LUCILLE FARMS INC
Form 10-K
July 14, 2005

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

[Mark One]

[x] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended March 31, 2005

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

Commission file number 1-12506

LUCILLE FARMS, INC.
(Exact name of Registrant as specified in its Charter)

Delaware	13-2963923
(State of incorporation)	(I.R.S. employer identification no.)

12 Jonergin Drive, P.O. Box 125 Swanton, VT 05488 (Address of principal executive office)	(802) 868-7051 (Registrant's telephone number)

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

Securities registered pursuant to Section 12 (g) of the Act:
Common Stock, par value $.001 per share
(Titles of Classes)

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant was $2,571,382 based on the average bid and asks price as reported by NASDAQ on June 24, 2005. Shares held by each officer, director, and person who owns 10% or more of the Registrant's outstanding common stock have been excluded in that such persons may be deemed to be affiliates. The determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of the Registrant's common stock outstanding as of June 28, 2005 was 3,353,937.

Documents Incorporated by Reference

None

PART I

ITEM 1. BUSINESS

General

Lucille Farms, Inc. (the "Company") is engaged in the manufacture, processing, shredding and marketing of low moisture mozzarella cheese (including whole milk, part skim and reduced fat low moisture mozzarella cheese), pizza cheese (a product made with low moisture mozzarella cheese and other natural ingredients) and square provolone, and the shredding of other cheese and cheese blends. The Company's pizza cheese and reduced fat low-moisture mozzarella cheese have been developed utilizing proprietary formulas and processes. The Company also sells whey, a by-product of its cheese making operation, for animal food. For the fiscal year ended March 31, 2005, sales of low moisture mozzarella cheese, shredded cheese and blended cheese accounted for approximately 85.2% of the Company's sales revenues. Sales of the Company's pizza cheese and square provolone products during the fiscal year ended March 31, 2005, were 5.5% of the Company's revenue, and sales from a variety of other cheese purchased by the Company, including round provolone, ricotta and cheddar, were 3.0% of the Company's revenues. Whey accounted for 3.6% of the Company's revenue and the sale of surplus ingredients accounted for 2.7%. The Company's low moisture mozzarella cheese, pizza cheese and square provolone products are manufactured in the Company's production facility in Swanton, Vermont, and are made of natural ingredients.

The Company's products are sold primarily to the food service and industrial segments of the cheese market. The food service segment consists of food service distributors, pizza chains and independent pizzerias, restaurants, recreational facilities, business feeders, health care facilities, schools and other institutions, which prepare food for on-premises consumption. The Company's products are sold into this marketplace by distributors who deal directly with the Company's in house sales staff and brokers. The industrial segment includes manufacturers that utilize the Company's products as an ingredient in processed foods and frozen entrees and side dishes. Products are sold into this marketplace by the Company's in-house sales staff and brokers.

The Company purchases round provolone, ricotta, and cheddar cheese from co-packers. These cheeses are all natural cheese that meets or exceeds all federal and industry standards for purity, freshness, taste, appearance and texture.

Products

The Company's products include the following:

(1) Low Moisture Mozzarella Cheese (including whole milk, part skim and reduced fat)

The Company's all natural low moisture mozzarella cheese meets or exceeds all

federal standards. During the fiscal years ended March 31, 2005, 2004 and 2003, low moisture mozzarella cheese loafs (including whole milk, part skim and reduced fat) and shredded cheese and cheese blends accounted for approximately 85.2%, 91.6% and 89.2%, respectively, of the Company's sales.

(2) Pizza Cheese and Square Provolone

During the fiscal years ended March 31, 2005, 2004, and 2003, the Company's pizza cheese and square provolone accounted for approximately 5.5%, 1.0% and 0.2%, respectively, of the Company's total sales.

These products are made using the formulas and processes developed by the Company, which are believed to be proprietary.

(3) Round Provolone, Cheddar and Ricotta

During the fiscal years ended March 31, 2005, 2004 and 2003, sales of these cheeses accounted for approximately 3.0%, 2.8% and 3.1%, respectively, of the Company's sales.

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(4) Whey

The Company dries whey, a by-product of cheese making, in its Company owned whey-drying facility, for sale as animal feed. During the fiscal years ended March 31, 2005, 2004, and 2003, sales of whey accounted for approximately 3.6%, 3.3% and 5%, respectively, of the Company's sales.

The sale of surplus ingredients accounted for the balance of sales during the fiscal years ended March 31, 2005, 2004 and 2003.

Production Facilities

Currently, the Company produces all of its products at its manufacturing plant in Franklin County, Swanton, Vermont. Franklin County is Vermont's largest milk producing area. The plant has 73 full-time employees. The Company has equipment to shred, dice, vacuum package, gas flush bag package, and label its products. The Company's facility has the capacity to produce approximately 36,000,000 pounds of cheese product per year and shred 24,000,000 pounds of product per year. In the event additional capacity is required, the Company may either (a) contract out its excess production to, and/or rent plant time from, other manufacturers, or (b) further expand its current plant facilities, subject to appropriate financing and the possible increase in the volume of wastewater it is licensed to process.

Whey Drying Facility

In 1999, the Company completed construction of, and began operating, a 10,000 square foot whey drying facility adjacent to its Swanton, Vermont cheese plant. The facility dries whey into a product referred to as popcorn whey, which its mills and sells to companies for mixture with other ingredients which are a component of animal feed.

Whey is a byproduct of the cheese making process. It consists of water, protein, calcium, lactose and other minerals. In the past, whey was regarded as an environmental pollutant, and its disposal was expensive. Reprocessed, the whey can be sold as a component of animal feed and for other uses. The whey is priced based on a formula tied to the price of whey on a commodity market.

Quality Control

The Company is supplied its milk by the largest milk cooperative headquartered in Vermont. Quality control starts on the local farms, which produce the milk for the cooperative. The milk is delivered to the Company directly from the farms on a regular and timely basis. The Company tests all milk received. Throughout the production process, the Company subjects its products to quality control inspection and testing in order to satisfy federal and state regulations, meet customer specifications and assure consistent product quality. The Company currently employs three persons qualified to perform the necessary testing as prescribed by state, federal and the Company's quality standards and specifications. Such tests are performed at the Company's on-site laboratory. On a regular basis, random samples are sent to qualified independent labs to test for bacteria and other micro-organisms. Federal and state regulatory agencies also perform regular inspections of the Company's products and facilities.

Raw Materials

At present, there are adequate supplies of raw materials, primarily milk, utilized by the Company in manufacturing its products and the Company expects such adequate supplies to continue to be available. The Company has a milk supply contract with St. Albans Cooperative Creamery, Inc. and has been able to purchase as much milk as needed for its production. The Cooperative also sells to the Company condensed skim milk and dry milk powder.

Markets and Customers

The Company's products are sold primarily to the food service and industrial segment of the cheese market.

The food service segment of the cheese market includes food service distributors, pizza chains, recreational facilities, business feeders, health care facilities, schools and other institutions that utilize the Company's products as ingredients in preparing foods for on premise consumption. The Company sells its products to the food service segment of the cheese market through the Company's in house sales force and network of non-exclusive food brokers who then sell to approximately 140 distributors throughout the eastern United States. For the fiscal years ended March 31, 2005, 2004 and 2003, sales of the Company's products to the food service segment of the cheese market accounted for approximately 94.1%, 90.5% and 69% of revenues, respectively. For the fiscal year ended March 31, 2005, approximately 93.8% of such sales were of the Company's low moisture mozzarella type cheeses and 11.4% was pizza cheese. In fiscal year ended March 31, 2005 one customer accounted for approximately 10% of sales. In the fiscal years ended March 31, 2004 and 2003, no one customer accounted for more than 10% of sales.

In the industrial segment of the cheese market, the Company sells its products to manufacturers for use as an ingredient in processed foods, such as frozen and refrigerated pizzas, a variety of Italian specialty convenience foods, and general frozen entrees and side dishes. The majority of the Company's sales of its cheese products to the industrial market are made directly by the Company's in-house sales staff and its brokers. For the fiscal years ended March 31, 2005, 2004 and 2003, sales of the Company's products to the industrial segment of the cheese market accounted for approximately 5.9%, 6% and 22% of revenues, respectively.

The Company discontinued sales to the retail segment of the cheese market in 2005. In 2004 and 2003, the retail segment accounted for approximately 2% and 2%

of total sales.

Sales and marketing

The Company has shifted its sales and marketing efforts to emphasize its four product groups: low moisture mozzarella cheese pizza cheese, provolone and shredded cheeses. The shredded cheese products range from low moisture mozzarella cheese, and pizza cheese to various blended cheese products The Company's reduced fat low moisture mozzarella cheese has been positioned for the health conscious consumer. The Company's pizza cheese product has been positioned to be an alternative to mozzarella cheese, designed for the value conscious customer who is looking for a lower cost alternative to mozzarella cheese.

The Company continues to offer its products to customers desiring a private label solution as well as customers choosing to sell the Company's brands.

Competition

The Company faces intense competition. Its whole milk and part skim low moisture mozzarella cheese and square provolone are commodity products. These are price sensitive products sold by numerous small local, medium-sized regional and large national competitors. National manufacturers include Sorrento Cheese Company Inc. and Saputo. Also, there are a number of national dairy cooperatives, D.F.A. Inc. and Land O' Lakes, Inc., which compete in the Company's marketplace. Many of these competitors have significantly greater resources (financial and other) than the Company.

The Company has positioned its reduced fat low moisture mozzarella cheese as a premium product within the low moisture mozzarella cheese category.

The Company's pizza cheese product was created to sell at prices below traditional mozzarella cheese. In this field the company competes with other manufacturers of pizza cheese, including Leprino and D.F.A. Inc.

The Company believes that the principal competitive factors in the marketing of its products are quality, performance characteristics, consistency, customer service, and price. The Company believes that its products compete favorably with respect to these factors in its primary market segments.

Trademarks and Patents

The Company has the trademarks Smart Cheese (TM), Salerno (TM), Select(TM), Monte Carlo(TM), Mozzi-RITE(TM), and Tasty-Lite Cheese(TM) for its products. The Company believes these trademarks are an important means of establishing customer recognition for the Company and its products. However, there can be no assurance as to the degree that these trademarks offer protection to the Company, or that the Company will have the financial resources to engage in litigation against any infringement of its trademarks, or as to the outcome of any litigation if commenced.

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Although the Company believes its formulas, processes and technology for its pizza cheese and reduced fat cheese products are proprietary, the Company has not sought and does not intend to seek patent protection for such technology. In not seeking patent protection, the Company is instead relying on the complexity of its technology, trade secrecy laws and employee confidentiality agreements. However, there can be no assurance that other companies will not acquire

information which the Company considers to be proprietary or will not independently develop equivalent or superior products or technology and obtain patents or similar rights with respect thereto. Although the Company believes that its technology has been independently developed and does not infringe upon the patents of others, certain components of the Company's manufacturing processes could infringe existing or future patents, in which event the Company may be required to modify its processes or obtain a license. No assurance can be given that the Company will be able to do so in a timely manner or upon acceptable terms and conditions, and the failure to do either of the forgoing could have a material adverse effect on the Company.

Government Regulation

The dairy industry is subject to extensive federal, state and local government regulation, including the Food and Drug Administration ("FDA"), the United States Department of Agriculture, the State of Vermont Department of Agriculture and the Vermont Environmental Protection Agency, regarding the quality, purity, manufacturing, marketing, advertising, labeling and distribution of food products. The Company's plant is subject to regulation and inspection by these agencies and failure to comply with one or more regulatory requirements can result in fines and sanctions, including the closing of all or a portion of the facility until brought back into compliance.

Food products are also subject to "standard of identity" requirements mandated by both federal and state agencies to determine the permissible qualitative and quantitative ingredient content of foods. The Company believes that all of its products subject to FDA standard of identity requirements meet those requirements.

The Company's manufacturing plant is believed to be operating in compliance with all regulations, and has all the necessary licenses, permits and approvals required to operate. The Company currently operates a facility for the purpose of pre-treating the wastewater generated from the Company's manufacturing facility. The Company entered into an agreement with the State of Vermont to make significant improvements in its wastewater facility. The improvements have been completed and the Company believes the facility is in compliance with all regulatory requirements.

Employees

The Company currently employs 79 full-time employees. Of the 79 employees, six are in executive and administrative positions, 68 are in production and distribution, and five are in clerical positions. The Company recently moved its headquarters to Swanton Vermont and 73 employees are located at that location. Four are located at the Company's sales offices in Montville, New Jersey.

Website

The Company's website is www.Lucille-Farms.com. The Company's website enables users to access its filings with the SEC as soon as reasonably practicable. The Company makes available, free of charge through its website, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC.

ITEM 2. PROPERTIES

The Company's Swanton, Vermont manufacturing plant was constructed in 1975 in conjunction with the Target Area Development Corporation (a non-affiliated industrial development agency), which was to retain title to the plant during a fixed lease period expiring on December 31, 1999. Under such lease, the Company was obligated by the Target Area Development Corporation to finance the cost of

constructing the plant. On July 5, 1994 the Company exercised its right to purchase the premises for $1.00 plus the unamortized balance of said loans. A majority of the machinery and equipment located at the plant is also included under the above arrangement. The Swanton facility is one floor consisting of approximately 40,000 square feet.

The Company currently operates a facility for the purpose of pre-treating the wastewater generated from the Company's manufacturing facility. The Company entered into an agreement with the State of Vermont to make significant improvements in the wastewater facility. The improvements have been completed and the Company believes the facility is in compliance with all regulatory requirements.

In 1999 the Company completed construction, and began operating, a 10,000 square foot whey drying facility adjacent to its Swanton, Vermont cheese plant.

The Company leases a parcel of land adjacent to the Vermont facility. Messrs Gennaro Falivene, Alfonso Falivene and the Estate of Philip Falivene, an officer and/or principal stockholder of the Company own this parcel. The space is used as an employee parking lot and its use was required in conjunction with the construction of the whey drying facility. The lease is for a ten-year period beginning April 1998. Rentals are $750 monthly for the first five years and $900 monthly for the additional five-year period. Rent expense for the years ended March 31, 2005, 2004, and 2003, was $10,800, $10,800 and $9,000 respectively. This lease has a purchase option to purchase the property at fair market value at the end of the ten-year period. This lease was assigned to UPS Capital Business Credit as security in conjunction with the whey plant financing.

The Company leases a building for administrative offices and warehouse space for dry goods across the street from the Vermont facility. The lease is for approximately one year beginning December 11, 2003 and expires on December 31, 2004, with the right to renew said lease for an additional term of one year subject to all of the terms and conditions set forth in the lease. The Company exercised its right to renew the lease for an additional one year term beginning January 1, 2005. The lease amount is $43,200 per year, payable in equal monthly installments of $3,600, in advance on the 11th day of each month. The Company has the right to purchase the premises for the sum of $610,000 at anytime during the initial term or, if the Company exercises its option for a renewal term, the renewal term of the lease.

The Company's sales offices, consisting of approximately 1,900 square feet, are located in Montville, New Jersey. Approximately 1,000 square feet of such premises are leased from Messrs. Gennaro Falivene, Alfonso Falivene and the Estate of Philip Falivene, an officer and/or principal stockholder of the Company, all of who own the office condominium unit. The Company currently pays Messrs. Falivene $1,200 per month rent for such premises, which is the fair market value for such space, on a month-to-month basis. During the fiscal years ended March 31, 2005, 2004 and 2003, the Company paid approximately $14,000, $14,000 and $14,000, respectively, towards the rental of such offices. The Company also leases an additional 900 adjacent square feet for $750 monthly on a month-to-month basis. Messrs. Alfonso Falivene, Gennaro Falivene, and the Estate of Philip Falivene also own these premises. This space is primarily used for marketing operations. Rent expense for this space was $9,000, $9,000 and $9,000, respectively, for the years ended March 31, 2005, 2004 and 2003.

ITEM 3. LEGAL PROCEEDINGS

The Company is not a party to any material pending legal proceedings.

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

Not Applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Common Stock trades on the National Association of Securities Dealers Automated quotation System ("NASDAQ") under the symbol "LUCY". The following table sets forth the high and low bid quotations reported on NASDAQ for the Common Stock for the periods indicated.

	High	Low
Year Ended March 31, 2005:		
First Quarter	2.200	1.190
Second Quarter	4.950	1.810
Third Quarter	3.940	1.800
Fourth Quarter	1.980	1.000
Year Ended March 31, 2004:		
First Quarter	1.190	.820
Second Quarter	1.490	.740
Third Quarter	1.580	1.010
Fourth Quarter	1.420	.840

The above quotations represent prices between dealers, do not include retail mark-ups, markdowns or commissions and do not necessarily reflect actual transactions.

As of June 28, 2005 there were approximately 96 holders of record of Common Stock. Since many shares are registered in street name, the number of beneficial owners is considerably higher.

The Company has never paid cash dividends on its Common Stock. Payment of dividends, if any, is within the discretion of the Company's Board of Directors and will depend, among other factors, on earnings, capital requirements and the operating and financial condition of the Company. At the present time, the anticipated capital requirements are such that the Company intends to follow a policy of retaining earnings, if any, in order to finance its business.

ITEM 6. SELECTED FINANCIAL DATA

The following tables summarize certain financial data, which should be read in conjunction with the reports of the Company's independent auditors and the more detailed financial statements and the notes thereto which appear elsewhere herein.

Statement of Operations Data (in thousands, except share and per share data)

	Year Ended March 31			
	2005	2004	2003	2002
Net Sales	$ 47,802	$ 42,174	$ 36,691	$ 44,915
Net income (loss)	$ (3,269)	209	(847)	(1,540)
Net income (loss) per share	(0.98)	0.07	(0.26)	(0.52)
Weighted average common and common equivalent shares outstanding	3,329,116	3,162,410	3,229,220	2,961,392

Balance Sheet Data (in thousands)

	March 31				
	2005	2004	2003	2002	2001
Total assets	$ 18,561	$ 18,960	$ 16,762	$ 18,827	$ 17,194
Long term debt and capital lease obligations	13,766	6,423	7,143	6,771	9,250
Total liabilities	18,823	15,953	13,817	18,583	15,924
Working capital	3,607	(383)	(238)	(3,885)	1,103
Stockholders' equity	(262)	3,007	2,945	244	1,270

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

Results of Operations

General

The Company's low moisture mozzarella cheese, which accounts for more than a majority of the Company's sales, is a commodity item. The Company prices this product competitively with others in the industry, which pricing is based on the Chicago Mercantile Exchange Block Cheddar Market (CME Block Market). The price the Company pays for fluid milk and condensed skim milk solids, a significant component of cost of goods sold, is not determined until the start of the month after its cheese has been sold. Generally, the price of milk for any particular month, is computed, based on formulas determined by the United States Department of Agriculture (USDA), by the National Agricultural Statistical Service (NASS) after the end of the month by reference to the average selling price of block cheddar cheese, barrel cheddar cheese, butter, non-fat dry milk and whey. Thus, everything else being equal and there being stability in the price of cheese, the price of milk will follow the price of cheese in an orderly manner, the normal spread between the selling price of cheese and the cost of milk will be maintained, and there will be stability in the Company's gross profit margin. However, sometimes things are not equal. For one thing, the market information required by NASS to compile the price of milk is not immediately available and takes time to collect. For this reason, the commodity prices used to calculate

the milk price is two weeks old when the NASS receives it at the end of a particular month (i.e. it includes the commodity prices for two weeks of the current month and two weeks of the prior month), creating a "lag" between the data used for determining the selling price of cheese for the month (the CME Block Market prices for the month) and the data used for determining the cost of milk for the month (based upon commodity prices for two weeks of the current month and two weeks of the prior month). Thus, if there is a precipitous increase or decrease in the price of block cheddar cheese during a given month, it may not be reflected in the average selling price of block cheddar cheese utilized in computing the price of milk for such month. In such event, there is a disconnect between the average price of cheese for the month and the cost of milk for the month . In such a case, the price of milk does not increase or decrease as fast as the price of cheese, and the Company's gross profit margin is affected accordingly. By virtue of the fact that the Company does not know its cost of milk for the month until the following month and customers are billed for cheese when it is shipped to them during the month, the Company cannot readily pass along to customers the changes in the cost of milk. As a consequence thereof, the Company's gross profit margin for its product is subject to fluctuation, which fluctuation, however slight, can have a significant effect on profitability.

Results for the year ended March 31, 2005 were down significantly from 2004. The spread between the selling price of cheese and the cost of milk changed dramatically during the year ended March 31, 2005, compared to historical spreads. This spread, which has a direct effect on gross margin for the company, declined over 50% compared to the year ended March 31, 2004, exceeding historical lows, and resulted in a negative gross profit of $1,668,000 for the last quarter of the Company's fiscal year ended March 31, 2005. This decline in gross margin has affected all cheese makers throughout the United States.

The Company is unable to predict any future increase or decrease in the prices in the CME Block Market as such market is subject to fluctuation based on factors and commodity markets outside the control of the Company. Although the cost of fluid milk does tend to move correspondingly with the CME Block Market, the extent of such movement and the timing thereof is not predictable. As a result of these factors, the Company is unable to predict pricing trends.

The financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. At March 31, 2005, the Company has a loss from continuing operations of $3,269,000, cash used in operating activities of $1,026,000 and a deficiency in assets of $262,000. These conditions raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the outcome of this uncertainty.

The Company has developed a business plan designed to improve gross margins and reduce its dependency on the spread allowed by the calculation of the milk price. The plan calls for various capital improvements that will significantly reduce the cost of producing cheese and change the type of whey produced by the Company to whey protein concentrate for human and animal consumption. The capital improvements needed to achieve the business plan will require an infusion of capital of approximately $8,000,000. Discussions are currently underway with St. Albans Cooperative, the Company's milk supplier, the Vermont Economic Development Authority, the United States Department of Agriculture, the Franklyn County Economic Development Authority, the Village of Swanton, Vermont, UPS Business Credit, LLC and LaSalle Business Credit, LLC to structure a financing package that would provide a portion of such financing as well as strengthen the Company's balance sheet. Also, the Company is having conversations with a potential joint venture partner that would provide the

necessary financing to modify the Company's whey facility. There can be no assurance that such a financing package or joint venture will be forthcoming.

Year ended March 31, 2005 compared to the year ended March 31, 2004

Sales for the year ended March 31, 2005 increased to $47,802,000 from $42,174,000 for the comparable period in 2004, an increase of $5,628,000 (or 13.3%). Approximately $6,887,000 (or 122%) of such increase was due to an increase in the average selling price for cheese. The increase in average selling price was the result of an increase in the CME Block Market prices resulting in a higher selling price per pound of cheese. This increase was partially offset by a decrease in the number of pounds of cheese sold reducing sales by approximately $1,591,000 or (28%). The remaining $332,000 sales increase this period represented an increase in whey sales. Such increase was due to an increase in the average selling price of whey. In the years ended March 31, 2005 and March 31, 2004, approximately 25,000,000 and 27,000,000 pounds of cheese and 8,900,000 and 10,100,000 pounds of whey were sold, respectively. The volume of cheese and whey sold during 2005 was less than that sold in 2004 as the Company did not choose to pursue marginal business.

During the fiscal year ended March 31, 2005, the average quarterly selling price of cheese ranged from approximately $1.72 to $2.06. During the fiscal year ended, March 31, 2004, the average quarterly selling price of cheese ranged from approximately $1.22 to $1.64. There is no way to predict the trend of the CME Block Market and the Company cannot provide any guidance as to future trends or as to range of selling price for commodity cheese.

In the years ended March 31, 2005 and March 31, 2004, sales of whey amounted to $1,744,000 and $1,412,000, respectively. As explained above, the average selling price of whey improved in 2005 compared to 2004. The average selling price of whey for 2005 was $.20 per pound compared to $.14 for 2004. Whey pounds sold were down due to lower cheese production

Cost of sales and gross profit margin for the year ended March 31, 2005 were $47,674,000 (or 99.7% of sales) and $128,000 (or 0.3% of sales), respectively, compared to a cost of sales and gross profit margin of $39,287,000 (or 93.1% of sales) and $2,887,000 (or 6.9% of sales), respectively, for the comparable period in 2004. Higher selling prices were offset by higher milk prices along with increased fuel costs, insurance, and repairs and maintenance.

Fuel costs were up $205,000 in 2005 compared to 2004 due to the higher market prices for gas in 2005. Insurance costs were up $170,000 due to higher worker's compensation rates. These rates are determined based on the previous three years experience. Experience has improved over the past year and rates are expected to decline next year. Repairs and maintenance was $97,000 higher in 2005. All items contributing to this increase were not significant by themselves.

Selling, general and administrative expenses for the year ended March 31, 2005 amounted to $2,422,000 (or 5.1% of sales) compared to $1,932,000 (or 4.7 % of sales) for the comparable period in 2004.

Selling expenses are mainly variable in nature. The most significant component of selling expense is sales commission and promotion expenses. Sales commission expenses were $392,000 and $330,000 in 2005 and 2004, respectively. The increase resulted from an increase in commissionable sales in the year ended March 31, 2005. Promotion expense was $333,000 and $130,000 in 2005 and 2004, respectively. Increased efforts to promote non-marginal business attributed to the increase in promotion expense. A portion of this increase is attributable to

a rebate program and a portion is attributable to use of a marketing consultant and brochures in 2005. Advertising expense also increased over the previous year to $135,000 in 2005 compared to $50,000 in 2004. This increase can be attributed also to the push to increase non-marginal business.

Generally, general and administrative expenses are fixed in nature. The more significant items in general and administrative expense are professional fees, payroll, provision for bad debts and bank charges amounting to:

	2005	2004
Professional fees	$ 192,000	$268,000
Payroll	428,000	346,000
Provision for bad debts	50,000	43,000
Bank charges	131,000	28,000

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Professional fees paid to engineering consultants were down as expenses associated with improving the efficiency of production and implementing good manufacturing procedures were incurred in 2004 and not in 2005. The increase in payroll costs is the result of a salary increase for some of the employees including the CEO and the President. The increase in bank charges is due to loan covenant violation fees.

Interest expense for the year ended March 31, 2005 amounted to $935,000 compared to $800,000 for the year ended March 31, 2004, an increase of $135,000. This increase is primarily due to financing higher milk costs during the year and losses incurred during the fourth quarter of the year. Interest rates were also somewhat higher compared to 2004.

The provision for income tax for the years ended March 31, 2005 and 2004 of $1,000 and $1,000 respectively, reflect minimum state taxes with the tax benefits of operating losses being offset by the effect of changes in the valuation allowance. Such amounts are re-evaluated each year based on the results of the operations.

The Company's net loss of $3,269,000 for 2005 was $3,478,000 less than the profit of $209,000 for the comparable period in 2004. The primary factors contributing to these changes are discussed above.

Year ended March 31, 2004 compared to the year ended March 31, 2003

Sales for the year ended March 31, 2004 increased to $42,174,000 from $36,691,000 for the comparable period in 2003, an increase of $5,483,000 (or 14.9%). Approximately $6,143,000 (or 112%) of such increase was due to an increase in the average selling price for cheese. The increase in average selling price was the result of an increase in the CME Block Market prices resulting in a higher selling price per pound of cheese. This increase was partially offset by a decrease in the number of pounds of cheese sold reducing sales by approximately $277,000 or (5%). The remaining $383,000 sales decrease this period represented a decrease in whey sales. Such decrease was due to a decrease in the average selling price of whey. In the years ended March 31, 2004 and March 31, 2003, approximately 27,000,000 and 27,200,000 pounds of cheese and 10,100,000 and 12,160,000 pounds of whey were sold, respectively.

During the fiscal year, ended March 31, 2004, the average quarterly selling price of cheese ranged from approximately $1.22 to $1.64. During the fiscal year

ended, March 31, 2003, the average quarterly selling price of cheese ranged from approximately $1.24 to $1.34. There is no way to predict the trend of the CME Block Market and the Company cannot provide any guidance as to future trends or as to range of selling price for commodity cheese.

In the years ended March 31, 2004 and March 31, 2003, sales of whey amounted to $1,412,000 and $1,795,000, respectively.

Cost of sales and gross profit margin for the year ended March 31, 2004 were $39,287,000 (or 93.1% of sales) and $2,887,000 (or 6.9% of sales), respectively, compared to a cost of sales and gross profit margin of $35,786,000 (or 97.5% of sales) and $905,000 (or 2.5% of sales), respectively, for the comparable period in 2003. Higher selling prices offset the increase in milk prices along with large reductions in labor costs, freight charges and repairs and maintenance. This increase was partially offset by an increase in whey removal, insurance expense and parts and supplies for the whey plant. The reduction in labor costs of approximately $195,000 can be attributed to better scheduling of shifts to reduce overtime and management's decision to increase production when milk costs are low and reduce production when milk costs were high. The decline in freight charges of approximately $687,000 is the result of getting bids for shipping needs instead of automatically renewing contracts with shippers. In addition, the sales agreement with the customer that buys the Company's whey is priced F.O.B .Swanton, Vermont, thus reducing freight charges. Repairs and maintenance also experienced a reduction of approximately $100,000 due to the in house maintenance department performing more of the repair work instead of hiring outside contractors to do this work

The increase in expenses for whey removal is a result of the Company not having sufficient capacity to process all of the whey it produced. This resulted in the Company having to haul away the excess whey. Insurance expense climbed approximately $140,000 due to the increase in the worker's compensation premium and the corporate package premiums. Parts and supplies for the whey plant grew by approximately $56,000 over the previous year due to the repairs of the boilers that dry the whey before it is sold.

Selling, general and administrative expenses for the year ended March 31, 2004 amounted to $1,932,000 (or 4.7% of sales) compared to $1,813,000 (or 5.0 % of sales) for the comparable period in 2003.

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Selling expenses are mainly variable in nature. The most significant component of selling expense is sales commission expense, which was $330,000 and $302,000 in 2004 and 2003, respectively. The increase resulted from an increase in commissionable sales in the year ended March 31, 2004. Advertising expense also increased over the previous year to $50,000 in 2004 compared to $28,000 in 2003.

Generally, general and administrative expenses are fixed in nature. The more significant items in general and administrative expense are professional fees, payroll, and provision for bad debts amounting to:

	2004	2003
Professional fees	$ 268,000	$166,000
Payroll	346,000	280,000
Provision for bad debts	43,000	145,000

The increase of $92,000 in professional fees can be attributed to expenses associated with improving the efficiency of production and implementing good manufacturing procedures. The increase in payroll costs is the result of

increases in employee salaries including the CEO. The decrease in provision for bad debts was due to a write-off of a large account that was in the reserve in 2003.

Interest expense for the year ended March 31, 2004 amounted to $800,000 compared to $812,000 for the year ended March 31, 2003, a decrease of $12,000. This decrease is the result of lower interest rates and the repayment of $500,000 on our term loan with Co-Bank.

The provision for income tax for the years ended March 31, 2004 and 2003 of $1,000 and $7,000, respectively, reflect minimum state taxes with the tax benefits of operating losses being offset by the effect of changes in the valuation allowance. Such amounts are re-evaluated each year based on the results of the operations.

The Company's net profit of $209,000 for 2004 was $2,004,000 more than the loss of $1,795,000 for the comparable period in 2003. The extraordinary item of $875,000, as a result of restructuring debt, reduced the loss to $847,000 for 2003. The primary factors contributing to these changes are discussed above.

Liquidity and Capital Resources

On December 2, 2004, the Company obtained an $11 million borrowing facility from LaSalle Business Credit, LLC, consisting of (a) a $7,000,000 revolving loan, with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate, (b) a $2,000,000, five-year, "Term Loan A", with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate, payable interest only for the first two years with principal payments beginning in year 3 (based on a 7 year amortization schedule), the proceeds of which were used to repay outstanding loans, (c) a $1,000,000, two year, "Term Loan B", with interest payable at 1.50% over the LaSalle Bank prime lending rate, payable in equal monthly installments commencing January 1, 2005, the proceeds of which are to be used for working capital, and (d) a $1,000,000 capital equipment line, with interest at 1.25% over the LaSalle Bank prime lending rate, the proceeds of which are to be used to purchase equipment. The commitment contains various restrictive covenants. In addition, the Company is required to maintain defined levels of net worth annually. At December 31, 2004, due to a significant adverse pricing move between the price of cheese and the price of milk for the month of December, the Company was in default of certain covenants under its borrowing facility for the test period ended December 31, 2004. On February 14, 2005, LaSalle and the Company entered into a First Amendment and Waiver to its Loan and Security Agreement which, among other things, waived the foregoing defaults, amended such covenants on a going forward basis, and suspended the capital expenditure loans unless and until (m) on or before February 15, 2006, LaSalle Business Credit, LLC shall have received the Company's internally-prepared quarterly financial statements for the fiscal quarter ended December 31, 2006, and (n) the Company shall have maintained a ratio of its FC Numerator to Fixed Charges of not less than 1.20 to 1.00 with respect to the twelve (12) month period then ended. At March 31, 2005, due to a significant adverse pricing move between the price of cheese and the price of milk for the month of February, the Company was in default of certain covenants under its borrowing facility, for the test period ended March 31, 2005, relating to, among other things, the maintenance of a Tangible Net Worth of not less than $2,500,000, and the maintenance of a Fixed Charge Coverage Ratio of not less than 1.00 x 1.00. On July 14, 2005 the Company has received waivers for the existing defaults at March 31, 2005 and amended such covenants to suspend the Company's compliance with (r) the Tangible Net Worth Covenant for the test periods ended April 30, 2005, May 31, 2005 and June 30, 2005, and (s) the Fixed Charge Coverage test for the ten (10) month period ended April 30, 2005, the eleven (11) month period ending May 31, 2005, and the twelve (12) month period ended June 30, 2005. Also, the Company's borrowing facility was amended to (x) reduce the total borrowing facility to $9,200,000 from $11,000,000, (y) reduce the revolving loan to $5,500,000 from $7,000,000,

and (z) reduce the capital expenditure loans to $700,000 from $1,000,000 and make it subject to various conditions precedent.

At March 31, 2005, the Company had working capital of $3,607,000 as compared to negative working capital of ($391,000) at March 31, 2004. The Company's revolving bank line of credit is available for the Company's working capital requirements.

At March 31, 2005, $5,751,000 was outstanding under such revolving credit line of credit and $100,000 was available for additional borrowing at that time.

In connection with the LaSalle Business Credit, LLC borrowing facility, St. Albans Cooperative Creamery, Inc., the Company's milk supplier, agreed to subordinate to LaSalle a $1,500,000 outstanding trade account payable due from the Company to St. Albans, on which trade account payable the Company is paying interest at the Bank North short-term repo rate. Pursuant to the terms of the subordination, St. Albans may receive, so long as no default exists with respect to the LaSalle borrowing facility (a) regularly scheduled payments of interest and principal, on a current basis, up to a maximum of $75,000 in any fiscal year of the Company (the "Basic Payment"), and (b) commencing with the Company's fiscal year ended March 31, 2006, a prepayment in an amount equal to 10% of the Company's Excess Cash Flow (as defined in the LaSalle lending documents) for the fiscal year, minus the amount of the Basic Payment made to St. Albans during the fiscal year, and (c) if LaSalle elects to defer all or a portion of its right to be paid 25% of the Company's Excess Cash Flow for any fiscal year (the "Deferred Amount"), St. Albans may receive an additional payment not to exceed the Deferred Amount, provided, however that the payments contemplated by clauses (b) and (c) may only be paid to St. Albans so long as and to the extent that at the time of and at all times during the thirty (30) day period immediately preceding such payments and after giving effect to such payments, the Company has Excess Availability (as defined in the LaSalle lending documents) of at least $300,000. Also, St. Albans may receive, toward the payment of such trade account payable, fifty percent (50%) of the amount of new equity capital raised by the Company in excess of six million dollars.

On February 8, 1999, a $4,950,000 bank loan agreement was signed. The loan is collateralized by the Company's plant and equipment and a guarantee by the USDA. Provisions of the loan are as follows:

> A $3,960,000 commercial term note with interest fixed at 9.75 percent having an amortization period of 20 years with a maturity in February 2019.
>
> A $990,000 commercial term note with interest fixed at 10.75 percent having an amortization period of 20 years with a maturity in February 2019.

At March 31, 2005, the Company was in default of various covenants related to this loan. The Company has received waivers for the existing defaults.

On May 23, 2001, the Company entered into a term loan with Co-op Bank for $2,000,000 with interest payable at 1% above the rate of interest established by the bank as its national variable rate. This loan was paid as part of the refinancing arrangement with LaSalle Business Credit, LLC.

On May 16, 2002, Lucille Farms, Inc. entered into an agreement with St. Albans Cooperative Creamery, Inc., the Company's primary supplier of raw materials, pursuant to which St. Albans (i) converted $1,000,000 of accounts payable owed

by Lucille Farms to St. Albans into 333,333 shares of common stock, (ii) converted $3,500,000 of accounts payable owed by Lucille Farms to St. Albans into (A) preferred stock convertible into 583,333 shares of common stock, which preferred stock (1) automatically converts into such number of shares of common stock if the common stock is $8.00 or higher for 30 consecutive trading days, and (2) may be redeemed by Lucille Farms for $3,500,000, and (B) a 10-year warrant to purchase 583,333 shares of common stock (subject to adjustment under certain circumstances to a maximum of 1,416,667 shares of common stock) at $.01 per share, which warrant (1) may not be exercised for a period of three-years, (2) terminates if, during such three-year period, Lucille Farms' common stock is $8.00 or higher for 30 consecutive trading days, and, (3) in the event Lucille Farms' common stock is not $8.00 or higher for 30 consecutive trading days during such three-year period, may only be exercised on the same basis percentage wise as the preferred shares are converted, (iii) converted an additional $1,000,000 of accounts payable owed by Lucille Farms to St. Albans into a convertible promissory note due on April 14, 2005, which note is convertible into common stock at $6.00 per share at any time by St. Albans and, at the option of Lucille Farms, automatically shall be converted into common stock at $6.00 per share if the common stock is $8.00 or higher for a period of 30 consecutive trading days, and (iv) provided Lucille Farms with a pricing structure for milk and milk by-products, for a minimum of one-year and a maximum of four-years (subject to renegotiation at the expiration of the applicable period), designed to produce profitability for Lucille Farms. The convertible promissory note due on April 14, 2005 was repaid as part of the refinancing arrangement with LaSalle Business Credit, LLC.

The Company's major source of external working capital financing is the revolving line of credit. For the foreseeable future the Company believes that the Company's revolving line of credit will continue to represent the major source of working capital financing besides any income generated from operations. Currently, the Company is seeking, as part of the financing package discussed above, an enhancement of $750,000 to the revolving line of credit to be guaranteed by the Vermont Economic Development Authority (VEDA). However, there is no assurance that the enhancement to the revolving line of credit can be secured and failure to secure such enhancement can have a significant negative effect on the Company's liquidity.

For the year ended March 31, 2005, cash used by operating activities was $1,026,000. Significant operating losses contributed to the use of cash for operating activities mostly due to low gross margins as explained above. The Company's Business Plan is designed to improve gross margins and reduce its dependency on the spread between the selling price of cheese and the cost of milk.. The Business Plan will be executed when financing efforts for capital improvements are completed as explained above. There is no assurance that financing for the Business Plan can be secured and failure to secure such financing can have a significant negative effect on the Company's liquidity.

Net cash used by investing activities was $497,000 for 2005, which represented $497,000 of purchases of plant and equipment.

Net cash provided by financing activities was $1,044,000 for 2005, provided primarily by increases in the Company's revolving line of credit and additional long term debt provided by the LaSalle Business Credit, LLC credit facility obtained on December 2, 2004. This was done to finance losses sustained during the year and purchases of plant and equipment of $497,000 and loan costs of $472,000 associated with closing of the LaSalle Business Credit, LLC loan facility.

New Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs." This statement requires the allocation of fixed production overhead to inventory based on the normal capacity of the production facilities and clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted materials should be recognized as period expense.
The Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company is evaluating the impact of this Statement but does not expect it to have a significant effect on financial position or results of operations.

In December 2004, the FASB issued SFAS 123R, "Share Based Payment." SFAS 123R is a revision to SFAS 123 and supersedes APB 25, "Accounting for Stock Issued to Employees," and amends SFAS 95, "Statement of Cash Flows." This statement requires a public entity to expense the cost of employee services received in exchange for an award of equity instruments. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements of these equity arrangements. The initial effective date for SFAS 123R was the first interim reporting period set to begin after June 15, 2005. On April 14, 2005 the SEC deferred the effective date six months therefore Lucille Farms, Inc. must comply with the provision of SFAS 123R in the first quarter of 2006. SFAS 123R permits public companies to choose between the following two adoption methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date, or

2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption

Lucille currently accounts for share-based payments to employees using APB 25's intrinsic value method and, as such, recognizes no compensation expense for employee stock options. The impact of the adoption of SFAS 123R on Lucille cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. There would have been no material impact on reported results of operations and earnings per share had the Company applied the fair value provisions of SFAS 123 to share-based payments.

The adoption of SFAS 123R's fair value method may have an impact, possibly material, on Lucille's future results of operations but no material impact on overall financial position. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation expense, if any, to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement may reduce net operating cash flows and increase net financing cash flows in the consolidated statement of cash flows of periods after adoption. Due to timing of the release of SFAS 123R and the choice between the two adoption methods, the Company is still analyzing the ultimate impact that this new pronouncement may have on its results of operations.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 153, "Exchanges of Nonmonetary Assets an amendment of APB Opinion No. 29". The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion,

however, included exceptions to that principle. This statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commerical substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. Lucille intends to follow the interpretive guidance on accounting for exchanges for nonmonetary assets as set forth in SFAS No. 153.

On March 29, 2005, the Staff of the Securities and Exchange Commission (SEC or the Staff) issued Staff Accounting Bulletin No. 107, "Share-Based Payment" (SAB 107). Although not altering any conclusions reached in SFAS 123R, SAB 107 provides the views of the Staff regarding the interaction between SFAS 123R and certain SEC rules and regulations and, among other things, provide the Staff's views regarding the valuation of share-based payment arrangements for public companies. Lucille intends to follow the interpretative guidance on share-based payment set forth in SAB 107 during the Company's adoption of SFAS 123R.

Critical Accounting Policies and Estimates

Our financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The policies discussed below are considered by management to be critical to an understanding of our financial statements because their application places the most significant demands on management's judgment, with financial reporting results relying on estimation about the effect of matters that are inherently uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. For all of these policies, management cautions that future events rarely develop exactly as forecast, and the best estimates routinely require adjustment.

Revenue Recognition- Our revenue recognition policy is significant because our revenue is a key component of our results of operations. Revenue is recognized when goods are shipped from production facilities or outside warehouses to customers.

Allowance for Doubtful Accounts - We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Based on historical information, we believe that our allowance is adequate to cover potential uncollectible accounts. Changes in general, economic, business and market conditions could result in an impairment in the ability of our customers to make their required payments; therefore, the allowance for doubtful accounts is reviewed monthly and changes to the allowance are updated based on actual collections.

Reserve for inventory obsolescence - We maintain an allowance for inventory obsolescence for losses resulting from inventory items becoming not saleable due to spoilage or changes in customers' requirements. Based on historical and projected sales information, we believe that our allowance is adequately stated. However, changes in general economic, business and market conditions could cause our customers purchasing requirements to change. These changes could affect the sales of our inventory; therefore, the allowance for inventory obsolescence is reviewed regularly and changes to the allowance are made as new information is

received.

Long Lived Asset Impairment - The Company reviews long-lived assets for impairment whenever circumstances indicate that the carrying amount of the asset may not be recoverable, and recognizes an impairment loss when the undiscounted future cash flows expected to be generated by the asset are less than the carrying amount of the asset. Long-lived assets held for sale, other than assets to be disposed of in connection with disposal of a discontinued business segment, are reported at the lower of carrying amount or fair value less cost to sell.

Valuation Allowance for Deferred Tax Assets - We have recorded a valuation allowance against deferred tax assets because there is a strong likelihood that we will not be able to generate sufficient future taxable income to realize the deferred tax assets. However, if these estimates and assumptions change in the future, we will reduce our valuation allowance and record a deferred tax asset for an amount that has a strong likelihood to be realized.

Impact of Inflation

Inflationary factor have not had a significant effect on our operations.

Website

The Company's website is www.Lucille-Farms.com. The Company's website enables users to access its filings with the SEC as soon as reasonably practicable. The Company makes available, free of charge through its website, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC.

Off Balance Sheet Arrangements

The Company does not have any off balance sheet arrangements.

Contractual Obligations

		Payment due by period		
Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 y
Long Term Debt Obligations	$14,416,000	$650,000	$1,590,000	$7,30
Capital Lese Obligations	15,000	15,000	-0-	
Operating Lease Obligations	78,000	36,000	41,000	
Purchase Obligations	-0-	-0-	-0-	
Other Long Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP	-0-	-0-	-0-	
Total	$14,509,000	$701,000	$1,631,000	$8,3

Safe Harbor Statement

This Annual Report on Form 10-K (and any other reports issued by the Company from time to time) contains certain forward-looking statements made in reliance upon the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are based on current expectations that involve numerous risks and uncertainties. Actual results could differ materially from those anticipated in such forward-looking statements as a result of various known and unknown factors including, without limitation, future economic, competitive, regulatory, and market conditions, future business decisions, the uncertainties inherent in the pricing of cheese on the Chicago Mercantile Exchange upon which the Company's prices are based, changes in consumer tastes, fluctuations in milk prices, and those factors discussed above under Management's Discussion and Analysis of Financial Condition and Results of Operations. Words such as "believes," "anticipates," "expects," "intends," "may," and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. The Company undertakes no obligation to revise any of these forward-looking statements.

ITEM 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

In September 2004, the Company began to hedge the risks of the prices in the cheese and milk markets to ensure profitability. The Company has undertaken a program to sell cheese under long-term contracts and to hedge the transaction through the purchase of milk futures. Increases and decreases in the price of milk in the market (resulting in potential losses or profits on the sale of cheese) would generally be offset by corresponding losses and gains on the related hedging instruments, resulting in negligible net exposure for such transactions. To date, the majority of our expense for milk is not hedged.

In designing a specific hedging program approach, the Company considers several factors including offsetting exposures, significance of exposures, costs associated with entering into a particular hedge instrument and potential effectiveness of the hedge. Our hedging program reduces, but does not entirely eliminate, the impact of milk price movements. Due primarily to our limited use of the hedging program to date, the impact of the hedging program on milk expense fluctuations has not been material to our consolidated financial statements.

The Company is subject to interest rate exposure on variable rate debt. The amount of that debt at balance sheet date, March 31, 2005 and March 31, 2004 amounted to $10,125,000, and $5,781,000, respectively. In as much as this debt is based upon the Prime Rate plus 1/4 of 1% or 1.5%, the cost of this debt will increase or decrease accordingly with changes in the prime rate.

The Company has exposure to the commodity prices for cheese, dry whey and fluid milk. We have addressed these exposures in the general paragraph of MD&A Item 7.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Lucille Farms, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of Lucille Farms, Inc. and Subsidiary as of March 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for the years then ended. These consolidated 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 audits 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lucille Farms, Inc. and Subsidiary at March 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that Lucille Farms, Inc. and Subsidiary will continue as a going concern. As more fully described in Note 2, at March 31, 2005, the Company has a loss from continuing operations of $3,269,000, cash used in operating activities of $1,026,000 and a

deficiency in assets of $262,000. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Mahoney Cohen & Company, CPA, P.C.

New York, New York
June 24, 2005, except for Note 7b
As to which date is July 14, 2005

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Report of Independent Accountants

To the Audit Committee of Lucille Farms, Inc. and Subsidiaries:

We have audited the accompanying consolidated balance sheet of Lucille Farms, Inc. and Subsidiaries as of March 31, 2003 and the related consolidated statements of operations, stockholders' equity and cash flows for the period ended March 31, 2003. The consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principals used and significant estimates made by management, as well as evaluating the overall consolidated financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lucille Farms, Inc. and Subsidiaries as of March 31, 2003 and the consolidated results of their operations and their consolidated cash flows for the period ended March 31, 2003 in conformity with accounting principals generally accepted in the United States of America.

WISS & COMPANY, LLP

Livingston, New Jersey
June 26, 2003, except for note 14 for which the date of July 14, 2003

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LUCILLE FARMS, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
MARCH 31,

	2005	200
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 132,000	$ 611,
Accounts receivable, net of allowances of $67,000 in 2005 and $170,000 in 2004	5,172,000	4,618,
Inventories	2,739,000	3,234,
Prepaid expenses and other current assets	621,000	676,
Total Current Assets	$ 8,664,000	9,139,
Property, Plant and Equipment, net	9,206,000	9,579,
Other Assets:		
Deferred loan costs, net	637,000	215,
Other	54,000	27,
Total Other Assets	691,000	242,
TOTAL ASSETS	$18,561,000	$18,960,
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Revolving credit loan	$ --	$ 4,281,
Accounts payable	3,730,000	3,964,
Current portion of long-term debt	665,000	711,
Accrued expenses	662,000	574,
Total Current Liabilities	5,057,000	9,530,
Long-Term Liabilities:		
Long-term debt, less current portion	13,766,000	6,423,
Total Long-Term Liabilities	13,766,000	6,423,
TOTAL LIABILITIES	$18,823,000	$15,953,
Stockholders' Equity:		
Preferred stock, $0.001 per share, 250,000 shares authorized:		
216 shares Series A convertible issued and outstanding at March 31, 2004	--	1,
583 shares Series B convertible issued and		

outstanding	1,000	1,
Common stock, $0.001 par value, 25,000,000 shares authorized, at March 31, 2005 and March 31, 2004; respectively; 3,570,675 shares issued, 3,353,937 outstanding at March 31, 2005 and 3,354,675 shares issued, 3,137,937 outstanding at March 31, 2004	4,000	3,
Additional paid-in capital	8,548,000	8,548,
Accumulated deficit	(8,503,000)	(5,234,
	50,000	3,319,
Less: cost of 216,738 shares of treasury stock	(312,000)	(312,
Total Stockholders' Equity (Deficit)	(262,000)	3,007,
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	$ 18,561,000	$ 18,960,

See accompanying notes to consolidated financial statements.

LUCILLE FARMS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED MARCH 31,

	2005	2004	200
Sales	$47,802,000	$42,174,000	$36,691
Cost of sales	47,674,000	39,287,000	35,786
Gross profit	128,000	2,887,000	905
Other expense (income):			
Selling	1,215,000	915,000	713
General and administration	1,207,000	1,017,000	1,100
Gain On Debt Restructuring	-0-	-0-	(875
Other income	39,000	(55,000)	(5
Interest expense	935,000	800,000	812
Total other expense (income)	3,396,000	2,677,000	1,745

Income (Loss) before income taxes	(3,268,000)	210,000	(840
Provision for income taxes	1,000	1,000	7
Net Income (Loss)	$(3,269,000)	$ 209,000	$ (847
Net Income (Loss) per Share:			
Basic and Diluted:			
Net Income (loss)	$ (0.98)	$ 0.07	$ (
Weighted average shares outstanding used to compute net income (loss) per share:			
Basic and Diluted	3,329,116	3,162,410	3,229

See accompanying notes to consolidated financial statements.

LUCILLE FARMS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)
FOR THE YEARS ENDED MARCH 31, 2005, 2004 AND 2003

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in capital	Accumulated Deficit	Treasu Sha
Balance March 31,2002	216	$1,000	3,021,342	$3,000	$5,001,000	$(4,596,000)	69,
Preferred							
Issued	583	1,000	333,333		3,548,000		
Net loss						(847,000)	
Balance March 31, 2003	799	2,000	3,354,675	3,000	8,548,000	(5,443,000)	69,
Purchase of treasury stock							146,
Net Income						209,000	
Balance March 31, 2004	799	2,000	3,354,675	3,000	8,548,000	(5,234,000)	216,

Net Loss						(3,269,000)	
Preferred							
stock converted to common	(216)	(1,000)	216,000	1,000			
	----	------	---------	------	---------	-----------	----
Balance March 31, 2005	583	$1,000	3,570,675	$4,000	$8,548,000	$(8,503,000)	216,
	====	======	=========	======	==========	===========	====

See accompanying notes to consolidated financial statements.

LUCILLE FARMS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED MARCH 31,

	2005	2004	
Cash Flows from Operating Activities:			
Net income/(loss)	$(3,269,000)	$ 209,000	$
Adjustments to reconcile net income/loss to net cash flow from operations:			
Depreciation and amortization	920,000	852,000	
Provision for doubtful accounts	50,000	43,000	
Deferred income taxes	0	0	
Inventory valuation allowance	211,000	(350,000)	
Non-cash compensation	0	0	
Extraordinary gain			
(Decrease) increase in assets:	0	0	
Accounts receivable	(604,000)	(1,131,000)	
Inventories	284,000	(699,000)	
Prepaid expense and other current assets	55,000	(114,000)	
Other assets	(27,000)	89,000	
Increase (decrease) in liabilities:			
Accounts payable	1,266,000	1,550,000	

Deferred income taxes	0	0
Accrued expenses	88,000	(52,000)
Cash flow provided by (used in) operating activities	(1,026,000)	397,000
Cash Flows from Investing Activities:		
Purchase of property, plant and equipment	(497,000)	(428,000)
Net Cash used by investing activities	(497,000)	(428,000)
Cash Flows from Financing Activities:		
Proceeds from (payments of) Line of Credit Facility	1,469,000	1,357,000
Proceeds from long-term debt	3,000,000	0
Principal payments of long-term debt	(2,953,000)	(719,000)
Payment of loan costs	(472,000)	0
Net cash provided by (used in) financing activities	1,044,000	(638,000)
Net (decrease) increase in cash and cash equivalents	(479,000)	607,000
Cash and cash equivalents - beginning	611,000	4,000
Cash and cash equivalents - ending	$ 132,000	$ 611,000
Supplemental disclosure of cash flow information: Cash paid for:		
Interest	$ 924,000	$ 824,000
Income taxes	1,000	1,000
Non-Cash Investing and Financing Activities:		
Treasury Stock acquired in settlement loan and accrued interest	0	147,000
Conversion of 216 shares of Series A Convertible Preferred Stock into 216,000 shares of common stock	1,000	0

See accompanying notes to consolidated financial statements.

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LUCILLE FARMS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business Activity
Lucille Farms, Inc. and its wholly owned subsidiary (the "Company") is engaged in the manufacture and marketing of a variety of cheese products which are sold primarily to the food service and industrial segments of the cheese market through independent distributors and the Company's sales staff, respectively. The Company's cheese products are sold in a highly competitive market place and as such the Company is unable to predict pricing trends that have a significant effect on its operations. Regulatory factors affect the Company's milk suppliers, such as dairy subsidies and price supports, which may have an effect on the Company's raw material cost, but the impact cannot be predicted.

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 the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Basis of Presentation
The consolidated financial statements include the accounts of Lucille Farms, Inc. and its wholly owned subsidiary. All significant intercompany balances and transactions have been eliminated.

Cash Equivalents
The Company considers temporary investments with a maturity of three months or less to be cash equivalents.

Concentration of Credit Risk
The Company maintains its cash balances at several financial institutions. Accounts at each institution are insured by the Federal Deposit Insurance Corporation up to $100,000. At times, cash balances may exceed insured limits.

Revenue Recognition
The Company follows the guidelines of the SEC Accounting Bulletin No. 104, "Revenue Recognized in Financial Statements". Revenues are recognized at the time products are shipped to the customer. Allowances are made for estimated returns and allowances. Sales of whey, $1,744,000, $1,412,000 and $1,795,000 for 2005, 2004 and 2003, respectively, are also recognized at time of shipment to customers.

Advertising
Advertising is expensed as incurred. Advertising expense was $135,000, $41,000 and $28,000 for 2005, 2004 and 2003, respectively.

Inventories
Inventories are stated at the lower of cost or market determined on a first in, first out method of accounting.

Property, Plant and Equipment
Property, plant and equipment are stated at cost. Depreciation and amortization is being provided on a straight-line basis over the estimated useful lives of

the assets as follows:

Plant	35 years
Equipment	3-10 years

Long-Lived Asset Impairment
Pursuant to Financial Accounting Standards Board Statement No. 144, "Accounting for the Impairment or disposal of Long-Lived Assets is recognized whenever events or changes in circumstances indicate that the carrying amount of the asset, or related group of assets, may not be fully recoverable from estimated future cash flows and the fair value of the related assets is less than their carrying value.

Deferred Loan Costs
Costs of obtaining term facilities were deferred and are being amortized on a straight-line basis over the term of the loans.

LUCILLE FARMS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Income Taxes
The Company provides for deferred income taxes resulting from temporary differences in reporting certain income and expense items (principally depreciation) for income tax and financial reporting purposes. Income tax benefits from operating loss carryforwards are recognized to the extent available less a valuation allowance if it is more likely than not that some portion of the deferred tax asset will not be realized.

Earnings per Share
Basic earnings per share are computed by dividing net earnings available to common shareholders by the weighted average common shares outstanding for the period. Diluted earnings per share is computed by dividing net earnings available to common shareholders by the weighted average common shares outstanding adjusted for the dilutive effect of options granted under the Company's stock option plans, outstanding warrants, and convertible preferred stock. Basic and diluted earnings per share were the same for 2005, 2004, and 2003 since options and warrants were not included in the calculation because their effect would have been antidilutive. For 2005, 2004, and 2003 conversion of preferred stock was not taken into consideration since the effect would be antidilutive.

Accounting for Stock-Based Compensation
The Company follows the intrinsic method of Accounting Principals Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25) and related Interpretations in accounting for it's employee stock options because, as discussed below, Financial Accounting Standards Board Statement No. 123," Accounting for Stock-Based Compensation" (FAS 123) requires use of option valuation models that were not developed for use in valuing employee stock options. FAS 123 permits a Company to elect the intrinsic method of APB 25 rather than the alternative fair value accounting provided under FAS 123 but requires pro forma net income and earnings per share disclosures as well as various other disclosures not required under APB 25 for companies following APB 25. The Company has adopted the disclosure provisions required under Financial Accounting Standards Board Statement No. 148, "Accounting for Stock-Based Compensation -Transition and Disclosure" (FAS 148). Under APB 25, because the exercise price of the Company's stock options equals the market price of the

underlying stock at the date of grant, no compensation expense was recognized. See "New Pronouncements".

Sales concentration
In fiscal year ended March 31, 2005 one customer accounted for approximately 10% of sales. In the fiscal years ended March 31, 2004 and 2003, no one customer accounted for more than 10% of sales.

Vendor concentration
The Company purchases milk from one vendor. Management believes that if this supplier should discontinue production there are other suppliers of milk in the region and new sources would be readily available.

New Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs." This statement requires the allocation of fixed production overhead to inventory based on the normal capacity of the production facilities and clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted materials should be recognized as period expense.
The Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company is evaluating the impact of this Statement but does not expect it to have a significant effect on financial position or results of operations.

In December 2004, the FASB issued SFAS 123R, "Share Based Payment." SFAS 123R is a revision to SFAS 123 and supersedes APB 25, "Accounting for Stock Issued to Employees," and amends SFAS 95, "Statement of Cash Flows." This statement requires a public entity to expense the cost of employee services received in exchange for an award of equity instruments. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements of these equity arrangements. The initial effective date for SFAS 123R was the first interim reporting period set to begin after June 15, 2005. On April 14, 2005 the SEC deferred the effective date six months therefore Lucille Farms, Inc. must comply with the provision of SFAS 123R in the first quarter of 2005. SFAS 123R permits public companies to choose between the following two adoption methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date, or

2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

Lucille currently accounts for share-based payments to employees using APB 25's intrinsic value method and, as such, recognizes no compensation expense for employee stock options. The impact of the adoption of SFAS 123R on Lucille cannot be predicted at this time because it will depend on levels of share-based

payments granted in the future. There would have been no material impact on reported results of operations and earnings per share had the Company applied the fair value provisions of SFAS 123 to share-based payments.

The adoption of SFAS 123R's fair value method may have an impact, possibly material, on Lucille's future results of operations but no material impact on overall financial position. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation expense, if any, to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement may reduce net operating cash flows and increase net financing cash flows in the consolidated statement of cash flows of periods after adoption. Due to timing of the release of SFAS 123R and the choice between the two adoption methods, the Company is still analyzing the ultimate impact that this new pronouncement may have on its results of operations.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 153, "Exchanges of Nonmonetary Assets an amendment of APB Opinion No. 29". The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included exceptions to that principle. This statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commerical substance. A nonmonetary exchange has commerical substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. Lucille intends to follow the interpretive guidance on accounting for exchanges for nonmonetary assets as set forth in SFAS No. 153.

On March 29, 2005, the Staff of the Securities and Exchange Commission (SEC or the Staff) issued Staff Accounting Bulletin No. 107, "Share-Based Payment" (SAB 107). Although not altering any conclusions reached in SFAS 123R, SAB 107 provides the views of the Staff regarding the interaction between SFAS 123R and certain SEC rules and regulations and, among other things, provide the Staff's views regarding the valuation of share-based payment arrangements for public companies. Lucille intends to follow the interpretative guidance on share-based payment set forth in SAB 107 during the Company's adoption of SFAS 123R.

Fair value and Credit Risk

The Company's other financial instruments are generally cash deposits, accounts receivable and debt. The Company's debt carries interest at market rates and the Company believes that the fair value of the cash deposits and accounts receivable approximates the carrying value due to the short term nature of those instruments.

The Company provides credit to customers on an unsecured basis after evaluating customer credit worthiness. Since the Company sells to a broad range of customers with a wide geographical dispersion, concentrations of credit risk are limited. In addition, the Company provides an allowance for doubtful accounts for accounts receivable, which are potentially uncollectable and carries credit insurance on large and mid-sized accounts.

Reclassifications
Certain reclassifications have been made to the prior years' financial statements to conform to the current year presentation. These reclassifications had no effect on previously reported results of operations or accumulated deficit.

LUCILLE FARMS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 - GOING CONCERN
The financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. At March 31, 2005, the Company has a loss from continuing operations of $3,269,000, cash used in operating activities of $1,026,000 and a deficiency in assets of $262,000. These conditions raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the outcome of this uncertainty.

The Company has developed a business plan designed to improve gross margins and reduce its dependency on the spread allowed by the calculation of the milk price. The plan calls for various capital improvements that will significantly reduce the cost of producing cheese and change the type of whey produced by the Company to whey protein concentrate for human and animal consumption. The capital improvements needed to achieve the business plan will require an infusion of capital of approximately $8,000,000. Discussions are currently underway with St. Albans Cooperative, the Company's milk supplier, the Vermont Economic Development Authority, the Village of Swanton, Vermont, UPS Business Credit, LLC and LaSalle Business Credit, LLC to structure a financing package that would provide a portion of such financing as well as strengthen the Company's balance sheet. Also, the Company is having conversations with a potential joint venture partner that would provide the necessary financing to modify the Company's whey facility. There can be no assurance that such a financing package or joint venture will be forthcoming.

NOTE 3 - ACCOUNTS RECEIVABLE AND ALLOWANCE FOR DOUBTFUL ACCOUNTS
Accounts receivable are net of $67,000 and $170,000 in allowance for doubtful accounts at March 31, 2005 and 2004, respectively. Credit is extended after a credit review by management that is based on a customer's ability to perform its obligations. Such reviews are regularly updated. The allowance for doubtful accounts is based upon agings of customer balances and specific account review by management. The Company has no concentration of credit risks and, generally, does not require collateral or other security from its customers.

NOTE 4 - INVENTORIES Inventories consist of the following:

	March 31, 2005	March 31, 2004
Finished goods	$2,244,000	$2,164,000
Raw materials	217,000	691,000
Supplies and packaging	489,000	379,000
	2,950,000	$3,234,000
Less: Reserve for Obsolescence	211,000	-0-
	$2,739,000	$3,234,000

LUCILLE FARMS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 - PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following:

	March 31, 2005	March 31, 2004
Land	$ 25,000	$ 25,000
Plant	4,962,000	4,867,000
Equipment	11,206,000	10,814,000
Whey facility	2,153,000	2,143,000
	$18,346,000	$17,849,000
Less: accumulated depreciation and amortization	9,140,000	8,270,000
	$ 9,206,000	$ 9,579,000

NOTE 6 - DUE FROM OFFICERS

Amounts due from officers reflect advances and loans, which effective June 1, 1992 were converted to promissory notes bearing interest at 9% per annum. Interest is payable annually. Principal originally due on June 1, 2000 was extended to June 1, 2003. During 2004, $146,838, the entire outstanding amount of the debt, was repaid by the Company acquiring shares of its common stock from the officers.

NOTE 7 - REVOLVING CREDIT LOAN

A) On December 2, 2004, the Company obtained an $11 million borrowing facility from LaSalle Business Credit, LLC, consisting of:

a. a $7,000,000 revolving loan with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate (5.75% at March 31, 2005) to be repaid on December 1, 2009.

b. a $2,000,000, five year, "term loan A," with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate, payable interest only for the first two years with equal monthly installments of principal of $23,810 (based on a 7 year amortization schedule) commencing on December 1, 2006 and continuing thereafter on the first day of each succeeding calendar month with any unpaid principal balance due on December 1, 2009. The proceeds of term loan A were used to repay outstanding loans,

c. a $1,000,000, two year "term loan B," with interest payable at 1.5% over the LaSalle Bank prime lending rate, payable in equal monthly installments of principal of $41,667 commencing January 1, 2005. The proceeds of term loan B will be used for working capital, and

d. capital equipment loans aggregating $1,000,000, with interest at 1.25% over the LaSalle prime lending rate, the proceeds of which will be used to purchase equipment as part of the Company's capital expansion plan. Each capital expenditure loan will be repaid in equal monthly installments in an amount sufficient to repay such loan in full by the end of the sixtieth month following the date of the loan advance. This loan facility has been suspended.

The borrowing facility is collateralized by all of the Company's assets with additional collateral in the form of an assignment of the proceeds of a life insurance policy insuring the life of the CEO of the Company in an amount of $1,000,000.

B) At March 31, 2005, the Company was in default of various covenants related to its debt with LaSalle Business Credit, LLC. As of July 14, 2005 the Company has received waivers for the existing defaults at March 31, 2005 and the covenants have been amended to suspend the Company's compliance with (a) the Tangible Net Worth covenant for the test periods ended April 30, 2005, May 31, 2005 and June 30, 2005, and (b) the Fixed Charge Coverage test for the ten (10) month period ended April 30, 2005, the eleven (11) month period ended May 31, 2005, and the twelve (12) month period ended June 30, 2005. Also, the Company's borrowing facility was amended to (1) reduce the total borrowing facility to $9,200,000 from $11,000,000, (2) reduce the revolving loan to $5,500,000 from $7,000,000, and (3) reduce the capital expenditure loan to $700,000 from $1,000,000 and make it subject to various conditions precedent.

LUCILLE FARMS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8 - LONG-TERM DEBT Long-term debt consists of the following:

	March 31, 2005	Marc
Term loan with a bank dated February 8, 1999, secured by real estate and equipment, payable monthly at $37,561 including interest at 9.75% for 20 years maturing February 8, 2019	$3,420,000	
Term loan with a bank dated February 8, 1999 secured by real estate and equipment, payable monthly at $10,051 including interest at 10.75% for 20 years maturing February 8, 2019	870,000	
Loan payable to bank due in annual installments of $500,000 beginning May 1, 2003. The loan, collateralized by the Company's plant and equipment, bears interest at 1% above the bank's national variable rate (5.25% at March 31, 2004). Interest is payable monthly. This loan was paid off as part of the restructuring with LaSalle Bank explained above.	-0-	
Promissory note to St. Albans Cooperative Creamery due April 14, 2005. The note bears interest at the applicable federal rate, paid annually in arrears on each anniversary date of the note. This loan was paid off as part of the restructuring with LaSalle Bank explained above.	-0-	
Equipment notes payable in monthly installments ranging from $972 to $3,006, including interest at rates of 9.75% to 11%, through September 2005. The notes are collateralized by equipment with a net book value of $236,000 at March 31, 2005	15,000	

Long term revolving credit loan with LaSalle Business Credit, LLC., $7,000,000 revolving loan with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate (5.75% at March 31, 2005) to be repaid on December 1, 2009. (See Note 7B)	5,751,000
Promissory note to LaSalle Business Credit LLC. of $2,000,000. Five year, "term loan A," with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate, payable interest only for the first two years with equal monthly installments of principal of $23,810 (based on a 7 year amortization schedule) commencing on December 1, 2006 and continuing thereafter on the first day of each succeeding calendar month with any unpaid principal balance due on December 1, 2009.	2,000,000

Promissory note to LaSalle Business Credit LLC. of $1,000,000. Two year "term loan B," with interest payable at 1.5% over the LaSalle Bank prime lending rate, payable in equal monthly installments of principal of $41,667 commencing January 1, 2005. The proceeds of term loan B will be used for working capital.	875,000

Long Term account payable with St. Albans Cooperative Creamery. In connection with the Company's borrowing facility with LaSalle Business Credit, LLC, St. Albans Cooperative Creamery, Inc., the Company's milk supplier, agreed to subordinate to LaSalle a $1,500,000 outstanding trade account payable due from the Company to St. Albans, on which trade account payable the Company is paying interest at the Bank North short-term repo rate. Pursuant to the terms of the subordination, St. Albans may receive, so long as no default exists with respect to the LaSalle borrowing facility (a) regularly scheduled payments of interest and principal, on a current basis, up to a maximum of $75,000 in any fiscal year of the Company (the "Basic Payment"), and (b)commencing with the Company's fiscal year ended March 31, 2006, a prepayment in an amount equal to 10% of the Company's Excess Cash Flow (as defined in the LaSalle lending documents) for the fiscal year, minus the amount of the Basic Payment made to St. Albans during the fiscal year, and (c) if LaSalle elects to defer all or a portion of its right to be paid 25% of the Company's Excess Cash Flow for any fiscal year (the "Deferred Amount"), St. Albans may receive an additional payment not to exceed the Deferred Amount, provided, however that the payments contemplated by clauses (b) and (c) may only be paid to St. Albans as long as and to the extent that at the time of and at all times during the thirty (30) day period immediately preceding such

payments and after giving effect to such payments, the Company has Excess Availability (as defined in the LaSalle lending documents) of at least $300,000. Also, St. Albans may receive, toward the payment of such trade account payable, fifty percent (50%) of the amount of new equity capital raised by the Company in excess of six million dollars ($6,000,000).	1,500,000
	14,431,000
Less: current portion	665,000
TOTAL	13,766,000

As of March 31, 2005 long-term debt matures as follows:

2006	665,000
2007	635,000
2008	468,000
2009	487,000
2010	7,306,000
Thereafter	4,870,000
	14,431,000

Substantially all of the Company's property, plant and equipment are pledged as collateral for these obligations.

NOTE 9 - INCOME TAXES

Temporary differences and carryforwards which give rise to deferred tax assets and liabilities are as follows:

	March 31, 2005		March 31, 2004	
	Deferred Tax Asset	Deferred Tax Liability	Deferred Tax Asset	Defer Ta Liabi
Depreciation	$ -	$ 676,000		$ 821,
Provision for doubtful accounts	26,000		65,000	
Reserve for obsolescence	80,000			
Reserve for compensated absences	26,000		14,000	
Operating loss carryforwards	4,443,000		3,227,000	
Contribution carryforwards	0		2,000	
	4,575,000	676,000	3,308,000	821,
Valuation allowance	3,899,000		2,487,000	
	$ 676,000	$ 676,000	$ 821,000	$ 821,

The net change in the valuation allowance for the periods presented were as follows:

	March 31,		
	2005	2004	2003
Valuation allowance increase (decrease)	$1,412,000	$(3,000)	$441,000

The provision for income taxes represents the provision for minimum state taxes, with the tax benefits of loss carryforwards being offset by increases or decreases in the valuation allowance.

The provision for income taxes is different than the amount computed using the United States Federal Statutory income tax rate for the reasons set forth below:

	Years Ended March 31,		
	2005	2004	2003
Expected tax at U.S. Statutory Rate	(34.0)%	34.0%	(34.0)%
State and local income taxes	0.0	.5	.1
Permanent differences and other			(.6)
Prior year tax adjustment	(9.2)	(32.6)	
Valuation allowance for operating loss Carryforwards	43.2	(1.4)	34.6
	0.0%	.5%	.1%

Operating loss carry forwards totaled $11,693,000 as of March 31, 2005 and expire on March 31, of the following years:

2009	$ 77,000
2011	$ 913,000
2013	2,122,000
2015	269,000
2016	1,562,000
2022	1,674,000
2023	1,274,000
2024	196,000
2025	3,606,000
Total	$11,693,000

NOTE 10 - LEASE COMMITMENTS

The Company leases automobiles for two of its officers under lease arrangements classified as operating leases. The leases expire in November 2005 and April 2006. Rent expense was approximately $17,000 and $17,000 in the years ended March 31, 2005 and 2004, respectively. Future minimum payments under the leases are approximately $13,000 at March 31, 2005.

The Company leases a building for administrative offices and warehouse space for dry goods with a purchase option (subject to terms and conditions). The lease expires December 31, 2004 with the right to renew for an additional year. The Company exercised its right to renew said lease for an additional term of one year. The lease amount is $43,200 per year in equal monthly installments.

NOTE 11 - RELATED PARTY TRANSACTIONS

The Company leases a parcel of land adjacent to its production facility. This parcel is owned by three of its stockholders. The space is used as an employee parking lot and its use was required in conjunction with the construction of the new whey drying facility. The ten- year lease term carries a monthly rental of $750 during the first five years and $900 during the remaining five years. Rent expense for the years ended March 31, 2005, 2004 and 2003 was $10,800, $10,800 and $9,000, respectively, in each of the years. This lease has a purchase option to purchase at fair market value at the end of the ten-year period. This lease was assigned to the bank as security in conjunction with the whey plant financing.

The Company purchases all of its milk supplies from one of its stockholders (see Note 13). Purchases totaled approximately $28,665,000 for 2005, $24,868,000 for 2004 and $21,290,000 for 2003.

The Company leases space for its executive offices at $1,200 per month from three of its stockholders on a month-to-month basis. Rent expense was approximately $14,000 for each of the years ended March 31, 2005, 2004 and 2003.

The Company also leases an additional 900 square feet for $750 monthly on a month-to- month basis. These premises are owned by three of its stockholders. This space is primarily used for the Company's marketing operations. Rent expense for the Co