textron Loan from May 26, 2006 until June 27, 2006 and reduced the maximum principal amount which could be borrowed under the Textron Loan to \$3,000,000. In exchange for the amendment and extension, the Company agreed to pay a fee of \$25,000 of which \$10,000 is to be paid immediately and \$15,000 is to be paid upon the termination date. If the Company refinances the Textron Loan with Textron or an affiliate of Textron, it will not be required to pay the \$15,000 fee upon termination.

The Company paid in full the Textron Loan and terminated its obligations under the Textron Loan Agreement on June 23, 2006 as further detailed in Note 19.

Term Notes Payable

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

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

In September 2005, Wachovia assigned this term loan to Beltway Capital Partners LLC. This loan was paid in full upon the sale of the equipment to Schreiber in December 2005. Beltway received proceeds of \$7,374,299 of which \$7,361,985 was for principal and \$12,314 was for interest and associated closing costs.

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

Related Party Notes Payable

Pursuant to a Note and Warrant Purchase Agreement dated September 12, 2005, the Company received \$1,200,000 as a loan from Mr. Frederick A. DeLuca, a greater than 10% shareholder. In October 2005, pursuant to several Note and Warrant Purchase Agreements dated September 28, 2005, the Company received a \$600,000 loan from Conversion Capital Master, Ltd., a \$485,200 loan from SRB Greenway Capital (Q.P.), L.P., a \$69,600 loan from SRB Greenway Capital, L.P. and a \$45,200 loan from SRB Greenway Offshore Operating Fund, L.P. The combined total of these loans is \$2,400,000. The loans are evidenced by unsecured promissory notes (the "Notes") held by the above referenced parties (the "Note Holders"). The Notes require monthly interest-only payments at 3% above the bank prime rate of interest per the Federal Reserve Bank and matured on June 15, 2006. In consideration for the Notes and in accordance with an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, the Company issued to Mr. DeLuca, Conversion Capital Master, Ltd., SRB Greenway Capital (Q.P.), L.P., SRB Greenway Capital, L.P., and SRB Greenway Offshore Operating Fund, L.P., warrants to purchase up to 300,000 shares, 150,000 shares, 121,300 shares, 17,400 shares, and 11,300 shares, respectively, of the Company's common stock at an exercise price equal to \$1.53 (95% of the lowest closing price of the Company's common stock in the sixty calendar days immediately preceding October 17, 2005). The

warrants fully vested on October 17, 2005 and can be exercised on or before the expiration date of October 17, 2008. Also in consideration for the Notes, the Company granted the Note Holders “piggy back” registration rights with respect to the shares underlying the warrants. These shares were registered on December 30, 2005.

The Company does not currently have the short-term liquidity to pay its related party Note Holders on the \$2.4 million Notes that matured on June 15, 2006 in accordance with their original terms. The Company received a letter on June 20, 2006 from all of the Note Holders, other than Mr. DeLuca, notifying the Company that its failure to pay the amounts due and owing on the maturity date constitutes a default under \$1.2 million of the Notes held by those Note Holders. Pursuant to the terms of the Notes, since the Company did not cure the default within 10 days after receipt of the notice of default, it is obligated to pay interest at the default rate of 8% above the Prime Rate. The Company is negotiating with the Note Holders regarding extending the maturity of the Notes, refinancing the Notes and/or converting all or a portion of the Notes into equity. There can be no assurance that the Company will be successful in its negotiations with the Note Holders or that the terms of any such refinancing or conversions will not result in the issuance, or potential issuance, of a significant amount of equity securities. In the event the Company is not successful, any collection actions by the Note Holders could have a material adverse affect on the liquidity and financial condition of the Company or its ability to secure additional financing. Additionally, it is unlikely that the Company would be able to continue as a going concern.

The Company recorded the \$444,731 initial fair value of the warrants, upon their issuance, as a discount to debt. This discount is being amortized from September 2005 through June 2006. The Company amortized \$317,752 in the fiscal year ended March 31, 2006. As of March 31, 2006, the outstanding principal balance of \$2,400,000 on the Notes less the remaining debt discount is \$2,273,021.

Since the exercise price for the warrants was not fixed until October 17, 2005, the Company revalued the warrants on October 17, 2005 and calculated a fair value of \$396,000. The \$48,731 difference between the initial \$444,731 value of the warrants and the value of the warrants on October 17, 2005 was recorded as a gain on fair value of warrants in the Statement of Operations.

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.

Other

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

On September 30, 1999, the Company obtained a \$4 million subordinated loan from FINOVA Mezzanine to finance additional working capital and capital improvement needs. This loan was paid in full as of May 30, 2003 by the proceeds from the new loan from Wachovia Bank, as discussed above, and from the equity proceeds raised in the private placements in May 2003, as discussed in Note 8.

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

Accrued and other current liabilities are summarized as follows:

| | <u>March 31, 2006</u> | <u>March 31, 2005</u> |
|----------------------------------|-----------------------|-----------------------|
| Tangible personal property taxes | \$ -- | \$ 1,049,841 |
| Warrant liability | -- | 740,000 |
| Registration rights penalty | 285,104 | -- |
| Other | <u>257,707</u> | <u>340,365</u> |
| Total | <u>\$ 542,811</u> | <u>\$ 2,130,206</u> |

In accordance with a registration rights agreement dated October 6, 2004, the Company agreed that within 180 days it would file with the Securities and Exchange Commission (“SEC”) and obtain effectiveness of a registration statement that included 2,000,000 shares issued in a private placement and 500,000 shares related to a stock purchase warrant. Per the terms of the agreement, if a registration statement was not filed, or did not become effective within 180 days, then in addition to any other rights the investor may have, the Company would be required to pay certain liquidated damages. The Company filed a registration statement on Form S-3 on March 14, 2005. However, the registration was not declared effective until December 30, 2005. The investor granted an extension of time to have the registration statement declared effective by the SEC and waived all damages and remedies for failure to have an effective registration statement until September 1, 2005. From September 2, 2005 through December 29, 2005, the Company accrued liquidated damages of \$285,104 (2.5% times the product of 2,500,000 registerable shares and the share price of \$1.15 per share every thirty days).

In accordance with Emerging Issues Task Force (“EITF”) Issue 00-19 “*Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled in the Company’s Own Stock,*” and EITF 05-04 “*The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF 00-19,*” because the maximum potential liquidated damages as described above may be greater than the difference in fair values between registered and unregistered shares, the value of the common stock subject to registration was classified as temporary equity. The Company recorded the \$2,220,590 value of common stock subject to registration as temporary equity as of March 31, 2005. Additionally, in accordance with EITF 00-19 and the terms of the above warrant for 500,000 shares of common stock, the fair value of the warrant was accounted for as a liability, with an offsetting reduction to the carrying value of the common stock. Using the Black-Scholes pricing model, the fair value of the warrant on October 6, 2004, was estimated at \$315,000. On March 31, 2005, the fair value of the warrant was re-measured and estimated at \$740,000. Subsequently in June 2005, the Company agreed to reduce the per-share exercise price on the warrant to \$0.92, in order to induce the investor to exercise his warrants. The warrant was exercised on June 16, 2005 into 500,000 common shares for \$460,000. Upon the effective registration in December 2005, the Company reclassified the \$2,680,590 value of common stock that was registered less an additional \$77,690 in registration costs into permanent equity.

(7) **Commitments and Contingencies**

Leases

The Company leases its operating facilities and certain equipment under operating and capital leases, expiring at various dates through its fiscal year 2009. The following schedule presents the Company's obligations as of March 31, 2006, regarding (1) future minimum lease payments under capital leases, together with the present value of the net minimum lease payments and (2) future minimum rental payments required under operating leases that have initial or remaining terms in excess of one year:

| | <u>Capital Leases</u> | <u>Operating Leases</u> |
|---|---------------------------|-----------------------------|
| 2007 | \$ 23,498 | \$ 679,934 |
| 2008 | 23,498 | 381,904 |
| 2009 | 16,231 | 365,212 |
| 2010 | -- | 122,823 |
| | <hr/> | <hr/> |
| Total net minimum lease payments | 63,227 | <u>\$ 1,549,873</u> |
| Less amount representing interest | <u>(5,489)</u> | |
| | <hr/> | |
| Present value of the net minimum lease payments | 57,738 | |
| Less current portion | <u>(20,231)</u> | |
| | <hr/> | |
| Long-term obligations under capital leases | <u>\$ 37,507</u> | |

The total capitalized cost for equipment under capital lease is \$69,600 with accumulated depreciation of \$17,731. These costs are included under Assets Held for Sale in the Balance Sheet as of March 31, 2006.

Rental expense was approximately, \$1,305,000, \$1,055,000 and \$1,088,000 for the fiscal years ended March 31, 2006, 2005 and 2004, respectively.

Employment Agreements

- *Angelo S. Morini*

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

Because Mr. Morini is no longer performing ongoing services for the Company, the Company accrued and expensed the five-year cost of this agreement in October 2003. The total estimated costs expensed under this agreement are \$1,830,329 of which \$925,982 remained unpaid and accrued (\$366,305 as short-term liabilities and \$559,677 as long-term liabilities) as of March 31, 2006. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

In June 1999, in connection with an amended and restated employment agreement for Mr. Morini, the Company consolidated two full-recourse notes receivable (\$1,200,000 from November 1994 and \$11,572,200 from October 1995) related to his purchase of 2,914,286 shares of the Company's common stock into a single stockholder note receivable in the amount of \$12,772,200 that is due on June 15, 2006. This stockholder note receivable is non-interest bearing and non-recourse and is secured by the 2,914,286 shares of the Company's common stock (the "Shares"). Per the terms of the June 1999 Employment Agreement that was amended and restated by the October 2003 Second Amended and Restated Employment Agreement between the Company and Mr. Morini, this loan may be forgiven upon the occurrence of any of the following events: 1) Mr. Morini is terminated without cause; 2) there is a material breach in the terms of Mr. Morini's employment agreement; or 3) there is a change in control of the Company for which Mr. Morini did not vote "FOR" in his capacity as a director or a stockholder. There have been no actions that have caused the loan to be forgiven.

In the event that Mr. Morini is unable to pay the loan when due and the Company forecloses on the Shares, the Company would reflect a loss on collection for the amount that the value of the Shares are below the value of the stockholder note receivable. For the fiscal year ended March 31, 2006, the Company reserved \$10,120,200 against this stockholder note receivable under the assumption that it would not be able to collect proceeds in excess of the \$2,652,000 value of the Shares as of such date. The value of the Shares was computed using the closing price of the Company's common stock on March 31, 2006 of \$0.91 multiplied by the 2,914,286 shares. Although this reserve resulted in a material loss to the Company's operations, it does not have any affect on the balance sheet since the \$12,772,200 stockholder note receivable was already shown as a reduction to Stockholders' Equity (Deficit). See Note 19 for subsequent information.

- *Christopher J. New*

On July 8, 2004, Christopher J. New resigned from his position as Chief Executive Officer in order to pursue other opportunities. In accordance with the Separation and Settlement Agreement between the Company and Mr. New, the Company recorded \$444,883 related to the employment contract expense in July 2004. In addition to the compensation, the Company agreed that Mr. New's stock option rights under that certain Non-Qualified Stock Option Agreement dated December 5, 2002 (for 25,000 shares at an exercise price of \$1.67 per share) and that certain Non-Qualified Stock Option Agreement dated July 16, 2001 (for 100,000 shares at an exercise price of \$2.05 per share) will continue in full force and effect as if he was still employed by the Company. This settlement will be paid out in nearly equal installments over two years payable on the Company's regular payroll dates. As of March 31, 2006, the remaining unpaid and accrued balance reflected in short-term liabilities was \$67,809.

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

- *Michael E. Broll*

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

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

(8) **Capital Stock**

Non-Cash Compensation Related to Stock-Based Transactions

Effective April 1, 2003, the Company elected to record compensation expense measured at fair value for all stock-based award transactions on or after April 1, 2003 under the provisions of SFAS 123. Prior to April 1, 2003, the Company only recorded the fair value of stock-based awards granted to non-employees or non-directors under the provisions of SFAS 123. The fair value of the stock-based award is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related award. Prior to April 1, 2003, the Company accounted for its stock-based employee and director compensation plans under the accounting provisions of APB No. 25 as interpreted by FASB Interpretation No. 44 ("FIN 44"). Any modifications of fixed stock options or awards granted to employees or directors originally accounted for under APB No. 25 may result in additional compensation expense under the provisions of FIN 44. FIN 44 covers specific events that occurred after December 15, 1998 and was effective as of July 1, 2000.

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

a. Stock-Based Award Issuances

During the fiscal years ended March 31, 2006, 2005 and 2004, the Company recorded \$1,118,819, \$194,097, and \$643,272, respectively, as non-cash compensation expense related to stock-based transactions that were issued to and vested by employees, officers, directors and consultants.

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

On October 11, 2002, the Company repriced all outstanding options granted to employees prior to October 11, 2002 (4,284,108 shares at former prices ranging from \$2.84 to \$10.28) to the market price of \$2.05 per share. Prior to the repricing modification, the options were accounted for as a fixed award under APB No. 25. In accordance with FIN 44, the repricing of the employee stock options requires additional compensation expense to be recognized and adjusted in subsequent periods for changes in the price of the Company's common stock that are in excess of the \$2.05 stock price on the date of modification (additional intrinsic value). If there is a decrease in the market price of the Company's common stock compared to the prior reporting period, the reduction is recorded as compensation income to reverse all or a portion of the expense recognized in prior periods. Compensation income is limited to the original base exercise price (the intrinsic value) of the options. This variable accounting treatment for these modified stock options began with the quarter ended December 31, 2002 and such variable accounting treatment was to continue until the related options were cancelled, expired or exercised. Effective April 1, 2006, the Company will adopt SFAS No. 123R at which time this variable accounting treatment will be discontinued. The Company recorded non-cash compensation (income) expense of (\$192,556), \$193,649 and \$8,001 related to these modified options for the fiscal years ended March 31, 2006, 2005 and 2004. There are 3,494,091 outstanding modified stock options remaining as of March 31, 2006.

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

Employee Stock Purchase Plan

In January 1992, the Company's stockholders approved the 1991 Employee Stock Purchase Plan (the "1991 Purchase Plan"). The 1991 Purchase Plan provided 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 were eligible to participate in the plan. During the fiscal year ended March 31, 2006, 10,899 shares were issued under this plan at prices of \$1.56 and \$1.09 per share. During the fiscal year ended March 31, 2005, 18,894 shares were issued under this plan at prices of \$1.31 and \$1.23 per share. During the fiscal year ended March 31, 2004, 16,339 shares were issued under this plan at prices of \$1.49 and \$1.96 per share. The weighted average exercise price of the shares issued were \$1.42, \$1.27 and \$1.75 per share for the fiscal years ended March 31, 2006, 2005 and 2004, respectively. In January 2006, the Board moved the last purchase period from February 28, 2006 to January 31, 2006, prior to the 1991 Purchase Plan's expiration on January 31, 2006. The Board has not replaced the 1991 Purchase Plan with any new stock purchase plan. As of March 31, 2006, there were no shares available for purchase under the 1991 Purchase Plan.

Stock Options

At March 31, 2006, the Company has three employee stock option plans, which were adopted in 1987, 1991, and 1996 and has granted additional non-plan stock options. Under the Company's stock option plans, qualified and nonqualified stock options to purchase up to 200,500 shares of the Company's common stock may be granted to employees and members of the Board of Directors. The maximum and typical term of options granted under the plans is ten years. Generally, options vest from zero to three years.

The Company estimated the fair value of all options issued during the periods using the Black-Scholes option-pricing model. This model uses the assumptions listed in Note 1 under Stock Based Compensation for each period. The estimated fair value is then recorded as a charge to non-cash compensation in the general and administrative line item in the Statement of Operations. During the fiscal years ended March 31, 2006, 2005 and 2004, the Company recorded \$25,583, \$150,763 and \$347,158, respectively, as non-cash compensation expense related to options that were issued to and vested by employees and directors.

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

| | <u>Shares</u> | <u>Weighted-Average Exercise Price per Share</u> | <u>Weighted-Average Fair Value of Options Granted</u> |
|-------------------------|-----------------|--|---|
| Balance, March 31, 2003 | 105,306 | \$ 2.66 | -- |
| Granted – at market | 914 | 2.90 | \$1.65 |
| Exercised | (7,911) | 2.05 | -- |
| Forfeited or Expired | <u>(2,948)</u> | <u>4.96</u> | -- |
| Balance, March 31, 2004 | 95,361 | 2.64 | -- |
| Granted – at market | 63,930 | 1.28 | \$0.77 |
| Exercised | (13,893) | 1.36 | -- |
| Forfeited or Expired | <u>(429)</u> | <u>19.25</u> | -- |
| Balance, March 31, 2005 | 144,969 | 2.11 | -- |
| Granted – at market | 1,430 | 1.75 | \$1.07 |
| Exercised | (2,250) | 1.28 | -- |
| Forfeited or Expired | <u>(14,583)</u> | <u>1.67</u> | -- |
| Balance, March 31, 2006 | <u>129,566</u> | <u>\$ 2.17</u> | -- |

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

| | <u>Shares</u> | <u>Weighted-Average Exercise Price per Share</u> | <u>Weighted-Average Fair Value of Options Granted</u> |
|-------------------------|------------------|--|---|
| Balance, March 31, 2003 | 4,546,840 | \$ 3.17 | -- |
| Granted – at market | 400,000 | 2.73 | \$0.77 |
| Forfeited or Expired | <u>(300,000)</u> | <u>2.24</u> | -- |
| Balance, March 31, 2004 | 4,646,840 | 3.19 | -- |
| Granted – at market | 270,000 | 1.69 | \$0.48 |
| Forfeited or Expired | <u>--</u> | <u>--</u> | -- |
| Balance, March 31, 2005 | 4,916,840 | 3.02 | -- |
| Forfeited or Expired | <u>(200,000)</u> | <u>2.17</u> | -- |
| Balance, March 31, 2006 | <u>4,716,840</u> | <u>\$ 3.15</u> | -- |

On September 30, 2003, the stockholders of the Company approved the issuance of 4,375,411 of these non-plan options of which 4,075,411 are still outstanding as of March 31, 2006.

The following table summarizes information about plan and non-plan stock options outstanding and exercisable at March 31, 2006:

| Range of Exercise Prices | Options Outstanding | Weighted-Average Remaining Life | Weighted-Average Exercise Price | Options Exercisable | Weighted-Average Remaining Life | Weighted-Average Exercise Price |
|--------------------------|---------------------|---------------------------------|---------------------------------|---------------------|---------------------------------|---------------------------------|
| \$ 1.20 – 1.99 | 374,431 | 5.2 years | \$ 1.61 | 324,431 | 5.5 years | \$ 1.62 |
| \$ 2.00 – 2.99 | 1,539,358 | 3.0 years | \$ 2.10 | 1,536,358 | 3.0 years | \$ 2.10 |
| \$ 3.00 – 3.99 | 1,921,198 | 3.4 years | \$ 3.41 | 1,921,198 | 3.4 years | \$ 3.41 |
| \$ 4.00 – 4.99 | 576,430 | 3.9 years | \$ 4.29 | 576,430 | 3.9 years | \$ 4.29 |
| \$ 5.00 – 5.99 | 432,797 | 1.3 years | \$ 5.20 | 432,797 | 1.3 years | \$ 5.20 |
| \$ 6.00 – 10.28 | 2,192 | 2.2 years | \$ 8.39 | 2,192 | 2.2 years | \$ 8.39 |
| | <u>4,846,406</u> | | | <u>4,793,406</u> | | |

Stock Warrants

At March 31, 2006, the Company had outstanding warrants to purchase the Company's common stock, which were issued in connection with sales consulting, financial consulting, and financing arrangements. Information relating to these warrants is summarized as follows:

| Expiration Date | Number of Warrants | Exercise Price |
|-----------------|--------------------|----------------|
| July 2006 | 10,000 | 5.00 |
| January 2007 | 42,592 | 5.74 |
| June 2007 | 122,549 | 5.52 |
| May 2008 | 50,000 | 2.05 |
| August 2008 | 1,429 | 2.05 |
| October 2008 | 600,000 | 1.53 |
| January 2009 | 1,429 | 2.05 |
| June 2009 | 100,000 | 1.97 |
| June 2009 | 153,000 | 2.05 |
| October 2009 | 50,000 | 1.20 |
| June 2012 | 2,143 | 2.05 |
| | <u>1,133,142</u> | |

The Company estimates the fair value of all warrants issued during the periods using the Black-Scholes option-pricing model. This model uses the assumptions listed in Note 1 under Stock Based Compensation for each period. The estimated fair value is then recorded as a charge to non-cash compensation in the general and administrative line item in the Statement of Operations or as a charge to additional paid-in capital in Stockholders' Equity (Deficit) depending on the situation in which the warrant was issued. During the fiscal years ended March 31, 2006, 2005 and 2004, the Company granted warrants totaling 600,000, 1,050,000 and 700,000 shares, respectively, to non-employees and non-directors. During the fiscal years ended March 31, 2006, 2005 and 2004, the Company recorded \$68,736, \$468,334, \$296,114, respectively, as non-cash compensation expense related to warrants that were issued to and vested by non-employees and non-directors.

Since the conversion of the Company's Series A convertible preferred stock could have resulted in a conversion into an indeterminable numbers of commons shares, the Company determined that under the guidance in paragraph 24 of EITF 00-19, it was prohibited from concluding that it had sufficient authorized and unissued shares to net-share settle any warrants or options issued to non-employees. Therefore, the Company recorded the fair value of all warrants and options issued to non-employees that were outstanding during the period that the Series A convertible preferred stock was outstanding from April 2001 to October 2004 as a liability. The fair value of the warrants and options was determined using the Black-Scholes pricing model. Any changes in the fair value of the securities after the initial valuation in April 2001 were recorded as a gain or loss in the Statement of Operations during the reporting periods. During the fiscal years ended March 31, 2005 and 2004, the Company

recorded a loss/(gain) on the fair value of warrants of (\$443,937) and \$242,835, respectively, related to the change in the fair value of the underlying warrants. There is no derivative liability as of March 31, 2006 or 2005 because the Series A convertible preferred stock was partially converted and the remaining shares redeemed on October 6, 2004.

Reserved

At March 31, 2006, the Company has reserved common stock for future issuance under all of the above arrangements totaling 6,005,909 shares.

Series A Convertible Preferred Stock

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

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

In connection with a Stock Repurchase Agreement dated October 6, 2004, BH Capital Investments, LP and Excalibur Limited Partnership, the holders of the Company's Series A convertible preferred stock (the "Series A Preferred Holders"), converted 10,278 Series A convertible preferred shares into approximately 600,000 shares of common stock. The value of these converted Series A convertible preferred shares including accrued dividends was \$644,068. Simultaneously, the remaining 30,316 Series A convertible preferred shares held by the Series A Preferred Holders were acquired by the Company for a total price of \$2,279,688. All previously outstanding shares of the Series A convertible preferred stock of the Company have now been cancelled. As part of the transaction, each former Series A Preferred Holder also received a warrant to purchase up to 250,000 shares of common stock at an exercise price of \$2.00 per share for a period of five years. The market price of the Company's common stock on October 6, 2004 was \$1.30. The fair value of the warrants is \$205,000.

The Series A Preferred Holders had the right to receive on any outstanding Series A convertible preferred stock a ten percent dividend on the shares, payable one year after the issuance of such preferred stock, and an eight percent dividend for the subsequent three years thereafter, payable in either cash or shares of preferred stock. For the fiscal years ended March 31, 2005 and 2004, the Company recorded preferred dividends of \$82,572 and \$201,791, respectively, on the outstanding shares of the Series A convertible preferred stock.

On April 6, 2001, the Company recorded the initial carrying value of the preferred stock as \$521,848. Each quarter the Company calculated an estimated redemption value of the remaining preferred stock and then calculated the difference between the initial carrying value and this estimated redemption value. The difference was then accreted over the redemption period (48 months beginning April 2001) using the straight-line method, which approximates the effective interest method. For the fiscal years ended March 31, 2005 and 2004, the Company recorded \$319,500 and \$1,256,019, respectively, related to the accretion of the redemption value of preferred stock.

Common Stock Issuances

Fiscal Year Ended March 31, 2006

In accordance with a warrant agreement dated April 10, 2003, the Company issued to Mr. Frederick DeLuca, a greater than 10% shareholder, a warrant to purchase up to 100,000 shares of common stock of the Company at an exercise price of \$1.70 per share. Additionally, in accordance with a warrant agreement dated October 6, 2004, the Company issued to Mr. DeLuca a warrant to purchase up to 500,000 shares of common stock of the Company at an exercise price of \$1.15 per share. Subsequently in June 2005, the Company agreed to reduce the per-share

exercise price on these warrants to \$1.36 and \$0.92, respectively, in order to induce Mr. DeLuca to exercise his warrants. All of the warrants were exercised on June 16, 2005 for total proceeds of \$596,000.

In accordance with EITF 00-19 and the terms of the above warrant for 500,000 shares of common stock, the fair value of the warrant was accounted for as a liability, with an offsetting reduction to the carrying value of the common stock. Using the Black-Scholes pricing model, the fair value of the warrant on October 6, 2004, was estimated at \$315,000. On March 31, 2005, the fair value of the warrant was re-measured and estimated at \$740,000. The increase of \$425,000 was reflected as a loss in the fair value of warrants line item in the Statement of Operations during the fiscal year ended March 31, 2005. Upon exercise of the warrant on June 16, 2005, the fair value was re-measured and estimated to be \$400,000. The \$340,000 change in fair value from the value at March 31, 2005 was reflected as a gain on the fair value of warrants line item in the Statement of Operations during the fiscal year ended March 31, 2006. The warrant liability was reclassified to temporary equity upon the exercise of the warrant in June 2005 and then to permanent equity upon registration of the shares through an effective registration statement in December 2005.

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

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

The Company used a portion of the proceeds from the warrant exercises to satisfy the \$750,000 over-advance provided by Textron under the Fourth Amendment and Waiver to the Textron Loan Agreement, as described in Note 5 and the remaining proceeds from the warrant exercises were used for working capital purposes.

Fiscal Year Ended March 31, 2005

On October 6, 2004, the Company completed a private placement of its common stock, whereby it issued a total of 2,000,000 shares to an existing stockholder of the Company for aggregate gross proceeds to the Company of \$2,300,000. These proceeds were used to redeem the Company's Series A convertible preferred stock as discussed above. The purchase price of the shares was \$1.15 per share (95% of the prior 5-day trading closing stock price average). The stockholder also received a warrant to purchase up to 500,000 shares of the Company's common stock at an exercise price of \$1.15 per share for a period of five years.

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

Fiscal Year Ended March 31, 2004

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

Pursuant to seven Securities Purchase Agreements dated May 21, 2003, the Company issued a total of 2,138,891 shares of its common stock at a price per share equal to \$1.80 for aggregate gross proceeds to the Company of \$3,850,000. Sales to related parties under the Securities Purchase Agreements include: 555,556 shares of common stock sold at an aggregate sales price of \$1,000,000 to Frederick DeLuca, a then greater than 5% stockholder; 55,556 shares of common stock sold at an aggregate sales price of \$100,000 to David H. Lipka, a Director of the Company; 83,333 and 55,556 shares of common stock sold at an aggregate sales price of \$150,000 and \$100,000, respectively, to Ruggieri of Windermere Family Limited Partnership and Ruggieri Financial

Pension Plan, respectively, each an affiliate of John Ruggieri, the Company's former Vice President of Manufacturing; 1,111,112 shares of common stock sold at an aggregate sales price of \$2,000,000 to Fromageries Bel S.A., a leading branded cheese company in Europe which signed a Master Distribution and Licensing Agreement effective May 22, 2003 with the Company. Sales to non-related parties under the Securities Purchase Agreements totaled 277,778 shares of common stock sold at an aggregate sales price of \$500,000.

The Company used \$2,000,000 of the proceeds generated from these May 2003 private placements to pay down the balance of the Company's mezzanine loan from FINOVA Mezzanine Capital, Inc. The Company then applied the additional proceeds from the new loan from Wachovia Bank, as discussed in Note 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 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.

(9) **Disposal Activities**

On June 30, 2005, the Company entered into a definitive agreement (the "Asset Purchase Agreement") for the sale of substantially all of its manufacturing and production equipment to Schreiber Foods, Inc., a Wisconsin corporation ("Schreiber"), for \$8,700,000 in cash.

Schreiber is a privately held cheese manufacturing company whose primary business is contract manufacturing cheese, cheese alternative and other dairy products for many well-known companies and brands.

In connection with the Asset Purchase Agreement, the Company also entered into a Supply Agreement with Schreiber (the "Supply Agreement") on June 30, 2005. Pursuant to the Supply Agreement, Schreiber has become the Company's sole source of supply for substantially all of its products. In November 2005, Schreiber began to deliver such products directly to the Company's customers. The prices for such products are based on cost plus a processing fee as determined by the parties from time to time. Other material terms of the Supply Agreement are as follows:

- The initial term of the Supply Agreement is for a period of five years from the effective date of September 1, 2005 and is renewable at the Company's option for up to two additional five-year periods (for a total term of up to fifteen years). Since October 2005, Schreiber has begun to purchase the Company's remaining raw materials, ingredients and packaging at cost. If the Company does not exercise its first option to extend the term, then the Company will be obligated to pay Schreiber \$1,500,000. If the Company has exercised the first option to extend the term, but does not exercise its second option to extend the term, then the Company will be obligated to pay Schreiber \$750,000.
- The Supply Agreement provides for a contingent short-fall payment obligation by the Company if a specified production level is not met during the one-year period from September 1, 2006 to August 31, 2007. If a contingent short-fall payment is accrued after such one-year period, it may be reduced by the amount by which production levels in the one-year period from September 1, 2007 to August 31, 2008 exceeds the specified target level of production, if any.

On December 8, 2005, the Company completed the sale of substantially all of its manufacturing and production equipment to Schreiber. This sale was approved by the Company's stockholders at a Special Meeting held on December 5, 2005. The \$8,700,000 in proceeds was used to pay \$1,319,583 for tangible personal property taxes due primarily on the sold assets and \$7,374,299 to Beltway Capital Partners LLC (successor by assignment of Wachovia Bank, N.A.) for the termination of the Company's term loan. The remaining proceeds balance of \$6,118 was used to reduce the Company's asset-based line of credit from Textron Financial Corporation.

The Company is accounting for the costs associated with these transactions in accordance with SFAS No. 146, "Accounting for Costs Associated with an Exit or Disposal Activity," because the above arrangements are planned and controlled by management and materially change the manner in which the Company's business will be conducted. In accordance with SFAS No. 146, costs associated with disposal activities should be reported as a reduction of income from operations. The above transactions were communicated to the Company's employees on July 6, 2005. As of March 31, 2006, all 104 employee positions related to the manufacturing and distribution of the Company's products had been eliminated. The remaining employee termination costs are expected to be paid in fiscal 2007. In December 2005, the Company abandoned its distribution facility and the production portion of its administrative facility and accrued \$396,197 related to abandonment of these facilities. This amount was calculated as the present value of the remaining lease rentals, reduced by the estimated market value of sublease rentals. If the Company does not sublease these facilities, the actual loss will exceed this estimate. Other exit costs consist primarily of legal and professional fees related to the disposal activities.

As of March 31, 2006, the Company has accrued the following quarterly costs associated with the above transactions:

| | Employee Termination Costs | Excess Facilities | Other Exit Costs | Total |
|-------------------------------------|---|------------------------------|-----------------------------|--------------|
| Accrued Balance March 31, 2005 | \$ -- | \$ -- | \$ -- | \$ -- |
| Charges | -- | -- | 189,069 | 189,069 |
| Payments | -- | -- | (189,069) | (189,069) |
| Accrued Balance, June 30, 2005 | -- | -- | -- | -- |
| Charges | 359,774 | -- | 124,425 | 484,199 |
| Payments | -- | -- | (124,425) | (124,425) |
| Accrued Balance, September 30, 2005 | 359,774 | -- | -- | 359,774 |
| Charges | 51,638 | 396,197 | 221,101 | 668,936 |
| Payments | (204,847) | -- | (221,101) | (425,948) |
| Accrued Balance, December 31, 2005 | 206,565 | \$ 396,197 | \$ -- | \$ 602,762 |
| Charges | 39,590 | 122,282 | 142,414 | 304,286 |
| Payments | (220,277) | (168,530) | (37,837) | (426,644) |
| Accrued Balance, March 31, 2006 | \$ 25,878 | \$ 349,949 | \$ 104,577 | \$ 480,404 |

For the fiscal year ended March 31, 2006, the Company incurred and reported \$1,646,490 as Costs of Disposal Activities in the Statement of Operations. A summary of the disposal costs recognized for the year ended March 31, 2006 is as follows:

| | Employee Termination Costs | Excess Facilities | Other Exit Costs | Total |
|-------------------------|---|------------------------------|-----------------------------|--------------|
| Disposal Costs Incurred | \$ 451,002 | \$ 518,479 | \$ 677,009 | \$ 1,646,490 |

The Company anticipates that in future periods, there will be additional disposal costs related to professional fees, contract cancellation charges and higher lease abandonment charges to reflect the cost of abandoned facilities that were not subleased during the period.

(10) **Impairment of Property and Equipment**

In light of the asset sale and supply arrangements discussed in Note 9, the Company determined that it is more likely than not that a majority of its fixed assets related to production activities would be sold or disposed prior to the end of their useful life. In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Term Assets," the Company wrote down the value of its assets to their estimated fair values in June 2005. The Company estimated the fair value based on the \$8,700,000 sales price discussed in Note 9 and the anticipated sales price related to any other assets to be held for sale plus future cash flows related to the assets from July 1, 2005 until the end of production in December 2005. Based on this estimate, the Company recorded an impairment of property and equipment of \$7,896,554 in order to reflect a net fair value of its equipment in June 2005.

All assets continued to be used and depreciated under Property and Equipment until the sale of substantially all of the Company's production machinery and equipment on December 8, 2005. For the fiscal year ended March 31, 2006, the Company recorded a \$3,628 gain on the disposal of assets related to the remaining value of assets sold or abandoned after production ceased in December 2005.

The Company has reclassified its remaining assets available for sale as Assets Held for Sale in the Balance Sheet and expects to sell these remaining assets by September 2006. The Company has estimated the fair value of these assets to be \$61,950. Any difference between the actual proceeds received and this estimated fair value will be recognized as a gain or loss on the sale of assets in the period that they are sold.

(11) **Income Taxes**

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

| March 31, | 2006 | 2005 |
|--|--------------|--------------|
| Deferred tax assets: | | |
| Net operating loss carry forwards | \$16,355,000 | \$14,732,000 |
| Non-deductible reserves | 4,475,000 | 1,033,000 |
| Investment, alternative minimum and general business tax credits | 85,000 | 80,000 |
| Accrued employment contract | 328,000 | 520,000 |
| Depreciation and amortization | 10,000 | -- |
| Other | 668,000 | 983,000 |
| Gross deferred income tax assets | 21,921,000 | 17,348,000 |
| Valuation allowance | (21,921,000) | (13,191,000) |
| Total deferred income tax assets | -- | 4,157,000 |
| Deferred income tax liabilities: | | |
| Depreciation and amortization | -- | (4,157,000) |
| Net deferred income tax assets | -- | -- |

The valuation allowance increased by \$8,730,000, \$1,375,000 and \$787,000 for the fiscal years ended March 31, 2006, 2005 and 2004, 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.

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

| Fiscal Years Ended March 31, | 2006 | 2005 | 2004 |
|--|---------|---------|---------|
| Federal income taxes at statutory rates | (34.0%) | (34.0%) | (34.0%) |
| Change in deferred tax asset valuation allowance | 32.6% | 31.5% | 26.6% |
| Non deductible expenses: | | | |
| Imputed interest on note receivable | 0.9% | 4.8% | 7.0% |
| Other | 0.5% | (2.3%) | 0.4% |
| Income taxes (benefit) at effective rates | -- | -- | -- |

Unused net operating losses for income tax purposes, expiring in various amounts from 2008 through 2026, of approximately \$43,500,000 are available at March 31, 2006 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.

(12) **Earnings Per Share**

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

| Fiscal Years Ended March 31, | 2006 | 2005 | 2004 |
|---|-----------------------|----------------------|----------------------|
| Net loss to common stockholders | <u>\$(24,148,553)</u> | <u>\$(4,261,855)</u> | <u>\$(4,757,087)</u> |
| Weighted average shares outstanding – basic & diluted | <u>19,704,483</u> | <u>17,007,791</u> | <u>14,937,005</u> |
| Basic & Diluted net loss per common share | <u>\$ (1.23)</u> | <u>\$ (0.25)</u> | <u>\$ (0.32)</u> |

Options for 4,846,406 shares and warrants for 1,133,142 shares have not been included in the computation of diluted net loss per common share for the fiscal year ended March 31, 2006 as their effects were antidilutive. Options for 5,061,809 shares and warrants for 2,285,356 shares have not been included in the computation of diluted net loss per common share for the fiscal year ended March 31, 2005 as their effects were antidilutive. Potential conversion of the Series A convertible preferred stock for 1,522,658 shares, options for 4,742,201 shares and warrants for 1,242,856 shares have not been included in the computation of diluted net loss per common share for the fiscal year ended March 31, 2004 as their effects were antidilutive.

(13) **Supplemental Cash Flow Information**

| Fiscal Years Ended March 31, | 2006 | 2005 | 2004 |
|--|---------|-----------|-----------|
| Non-cash financing and investing activities: | | | |
| Purchase of equipment through capital lease obligations and term notes payable | \$ -- | \$ 82,583 | \$ 55,672 |
| Reduction in accounts payable through issuance of common stock | -- | -- | 37,650 |
| Reduction in notes payable through issuance of common stock | -- | -- | 162,424 |
| Accrued preferred stock dividends | -- | 82,572 | 201,791 |
| Accretion of discount on preferred stock | -- | 319,500 | 1,256,019 |
| Cash paid for: | | | |
| Interest | 975,742 | 967,303 | 1,160,098 |
| Income taxes | -- | -- | -- |

(14) **Related Party Transactions**

Angelo S. Morini

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

Because Mr. Morini is no longer performing ongoing services for the Company, the Company accrued and expensed the five-year cost of this agreement in October 2003. The total estimated costs expensed under this agreement were \$1,830,329 of which \$925,982 remained unpaid but accrued (\$366,305 as short-term liabilities and \$559,677 as long-term liabilities) as of March 31, 2006. The long-term portion will be paid out in nearly equal monthly installments ending in October 2008.

In June 1999, in connection with an amended and restated employment agreement for Mr. Morini, the Company consolidated two full-recourse notes receivable (\$1,200,000 from November 1994 and \$11,572,200 from October 1995) related to his purchase of 2,914,286 shares of the Company's common stock into a single stockholder note receivable in the amount of \$12,772,200 that is due on June 15, 2006. This stockholder note receivable is non-interest bearing and non-recourse and is secured by the 2,914,286 shares of the Company's common stock (the

“Shares”). Per the terms of the June 1999 Employment Agreement that was amended and restated by the October 2003 Second Amended and Restated Employment Agreement between the Company and Mr. Morini, this loan may be forgiven upon the occurrence of any of the following events: 1) Mr. Morini is terminated without cause; 2) there is a material breach in the terms of Mr. Morini’s employment agreement; or 3) there is a change in control of the Company for which Mr. Morini did not vote “FOR” in his capacity as a director or a stockholder. There have been no actions that have caused the loan to be forgiven.

In the event that Mr. Morini is unable to pay the loan when due and the Company forecloses on the Shares, the Company would reflect a loss on collection for the amount that the value of the Shares are below the value of the stockholder note receivable. For the fiscal year ended March 31, 2006, the Company reserved \$10,120,200 against this stockholder note receivable under the assumption that it would not be able to collect proceeds in excess of the \$2,652,000 value of the Shares as of such date. The value of the Shares was computed using the closing price of the Company’s common stock on March 31, 2006 of \$0.91 multiplied by the 2,914,286 shares. Although this reserve resulted in a material loss to the Company’s operations, it does not have any affect on the balance sheet since the \$12,772,200 stockholder note receivable was already shown as a reduction to Stockholders’ Equity (Deficit). See Note 19 for subsequent information.

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

In October 2000, the Company obtained a \$1.5 million bridge loan from Wachovia Bank (as discussed in Note 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 in February 2004.

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

Other Related Party Transactions

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

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

On May 22, 2003, the Company entered into a Master Distribution and Licensing Agreement with Fromageries Bel S.A. (“Bel”), a leading branded cheese company in Europe who is a greater than 5% stockholder in the Company. Under the agreement, the Company granted Bel exclusive distribution rights for the Company’s products in a territory comprised of the European Union States and to more than 21 other European countries and territories (the “Territory”). The Company also granted Bel the exclusive option during the term of the agreement

to elect to manufacture the products designated by Bel for distribution in the Territory. The term of the agreement is ten years, provided that either of the parties may elect to terminate the agreement by delivery of notice to the other between March 24, 2007 and May 22, 2007, which termination shall be effective as of the first anniversary of the date of the notice of termination. Alternatively, the parties may mutually agree to continue operating under the agreement, to convert the agreement to a manufacturing and license agreement, or to terminate the agreement. Pursuant to a Termination, Settlement and Release Agreement signed on July 22, 2005 with Bel, the Company received \$150,000.

A former director of the Company was paid \$37,500 and \$59,000 for his consulting services on marketing issues during each of the fiscal years ended March 31, 2006 and 2005, respectively. Another director was paid \$33,500 for her consulting services on marketing plans and materials provided to the Company during the fiscal year ended March 31, 2006.

(15) **Economic Dependence and Segment Information**

For the fiscal years ended March 31, 2006 and 2004, the Company did not have any customer that comprised more than 10% of net sales.

For the fiscal year ended March 31, 2005, the Company had one customer that accounted for approximately 12% of net sales. As of March 31, 2005, the customer owed the Company approximately \$1,550,000 or 22% of the Company's gross trade receivable balance.

The Company sells to customers throughout the United States and 14 other countries. For the fiscal years ended March 31, 2006, 2005 and 2004, the Company's gross sales were \$41,492,717, \$48,421,384 and \$40,041,371, respectively. Gross sales derived from foreign countries were approximately \$5,158,000, \$4,896,000 and \$4,297,000 for the fiscal years ended March 31, 2006, 2005 and 2004, respectively. These sales represent 12%, 10% and 11% of gross sales in the fiscal years ended March 31, 2006, 2005 and 2004, respectively. Gross sales are attributed to individual countries based on the customer's shipping address. The Company has no long-term assets located outside of the United States.

The following table sets forth the percentage of foreign gross sales to each country, which accounted for 5% or more of the Company's foreign gross sales for the fiscal years ended March 31, 2006, 2005 and 2004:

| <u>Country</u> | Percentage of Gross Foreign Sales Fiscal Years Ended March 31, | | |
|----------------|---|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Canada | 60.0% | 47.9% | 44.4% |
| Puerto Rico | 22.8% | 33.4% | 32.9% |
| Israel | * | * | 5.9% |

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

For the fiscal year ended March 31, 2006, the Company purchased \$9,094,000 of products from two suppliers totaling approximately 51% of total raw material purchases for the fiscal year. For the fiscal year ended March 31, 2005, the Company purchased \$9,193,000 of products from four suppliers totaling approximately 40% of total raw material purchases for the fiscal year. For the fiscal year ended March 31, 2004, the Company did not have any supplier that comprised more than 10% of total raw material purchases.

(16) **Employee Benefit Plan**

The Company has a 401(k) defined contribution plan covering all employees meeting certain minimum age and service requirements. The Company's matching contributions to the plan are determined by the Board of Directors. On August 1, 2003, the Company match was raised from 25% to a maximum of 50% of the employee's contribution up to 6% of the employee's compensation. Company contributions to the plan amounted to \$47,845, \$56,170 and \$35,807 for the fiscal years ended March 31, 2006, 2005 and 2004, respectively.

(17) **Fourth Quarter Adjustments**

There were no significant or unusual adjustments in the fourth quarter of fiscal 2006 or fiscal 2004.

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

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

As of March 31, 2005, a customer owed the Company approximately \$1,550,000 or 22% of the Company's gross trade receivable balance. Additionally, the Company had approximately \$210,000 of inventory in stock as of March 31, 2005 related to this customer. Based on information that arose in April 2005 after the products were shipped, the Company determined that collection of the outstanding receivable balance and inventory amounts were in question as of March 31, 2005 and therefore, reserved 100% of these amounts in its reserve for trade receivables and inventory at year-end. In March 2005, the Company reviewed its inventory and wrote off the value of unsalable items that it would no longer use in production due to low margins, low volume, change in inventory formulas or loss of customer.

(18) **Quarterly Operating Results (Unaudited)**

Unaudited quarterly operating results are summarized as follows:

| <u>2006</u> | <u>Three Months Ended (Unaudited)</u> | | | |
|--|---------------------------------------|--------------------|---------------------|----------------|
| | <u>March 31</u> | <u>December 31</u> | <u>September 30</u> | <u>June 30</u> |
| Net sales | \$ 8,414,387 | \$ 9,072,097 | \$ 10,438,225 | \$ 9,851,153 |
| Gross margin | 2,854,363 | 1,889,595 | 2,620,874 | 2,268,298 |
| Net income (loss) | (1,833,320) | (11,754,981) | (1,416,138) | (9,144,114) |
| Net income (loss) for common stockholders | (1,833,320) | (11,754,981) | (1,416,138) | (9,144,114) |
| Basic & diluted net income (loss) per common share | (0.09) | (0.59) | (0.07) | (0.49) |
| Stockholders' equity (deficit) | (3,682,660) | (2,806,092) | (3,224,401) | 873,278 |

| <u>2005</u> | <u>Three Months Ended (Unaudited)</u> | | | |
|--|---------------------------------------|--------------------|---------------------|----------------|
| | <u>March 31</u> | <u>December 31</u> | <u>September 30</u> | <u>June 30</u> |
| Net sales | \$ 10,785,379 | \$ 10,632,877 | \$ 11,900,553 | \$ 11,191,678 |
| Gross margin | 1,909,635 | 2,343,326 | 2,580,584 | 2,940,348 |
| Net income (loss) | (2,545,790) | (1,015,473) | 223,091 | (521,611) |
| Net income (loss) for common stockholders | (2,545,790) | (1,061,807) | 410,389 | (1,064,647) |
| Basic & diluted net income (loss) per common share | (0.14) | (0.06) | 0.03 | (0.07) |
| Stockholders' equity | 4,801,933 | 7,129,196 | 6,528,219 | 6,014,676 |

(19) **Subsequent Events**

On June 16, 2006, Angelo S. Morini failed to repay the non-recourse note obligation to the Company in the amount of \$12,772,200. The stockholder note receivable is non-recourse to Mr. Morini and is secured by a pledge of 2,914,286 shares of the Company's common stock (the "Shares"). On June 20, 2006, the Company delivered notice to Mr. Morini that it intended to exercise its rights to the Shares and retain all the Shares in full satisfaction of his obligations under the stockholder note receivable. On July 6, 2006, Mr. Morini consented to the Company's acceptance of the Shares in full satisfaction of his obligations under the stockholder note receivable. As a result, the Company is in the process of canceling the Shares along with an additional 30,443 treasury shares. The Company's total number of issued and outstanding shares of common stock is now 17,109,894 shares. Based upon the \$0.42 closing price of the Company's common stock as quoted on the OTC Bulletin Board on June 16, 2006, the Shares have an approximate value of \$1,224,000. Accordingly, the Company will recognize an additional expense of \$1,428,000 in the first quarter of fiscal 2007 in order to record the additional decline in the value of the Shares from its \$2,652,000 value as of March 31, 2006.

On June 23, 2006, the Company entered into a Receivables Purchase Agreement with Systran Financial Services Corporation, a subsidiary of Textron Financial Corporation (“Systran”), whereby Systran will provide financing to the Company through advances against certain trade receivable invoices due to the Company (the “Systran Agreement”). The Systran Agreement is secured by the Company’s accounts receivable and all other assets. Generally, subject to a maximum principal amount of \$3,500,000 which can be borrowed under the Systran Agreement, the amount available for borrowing is equal to 85% of the Company’s eligible accounts receivable invoices less a dilution reserve and any required fixed dollar reserves. The dilution and fixed dollar reserves have been initially set at 7% and \$100,000, respectively. Advances under the Systran Agreement bear interest at a variable rate equal to the prime rate plus 1.5% per annum (9.5% on June 23, 2006). The Company paid a one-time closing fee of \$35,000 and is also obligated to pay a \$1,500 monthly service fee. The initial term of the Systran Agreement ends on June 23, 2009 and may renew automatically for consecutive twelve-month terms unless terminated sooner.

The Systran Agreement may be accelerated in the event of certain defaults by the Company including among other things, a default in the Company’s payment and/or performance of any obligation to Systran or any other financial institution, creditor, or bank; and any change in the conditions, financial or otherwise, of the Company which reasonably causes Systran to deem itself insecure. In such an event, interest on the Company’s borrowings would accrue at the greater of twelve percent per annum or the variable rate of prime plus 1.5% and the Company would be liable for an early termination premium ranging from 1% to 3% of the maximum principal amount available under the Systran Agreement.

On June 23, 2006, Systran advanced \$2,379,262 under the Systran Agreement of which \$1,839,086 was used to pay in full and terminate the Company’s obligations under its line of credit with Textron Financial Corporation which was to terminate on June 27, 2006.

Effective April 15, 2006 through October 31, 2006, the Company entered into a sublease agreement for a portion of some of its unused manufacturing and parking space whereby it expects to receive approximately \$83,901 in rental income to offset its lease payment obligations in fiscal 2007.

CONTROLS AND PROCEDURES

As of March 31, 2006, an evaluation was performed under the supervision and with the participation of our management, including the Chief Executive Officer ("CEO"), and the Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of our disclosure controls and procedures to insure that the Company records, processes, summarizes and reports in a timely and effective manner the information required to be disclosed in reports filed with or submitted to the Securities and Exchange Commission. Based on that evaluation, our management, including the CEO and CFO, concluded that our disclosure controls and procedures were effective in timely bringing to their attention material information related to our Company required to be included in our periodic Securities and Exchange Commission filings, except for the control noted below. During the quarter ended March 31, 2006, there have been no changes in our internal controls over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect those controls.

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

Board of Directors, Special Committees, Elected Officers and Senior Management



David H. Lipka
Chairman of the Board



Michael E. Broll
CEO, Director



Angelo S. Morini
*Founder, Chairman Emeritus,
Director*



Salvatore J. Furnari
Chief Financial Officer



LeAnn C. Hitchcock
*SEC Compliance, Internal Audit
Manager and Corporate Secretary*

Senior Management

John W. Jackson
V.P. of Global Sales

Christopher E. Morini
*V.P. of New Business Development
& Key Accounts*

Thomas J. Perno
V.P. of Contract Manufacturing

Kulbir Sabharwal
V.P. of Technical Services

David H. Lipka spent forty years (1955-1995) with DCA Food Industries Inc., an international manufacturer of food ingredients and equipment with combined sales in excess of \$1 billion per annum, holding positions of president, chief executive officer, and chief operating officer. Since 2001, Mr. Lipka served on the board of directors of Doctor's Associates Inc. (Subway Stores) and has served on numerous boards including Dunkin Donuts Inc. (1989-1994), Allied-Lyons Inc. (1988-1994), and Kerry Group PLC (1995-1996). Mr. Lipka has also been chairman and chief executive officer of Pennant Foods and Leons Baking Company. He obtained a B.S. degree from Brooklyn College and attended the Graduate School of Business at New York University. Since December 2002, Mr. Lipka has agreed to serve as a director of our Company at the request of Frederick A. DeLuca, a beneficial owner of more than ten percent (10%) of our common stock. Both Mr. Lipka and Mr. DeLuca are members of the Board of Directors of Doctor's Associates Inc.

Michael E. Broll was appointed as a director of our Company in December 2003 and as Chief Executive Officer ("CEO") of our Company in July 2004 upon the resignation of Christopher J. New. Mr. Broll is a private investor and consultant in the food industry, and most recently was President and Chief Executive Officer, from 1999 to 2002, of Chef Solutions Inc., a subsidiary of Lufthansa Service Group ("LSG"), a business specializing in providing convenient baked foods and prepared meals to food service and retail segments of the food industry. As an executive of SCIS/Sky Chef's a subsidiary of ONEX Corporation, a Canadian based private equity group, Mr. Broll assembled a group of six companies in the bakery and prepared food business to ultimately form and merge into a one new entity called Chef Solutions Inc., an ONEX controlled company. Chef Solutions Inc. was subsequently sold to LSG in 2001. Mr. Broll's career also includes major executive assignments with Allied-Domecq Retailing as the head of its total supply chain for North America from 1997 to 1999, Ready Pac Produce, Inc. as President and Chief Operating Officer from 1995 to 1997, Nestle USA as the head of all supply chains for the chilled food group in North America from 1993 to 1995, and Pillsbury Company as Vice President of Operations for the bakery group supply chain from 1991 to 1993. Mr. Broll received his B.S. in Economics from the University of Illinois in 1978.

Angelo S. Morini was the Founder and inventor of our Company's healthier dairy alternative formula and was our Company's President since its inception in 1980 until October 2003. On December 17, 2002, Mr. Morini resigned from his positions as Chief Executive Officer and Chairman of the Board of our Company and became the Vice-Chairman of the Board. Effective October 13, 2003, Mr. Morini resigned from his positions as Vice-Chairman and President of our Company and he is no longer involved in the daily operations of the Company. He retains the title of Founder and was named Chairman Emeritus. Between 1972 and 1980, Mr. Morini was the general manager of Galaxy Cheese Company, which operated as a sole proprietorship until its incorporation in May 1980. Prior to 1974, he was associated with the Food Service Division of Pillsbury Company and the Post Division of General Foods Company. In addition, he

worked in Morini Markets, his family-owned and operated chain of retail grocery stores in the New Castle, Pennsylvania area. Mr. Morini received a B.S. degree in Business Administration from Youngstown State University in 1968. Mr. Morini's brother, Christopher E. Morini, works for our Company as Vice President of New Business Development and Key Accounts. Prior to November 2003, Angelo S. Morini's wife, Julie Morini, was employed by our Company in the marketing and public relations departments. Mr. Morini's brother, Ronald Morini, worked for our Company until October 31, 2003 as an engineering consultant and was paid \$61,310 in consulting fees and benefits during the fiscal year ended March 31, 2004.

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

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

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

Thomas J. Perno has worked for our Company since 1983. He began as a Shipping and Receiving Supervisor, he was later promoted to Plant Manager and then to Vice President of Operations. In December 2006, his title changed to Vice President of Contract Manufacturing. Mr. Perno received his M.S. in Electrical Engineering from Penn State University in 1976.

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

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A Galaxy of Smart Food Choices™

Corporate and Shareholder Information

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Financial Information Requests:

E-mail: galxinvest@galaxyfoods.com
Updated financial reports and press releases are available on our website: www.galaxyfoods.com

Common Stock:

Galaxy's shares are traded on the Over The Counter Bulletin Board under the trading symbol "GXZF"

Legal Counsel:

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Boca Raton, FL 33431

Independent Auditors: (For FY2006)

BDO Seidman, LLP
285 Peachtree Center Ave, Suite 800
Atlanta, GA 30303

Independent Auditors: (For FY2007)

Cross, Fernandez and Riley, LLP
201 S. Orange Ave., Ste. 950
Orlando, FL 32801

Transfer Agent & Registrar:

Continental Stock Transfer & Trust Company
17 Battery Place, New York, NY 10004
(212) 509-4000

Investor Relations:

Dawn M. Robert,
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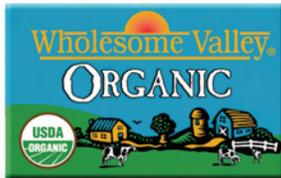
Website Information:

www.galaxyfoods.com
www.galaxynutritionalfoods.com
www.veggieslices.com

Consumer Relations & Product Information:

Phone: (407) 855-5500, Fax: (407) 855-7485,
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Our Branded Products





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