

YOCREAM[®]
INTERNATIONAL

2005
Annual Report



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To our shareholders, customers and suppliers:

We are pleased to be profitable through two of the most challenging years of our corporate history. Volatile ingredient costs, excessive fuel related distribution expenses and market resistance to price increases plagued our industry. Nevertheless, the Company managed some growth and created efficiencies to maintain profitability.

The pressures did not deter our aggressive efforts. Research and development activity remained intense, resulting in refinement of existing products and development of new ones. The home page of the Company web site features two promising new products for review at your convenience. Furthermore, selling expenditures were increased reflecting our commitment to the marketplace.

Interest in the Company's experience and production capacity has prompted major customers to approach us for custom manufacturing needs. A contract with one of these companies is being completed and the related volume projections portend double digit growth for the current year. This and other opportunities have prompted facility expansion plans and construction is scheduled to begin in March.

Your favorable support is acknowledged with appreciation by all of us at YoCream, and we intend to keep you informed of the Company's progress.

Sincerely,

John N. Hanna,
Chairman of the Board and
Chief Executive Officer

Report of Independent Registered Public Accounting Firm

Board of Directors
YoCream International, Inc.
Portland, Oregon

We have audited the balance sheets of YoCream International, Inc. as of October 31, 2005 and 2004, and the related statements of income, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of YoCream International, Inc. as of October 31, 2005 and 2004, and the results of its operations, shareholders' equity and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.



Portland, Oregon
February 3, 2006

YOCREAM INTERNATIONAL, INC.

BALANCE SHEETS

October 31,

	<u>2005</u>	<u>2004</u>
ASSETS		
Current assets		
Cash and cash equivalents	\$ 2,759,066	\$ 3,806,993
Trade accounts receivable, net of allowance for doubtful accounts of \$52,500 in 2005 and \$41,500 in 2004	722,065	858,720
Inventories	2,368,293	1,866,051
Other current assets	347,525	219,634
Income tax receivable	37,351	51,154
Deferred tax assets	<u>193,027</u>	<u>194,519</u>
Total current assets	6,427,327	6,997,071
Fixed assets, net	6,401,603	6,328,875
Intangible and other long-term assets, net	<u>426,617</u>	<u>399,672</u>
	<u>\$ 13,255,547</u>	<u>\$ 13,725,618</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Current portion of long-term debt	\$ 415,346	\$ 403,319
Accounts payable	1,519,342	1,170,882
Other accrued liabilities	<u>233,925</u>	<u>156,120</u>
Total current liabilities	2,168,613	1,730,321
Long-term debt, less current portion	1,856,405	2,305,939
Deferred tax liabilities	1,135,327	1,070,720
Other liabilities	<u>63,330</u>	<u>46,060</u>
Total liabilities	<u>5,223,675</u>	<u>5,153,040</u>
Commitments		
Shareholders' equity		
Preferred stock, no par value, 5,000,000 shares authorized, none issued or outstanding	-	-
Common stock, no par value, 30,000,000 shares authorized	5,468,006	4,739,581
Unearned compensation – restricted stock	(1,500,000)	-
Retained earnings	4,042,766	3,832,997
Accumulated other comprehensive income	<u>21,100</u>	<u>-</u>
Total shareholders' equity	<u>8,031,872</u>	<u>8,572,578</u>
	<u>\$ 13,255,547</u>	<u>\$ 13,725,618</u>

The accompanying notes are an integral part of these statements.

YOCREAM INTERNATIONAL, INC.

STATEMENTS OF INCOME

For the years ended October 31,

	<u>2005</u>	<u>2004</u>
Sales	\$ 19,563,463	\$ 19,272,376
Cost of goods sold	<u>14,534,597</u>	<u>14,214,810</u>
Gross profit	5,028,866	5,057,566
Selling and marketing expenses	2,444,762	2,208,238
General and administrative expenses	<u>2,236,447</u>	<u>2,155,784</u>
Income from operations	347,657	693,544
Other income (expense)		
Interest income	34,354	7,563
Interest expense	(141,826)	(89,910)
Other, net	<u>27,584</u>	<u>28,442</u>
Income before income taxes	267,769	639,639
Income tax provision	<u>58,000</u>	<u>219,000</u>
Net income	<u>\$ 209,769</u>	<u>\$ 420,639</u>
Earnings per common share - basic	<u>\$ 0.10</u>	<u>\$ 0.18</u>
Earnings per common share - diluted	<u>\$ 0.10</u>	<u>\$ 0.18</u>
Shares used in basic earnings per share	<u>2,133,274</u>	<u>2,278,284</u>
Shares used in diluted earnings per share	<u>2,179,154</u>	<u>2,294,474</u>

The accompanying notes are an integral part of these statements.

YOCREAM INTERNATIONAL, INC.

STATEMENT OF SHAREHOLDERS' EQUITY

	Shares	Amounts	Unearned Compensation - Restricted Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, October 31, 2003	2,277,956	\$ 4,733,281	\$ -	\$ 3,412,358	\$ -	\$ 8,145,639
Comprehensive income:						
Net income	-	-	-	420,639	-	420,639
Stock held exchanged for stock option exercise cost	4,544	-	-	-	-	-
Tax benefit of options exercised	-	6,300	-	-	-	6,300
Balance, October 31, 2004	2,282,500	4,739,581	-	3,832,997	-	8,572,578
Comprehensive income:						
Net income	-	-	-	209,769	-	209,769
Change in fair value of derivative financial instruments, net of income taxes of \$13,100	-	-	-	-	21,100	21,100
Comprehensive income						230,869
Repurchase of common stock	(177,900)	(771,575)	-	-	-	(771,575)
Restricted common stock issued under stock incentive plan	300,000	1,500,000	(1,500,000)	-	-	-
Balance, October 31, 2005	<u>2,404,600</u>	<u>\$ 5,468,006</u>	<u>\$ (1,500,000)</u>	<u>\$ 4,042,766</u>	<u>\$ 21,100</u>	<u>\$ 8,031,872</u>

The accompanying notes are an integral part of this statement.

YOCREAM INTERNATIONAL, INC.

STATEMENTS OF CASH FLOWS

For the year ended October 31,

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities		
Net income	\$ 209,769	\$ 420,639
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	643,195	612,700
Gain on disposal of equipment	(27,584)	(28,442)
Deferred income taxes	52,999	155,000
Tax benefit related to exercise of stock options	-	6,300
Change in assets and liabilities		
Accounts receivable	136,655	75,539
Inventories	(502,242)	(19,062)
Other assets	(154,836)	127,676
Accounts payable	210,752	337,457
Income taxes receivable and payable	13,803	327,115
Other accrued liabilities	<u>95,075</u>	<u>36,208</u>
Net cash provided by operating activities	<u>677,586</u>	<u>2,051,130</u>
Cash flows from investing activities		
Expenditures for fixed assets	<u>(550,631)</u>	<u>(933,868)</u>
Net cash used in investing activities	<u>(550,631)</u>	<u>(933,868)</u>
Cash flows from financing activities		
Proceeds from issuance of long-term debt	-	394,886
Principal payments on long-term debt	(403,307)	(349,591)
Repurchase of common stock	<u>(771,575)</u>	<u>-</u>
Net cash provided by (used in) financing activities	<u>(1,174,882)</u>	<u>45,295</u>
Net increase (decrease) in cash And cash equivalents	(1,047,927)	1,162,557
Cash and cash equivalents, beginning of year	<u>3,806,993</u>	<u>2,644,436</u>
Cash and cash equivalents, end of year	<u>\$ 2,759,066</u>	<u>\$ 3,806,993</u>

The accompanying notes are an integral part of these statements.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE A - OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

YoCream International, Inc., with headquarters and manufacturing facility in Portland, OR, was founded in 1977. The Company produces, markets and sells its flagship product under the Dannon® YoCream® Frozen Yogurt brand. The Company also produces ice cream and frozen custard mixes under the YoCream brand. YoCream's frozen beverage product lines include Fruitquake® Smoothies, ready-to-use aseptically packaged real fruit smoothies; Frozen Dannon® Frusion® Smoothie, a ready-to-use frozen blended yogurt and fruit smoothie; and the new Jolly Rancher™ Frozen Beverages, a shelf-stable bag-in-box drink mix. The Company is an established food service vendor and private label co packer with a proven history of providing high-quality products and solution-based customer service.

On January 3, 2006, the Company filed Form 15 with the Securities and Exchange Commission to provide notice of the voluntary termination of its registration under Section 12(g) of Securities and Exchange Act of 1934 due to the number of shareholders being under 300. Concurrently the Company also voluntarily delisted its shares with NASDAQ. Several significant shareholders recommended that the Company consider alternatives to reduce the escalating costs of being registered with the SEC. The Board of Directors took this recommendation into consideration and decided that voluntarily delisting was the most cost effective alternative, as well as allowing management to intensify its focus on business opportunities. The Company's stock is currently listed on the Pink Sheets.

1. Significant Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Cash and cash equivalents

Cash and cash equivalents include money market and other short-term investments with a remaining maturity of three months or less when purchased.

3. Accounts receivable

The majority of the Company's accounts receivable are due from companies in the retail and wholesale food service industries. Credit is extended based on evaluation of a customers' financial condition and, the Company periodically performs credit evaluations of its customers. Credit insurance is obtained on selected accounts. Accounts receivable are generally due within 15 days and are stated at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the contractual payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customers' current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. Historically the Company's credit losses have been insignificant.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE A - OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

4. Inventories

Inventories are stated at the lower of cost or market. The Company determines cost based on the first-in, first-out (FIFO) method for raw materials, packaging materials and supplies, and based on standard costs for finished goods, which approximates cost based on the first-in, first-out method.

5. Fixed Assets

Fixed assets are stated at cost. Expenditures for replacements and improvements are capitalized, and expenditures for repairs and maintenance and routine replacements are charged to operating expense as incurred. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation are eliminated from the accounts and any resulting gain or loss is included in operations. Depreciation is provided for on a straight-line basis in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. Leasehold improvements are amortized over the life of the lease or the service life of the improvement, whichever is shorter. Property, plant and equipment are reviewed for impairment whenever events or circumstances indicate that the carrying amount of assets may not be recoverable in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 144 “Accounting for the Impairment or Disposal of Long-Lived Assets.” The recoverability of property, plant and equipment to be held and used is evaluated by comparing the carrying amount of an asset to the estimated future net undiscounted cash flows to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. The estimated lives used in calculating depreciation and amortization are as follows:

Plant equipment	10-25 years
Office equipment and furnishings	3-10 years
Leasehold improvements	5-14 years

6. Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable and payable, approximate fair value because of the relatively short maturity of these instruments. The carrying value of notes payable and long-term debt approximate fair values based upon the interest rates available to the Company for similar instruments.

7. Other Comprehensive Income

Other comprehensive income, which is related to an interest rate swap at fair value, is accounted for in accordance with SFAS No. 130 “Reporting Comprehensive Income” that establishes standards for reporting and display of comprehensive income and its components in the financial statements.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE A - OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

8. Revenue Recognition and Sales Incentives

Revenue from the sale of products is generally recognized at the time of shipment to the customer. Pursuant to EITF 01-9, "Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Products" certain promotional payments paid to wholesalers or retailers by a vendor for the sale of its products must be shown as a reduction of the revenues in the period they are provided. For the years ended October 31, 2005, and 2004 the total of rebates and promotional costs charged against sales were approximately \$988,000 and \$696,000, respectively.

9. Shipping and Handling Costs

Pursuant to EITF 00-10, "Accounting for Shipping and Handling Fees and Costs" such costs are classified as part of cost of sales. Payments received from customers for shipping and handling costs are classified as part of net sales upon recognition of the related sale.

10. Research and Development Costs

Research and development costs are expensed as incurred. For the years ended October 31, 2005, and 2004 such costs aggregated approximately \$459,000 and \$467,000, respectively, and are classified in the financial statements as part of cost of sales, selling, general and administrative expenses, as appropriate.

11. Earnings Per Share (EPS)

Basic EPS is computed using the weighted average number of shares of common stock outstanding for the period. Diluted EPS is computed using the weighted average number of shares of common stock and dilutive common stock equivalents outstanding during the period. Common equivalent shares from stock options are excluded from the computation when their effect is antidilutive.

12. Stock Based Compensation Plans

The Company has stock-based employee compensation plans which are more fully described in Note L. The Company has adopted the disclosure only provisions of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). It applies APB Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for its Plans.

Had the Company used the fair value methodology of SFAS 123 for determining compensation expense, the Company's net income and net income per share would approximate the pro forma amounts below:

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE A - OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

	<u>2005</u>	<u>2004</u>
Net income, as reported	\$ 209,769	\$ 420,639
Deduct: stock based compensation expense determined under the fair value method, net of tax	<u>(21,000)</u>	<u>(40,000)</u>
Net income pro forma	<u>\$ 188,769</u>	<u>\$ 380,639</u>
Net income per share, as reported		
Basic	\$.10	\$.18
Diluted	\$.10	\$.18
Net income per share, pro forma		
Basic	\$.09	\$.17
Diluted	\$.09	\$.17
Weighted average assumptions:		
Risk-free interest rate	3.07%	3.30%
Expected dividend yield	-	-
Expected lives (years)	5	5
Expected volatility	40.2%	38.0%

13. Supplemental Cash Flow Information

Supplemental cash flow information for the years ended October 31, are as follows:

	<u>2005</u>	<u>2004</u>
Cash paid during the period for income taxes	\$ 2,000	\$ 32,000
Cash paid during the period for interest	\$ 141,000	\$ 82,000
Fair value of interest rate swap, net of taxes	\$ 21,100	-
Acquisition of capital assets with debt	-	\$ 47,963
Payment (addition) of vendor payables used to acquire capital assets	\$ (137,708)	\$ 310,620
Deferred taxes related to interest rate swap	\$ 13,100	-

The statement of cash flows for the year ended October 31, 2004 excludes non-cash transactions whereby certain options were exercised by exchange of previously issued shares, as defined in the stock option plan, which resulted in a net increase in shares outstanding of 4,544.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE A - OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

14. Concentrations of Credit Risk and Major Customer

One customer accounted for 79% and 63% of accounts receivable at October 31, 2005 and 2004. This same customer accounted for 71% and 72% of total revenues in the years ended October 31, 2005 and 2004.

15. Reclassifications

Certain amounts from prior years' financial statements have been reclassified to conform to the current year presentation.

NOTE B – ADOPTION OF ACCOUNTING PRONOUNCEMENTS

SFAS No. 123 (Revised)

In December 2004, the FASB issued SFAS No. 123 (R) (revised 2004), "Share-Based Payment", which amends FASB Statement Nos. 123 and 95 and will be effective for public companies for interim or annual periods beginning after June 15, 2005. The new standard will require the Company to expense employee stock options and other share-based payments. The new standard may be adopted in one of three ways - the modified prospective transition method, a variation of the modified prospective transition method or the modified retrospective transition method. The Company is currently evaluating the effect that the adoption of SFAS 123 (R) will have on its financial position and results of operations.

SFAS No. 154

The Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections" in May 2005. This statement generally requires retrospective application to prior periods' financial statements of voluntary changes in accounting principles. Under the prior rules, changes in accounting principles were generally recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This statement does not change the previous guidance for reporting the correction of an error in previously issued financial statements, change in accounting estimate or justification of a change in accounting principle on the basis of preferability. This statement is effective for accounting changes made in fiscal years beginning after December 15, 2005. The Company does not expect this pronouncement to have a material impact on the financial statements.

NOTE C – COMPREHENSIVE INCOME

Comprehensive income is net income, plus certain other items that are recorded directly to shareholder's equity. For the year ended October 31, 2005, comprehensive income was \$230,869. In fiscal 2005, the change in fair value of derivative financial instruments, net of income taxes of \$13,100 is the only component applied to net income to calculate the Company's comprehensive income.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE D - INVENTORIES

Inventories consist of the following at October 31,:

	<u>2005</u>	<u>2004</u>
Finished goods	\$ 1,677,833	\$ 1,467,790
Raw materials	370,275	249,068
Packaging material and supplies	<u>320,185</u>	<u>149,193</u>
	<u>\$ 2,368,293</u>	<u>\$ 1,866,051</u>

NOTE E - FIXED ASSETS

Fixed assets consist of the following at October 31,:

	<u>2005</u>	<u>2004</u>
Machinery and equipment	\$ 7,527,880	\$ 7,598,297
Office equipment and furnishings	343,429	336,801
Leasehold improvements	1,389,736	1,374,401
Construction in process	<u>1,115,889</u>	<u>649,233</u>
	10,376,934	9,958,732
Less accumulated depreciation and amortization	<u>(3,975,331)</u>	<u>(3,629,857)</u>
	<u>\$ 6,401,603</u>	<u>\$ 6,328,875</u>

For the year ended October 31, 2005, capitalized interest and wages relating to construction in progress amounted to \$2,600 and \$34,400, respectively.

NOTE F - INTANGIBLE AND OTHER LONG-TERM ASSETS

Intangible assets consist of trademarks, principally “YoCream” with a cost basis of \$257,000. Accumulated amortization associated with intangible assets totaled \$161,000 at October 31, 2005 and 2004. In accordance with the provisions of SFAS No. 142, the amortization of trademarks ceased beginning in the first quarter 2003.

As of October 31, 2005 and 2004, the Company made deposits totaling \$82,000 related to the leases of various equipment and its production and office facility, and had insurance policy premium advances of \$244,000 and \$217,000, respectively (see Note P). As of October 31, 2005 and 2004, the Company also had other long-term assets of \$5,000. These items are included in intangible and other long-term assets in the accompanying balance sheet.

NOTE G – CURRENT AND LONG-TERM DEBT

The Company has an uncollateralized bank line of credit, which permits borrowing of up to \$2,000,000. The line bears interest at the bank’s commercial lending rate, 6.75% at October 31, 2005. The line is subject to renewal by July 2007. There were no amounts drawn on this line at October 31, 2005 and 2004.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE G – CURRENT AND LONG-TERM DEBT - Continued

In December 2003, the Company finalized the terms of the master finance lease facility in the amount of \$2,552,553. The facility provides for payments over seven years with interest at 30-day LIBOR plus 175 basis points (5.84% at October 31, 2005), with the option to convert to a fixed rate by using an interest rate swap at the Company's discretion (see Note H). The facility is subject to the same financial covenants as the revolving line of credit, and is collateralized by the aseptic system project assets, and by the other equipment and fixtures related to the refinanced term loans.

The master finance lease facility contains certain financial covenants including covenants related to the ratio of senior liabilities (as defined) to adjusted tangible capital, current ratio and operating cash flow to fixed charge as well as limits on the amount of common stock which can be repurchased by the Company. At October 31, 2005, the Company believes that it was in compliance with all of these ratios and covenants.

In December 2004, the Bank modified the covenants of the Business Loan Agreement to permit the Company to purchase or retire up to \$1,250,000 of its common stock during the fiscal year ended October 31, 2005, and in the fiscal year thereafter the Company is allowed to purchase or retire up to \$500,000 of its common stock.

Long-term debt consists of the following at October 31,:

	<u>2005</u>	<u>2004</u>
Master finance lease obligation to a bank in monthly installments of \$38,880 through January 2011, plus interest at 30-day LIBOR plus 1.75% (5.84% October 31, 2005), collateralized by certain equipment.	\$ 2,269,555	\$ 2,644,074
Interest rate swap fair value	(34,200)	-
Note payable in monthly installments of \$913 through June 2009, including interest at 5.25%, collateralized by certain equipment.	<u>36,396</u>	<u>45,184</u>
	2,271,751	2,709,258
Less portion due within one year	<u>(415,346)</u>	<u>(403,319)</u>
	<u>\$ 1,856,405</u>	<u>\$ 2,305,939</u>
<u>Year ending</u> <u>October 31,</u>		
2006	\$ 415,346	
2007	427,785	
2008	440,602	
2009	450,139	
2010	456,000	
Thereafter	116,079	
Less interest rate swap fair value	<u>(34,200)</u>	
	<u>\$ 2,271,751</u>	

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE H – FAIR VALUE OF DERIVATIVE FINANCIAL INSTRUMENTS

In November 2004, the Company entered into an interest rate swap agreement, which converted the variable interest rate paid on its debt to a fixed rate of 5.88%. This agreement will terminate on January 1, 2011. It is the Company's policy to enter into agreements when management deems them useful in reducing risks to the Company. To the extent that the fixed rate is higher than the Libor rate as defined in the Master Lease Agreement, payment is due from the Company for the difference. To the extent that the fixed rate is below the Libor rate, the Company is entitled to receive the difference. In accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, the Company has reviewed and designated its interest rate swap agreement as a cash flow hedge and recognizes the fair value of its interest rate swap agreement on the balance sheet. Changes in the fair value of this agreement are recorded, net of taxes, in accumulated other comprehensive income. The hedge ineffectiveness, if any, is recorded in earnings. There was no hedge ineffectiveness for the year ended October 31, 2005. At October 31, 2005, the mark-to-market adjustment was \$34,200, and the related tax effect was \$13,100.

NOTE I – STOCK REPURCHASE PLAN

On November 8, 2004, the Company's Board of Directors authorized the repurchase of up to \$1,250,000 of the Company's common stock. Under the terms of Plan, the Company may make purchases over time through open market transactions, block purchases, or through privately negotiated transactions. To assist the Company in executing the stock repurchases, the Company has entered into 10b5-1 trading plans that are administered and executed by a designated broker that purchased shares on behalf of the Company beginning November 8, 2004 and ending on February 6, 2006.

For the year ended October 31, 2005, total shares repurchased were 177,900 at an average price of \$4.337 per share for a total cost of \$771,575. There were no repurchases in 2004.

NOTE J- ADVERTISING COSTS

Advertising costs are charged to operations in the year incurred. For the years ended October 31, 2005 and 2004 advertising costs aggregated approximately \$405,000 and \$391,000, respectively.

NOTE K - EMPLOYEE BENEFIT PLANS

The Company has a 401(k) Employee Savings Plan and Trust (the Plan) which requires the Company to make contributions to the Plan in the amount of 3% of eligible employee compensation. The Plan allows that the required contributions may be invested in common stock of the Company. The Company made contributions to the Plan of approximately \$72,000 and \$60,000 during the years ended October 31, 2005 and 2004, respectively. All such contributions have been made in the form of common stock of the Company, which has been purchased on the open market. Employees who have met the eligibility requirements may elect to contribute to the Plan, subject to Internal Revenue Code limitations. In addition, employees may elect to sell the common stock of the Company, which was contributed by the Company, and request that the proceeds be transferred to their own account in the Plan.

Additionally, the Company has a profit-sharing plan for eligible employees. Under the provisions of the plan, the Company may, at its discretion, make contributions of a sum not in excess of the amount permitted under the Internal Revenue Code as a deductible expense. The Company has not made any contributions to this plan.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE L - STOCK INCENTIVE PLAN

In March 2000, the shareholders approved the 2000 Stock Option Plan. The plan provides for the grant of options to directors, key employees including employees who are directors and other persons who provide services to the Company. Initially the plan authorized the issuance of 100,000 shares of common stock upon exercise of options granted under the plan. In April 2002 and 2003, the shareholders approved amendments to the plan to increase the number of shares authorized for grants under the plan to 400,000. Options granted under the plan are exercisable at a per share price not less than 100% of the fair market value of the underlying common stock on the date of the grant. Incentive stock options granted to any person with beneficial ownership of 10% or more of the outstanding shares of common stock must be exercisable at a per share price not less than 110% of the fair market value of the stock on the date of the grant. The plan will terminate January 25, 2010.

In April 2005, the shareholders approved the amendment and restatement of the Company's 2000 Stock Option Plan. The plan was renamed the 2005 Stock Incentive Plan; and was amended so stock settled SARs, performance share awards and restricted share awards were added to the types of equity awards that may be granted; and the total number of shares authorized for grants under the stock incentive plan was increased from 400,000 to 650,000.

A summary of option transactions relating to the 2005 Stock Incentive Plan is as follows:

	<u>Shares Under Option</u>	<u>Weighted Average Exercise Price</u>
Balance, October 31, 2003	255,000	\$4.70
Granted	<u>35,000</u>	4.65
Balance, October 31, 2004	290,000	4.70
Exercised	<u>(30,000)</u>	4.50
Balance, October 31, 2005 (average remaining life 2.5 years)	<u>260,000</u>	4.72
	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Options exercisable		
October 31, 2004	243,332	\$4.68
October 31, 2005	250,000	4.73

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

The following table summarizes information about stock options outstanding at October 31, 2005:

<u>Exercise Prices</u>	<u>Options Outstanding</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>	<u>Options Exercisable</u>
\$3.21	15,000	.67	15,000
5.26	50,000	1.58	50,000
7.17	5,000	2.08	5,000
4.63	155,000	2.83	155,000
4.59	15,000	3.67	5,000
4.70	<u>20,000</u>	2.83	<u>20,000</u>
	<u>260,000</u>		<u>250,000</u>

During the year ended October 31, 2005, the Company paid \$23,600 to employees to settle 30,000 shares of vested stock options. This amount has been recorded as compensation expense in 2005. The options were settled for the difference in the options exercise price and the fair market value of the stock on the date of the transaction.

On September 19, 2005, restricted shares of common stock aggregating 300,000 shares were awarded, to directors, officers and senior managers pursuant to the terms of the 2005 Stock Incentive Plan. The shares vest ratably equal to one-seventh of the original grant on the anniversary date of the award. The related compensation cost will be recognized as the shares vest. The fair value on the date of the award was \$5.00 per share.

At October 31, 2005, there were 15,000 shares of common stock available for issuance under the Company's stock incentive plan.

NOTE M - INCOME TAXES

The provision for income taxes for the years ended October 31, consists of the following:

	<u>2005</u>	<u>2004</u>
Current	\$ 5,000	\$ 64,000
Deferred	<u>53,000</u>	<u>155,000</u>
	<u>\$ 58,000</u>	<u>\$ 219,000</u>

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE M - INCOME TAXES - Continued

The effective tax rate differed from the statutory federal tax rate due to the following:

	<u>Year ended October 31,</u>	
	<u>2005</u>	<u>2004</u>
Statutory federal tax rate (graduated)	34.0%	34.0%
State taxes, net of federal benefit	3.7	3.9
Tax credits	(8.9)	(4.1)
Benefit of graduated tax rates	(3.2)	-
Other	(3.9)	0.4
	<u>21.7%</u>	<u>34.2%</u>

Deferred tax assets (liabilities) consist of the following at October 31,:

	<u>2005</u>	<u>2004</u>
Deferred tax assets		
Accrued expenses	\$ 9,400	\$ 5,000
Allowance for doubtful accounts	20,200	15,900
State NOL carryforward	19,800	25,600
Federal credits carryforward	95,800	118,500
Other	<u>47,827</u>	<u>29,519</u>
Deferred tax assets	<u>\$ 193,027</u>	<u>\$ 194,519</u>
Deferred tax liabilities		
Fixed assets	<u>\$ (1,135,327)</u>	<u>\$ (1,070,720)</u>

Federal credit carryforwards expire starting in 2022 through 2024. The State NOL carryforwards expire in 2017 and 2018.

NOTE N - OPERATING LEASE COMMITMENTS

The Company leases its production, warehouse and office facilities under operating lease agreements with related parties (see Note P). In addition, the Company leases equipment under non-cancelable operating leases with unrelated third parties.

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE N - OPERATING LEASE COMMITMENTS - Continued

Minimum lease payments required under these operating leases are as follows:

<u>Year ending October 31,</u>	
2006	\$ 459,000
2007	431,000
2008	392,000
2009	389,000
2010	394,000
Thereafter	<u>1,638,000</u>
	<u>\$ 3,703,000</u>

Operating lease expense for the years ended October 31, 2005 and 2004 approximated \$600,000 and \$663,000, respectively. Operating lease expenses are allocated between manufacturing costs and general and administrative expenses in the accompanying statements of income.

NOTE O – EARNINGS PER SHARE

The following table is a reconciliation of the numerators and denominators of the basic and diluted per share computations for each of the years ended October 31,:

	<u>2005</u>	<u>2004</u>
Numerator		
Net income	<u>\$ 209,769</u>	<u>\$ 420,639</u>
Denominator		
Weighted-average shares outstanding, excluding unvested restricted stock	2,133,274	2,278,284
Effect of dilutive options and restricted stock	<u>45,047</u>	<u>16,190</u>
Denominator for diluted earnings per share	<u>2,179,154</u>	<u>2,294,474</u>
Basic earnings per share	\$0.10	\$0.18
Diluted earnings per share	\$0.10	\$0.18

For the years ended October 31, 2005 and 2004 options to purchase approximately 55,000 and 20,000, respectively, shares of common stock were outstanding but not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the underlying shares.

NOTE P – RELATED PARTY TRANSACTIONS

The Company leases its production and office facilities from a company that is owned by the Company's chief executive officer, its former president, a director and secretary, and certain other shareholders of the

YOCREAM INTERNATIONAL, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE P – RELATED PARTY TRANSACTIONS - Continued

Company. The lease has a remaining term of approximately 7 years with renewal provisions and currently provides for a base rent of \$17,000 per month for the period from July 2003 to July 2006. Thereafter the lease increases approximately 8% every three years.

In October 2003, the Company entered into an agreement to lease an adjoining warehouse facility from the same company described above. The lease has a remaining term of approximately 13 years and provides for a base rent of approximately \$12,800 per month for the period from November 2003 to 2006. Thereafter the lease payment changes every three years based on the change in a “CPI Index Factor”, which is derived from the Consumer Price Index for the three year period.

Payments under the leases for the years ended October 31, 2005 and 2004 were approximately \$358,000 for each year.

The Company has retained the services of a law firm in which a director of the Company is a shareholder. The law firm has served as the Company's general counsel and for the years ended October 31, 2005 and 2004 billed the Company fees of approximately \$36,000 and \$28,000, respectively.

In August 2003, the Company entered into a three-year consulting agreement with its former president, upon his retirement after 27 years of service, and resignation from his positions as president and a director of the Company. Under the terms of the consulting agreement, he will be paid an annual fee of approximately \$136,700. Payments under the consulting agreement for the years ended October 31, 2005 and 2004, amounted to approximately \$136,700 for each year. Additionally, the Company will continue to provide health insurance benefits during the term of the agreement, and fund a \$500,000 split dollar life insurance policy until the policy is paid in full, or the event of death. The policy has been assigned to the Company as collateral for the repayment of the premiums. In the event of the death of the former employee, the Company would be paid the amount of its premium advances. The Company's premium advances since the inception of this policy are approximately \$110,000 and \$98,000 at October 31, 2005 and 2004, respectively, and are classified as part of Other Long-Term Assets (see Note F).

The Company also maintains a \$500,000 split dollar life insurance policy on its chief executive officer under which the Company pays the premiums. The policy is assigned to the Company as collateral for the repayment of the premiums. In the event of the death of the employee, the Company would be paid the amount of its premium advances. Since the inception of this policy such advances are approximately \$134,000 and \$119,000 at October 31, 2005 and 2004, respectively, and are classified as part of Other Long-Term Assets (see Note F).

Shareholder Information

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Annual Report
This report is available to shareholders of
record upon written request to :
Terry Lusetti, Director of Investor
Relations

YoCream International, Inc. stock is publicly traded on the Pink Sheets
www.pinksheets.com YOCM

Directors & Officers

<u>Name</u>	<u>Age</u>	<u>Position held with Company and Principal Occupation During the Past Five Years</u>	<u>Director Since</u>
John N. Hanna	65	Director; Chairman of the Board of Directors; Chief Executive Officer	1977
James S. Hanna	72	Director; Secretary	1977
William J. Rush	71	Director; Partner in Rush, Hannula, Harkins, & Kyler, LLP Attorneys at Law	1987
Carl G. Behnke	60	Director; President R.E.B. Enterprises; Chairman of Sur La Table	1994
Joseph J. Hanna, Jr.	67	Director; President of Hanna Strader PC Tax Attorney	2001
Fred M. Kinyon	67	Director; Owner of Capital Values Northwest	2004
W. Douglas Caudell	62	Chief Financial Officer	NA