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LIFEWAY FOODS INC  
Form 10QSB  
August 16, 2004

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-QSB

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2004

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-17363

LIFEWAY FOODS, INC.

-----  
(Exact name of small business issuer as specified in its charter)

Illinois

36-3442829

-----  
(State or other jurisdiction of  
incorporation or organization)

-----  
(IRS Employer Identification No.)

6431 WEST OAKTON, MORTON GROVE, ILLINOIS 60053

-----  
(Address of principal executive offices)

(847) 967-1010

-----  
(Issuer's telephone number)

-----  
(Former name, former address and former fiscal year,  
if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or such shorter period that the issuer was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of August 12, 2004, the issuer had 8,438,888 shares of common stock, no par value, outstanding.

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Transitional Small Business Disclosure Format (Check one): Yes [ ] No [X]

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## PART I - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION AS OF JUNE 30, 2004 AND  
2003 AND DECEMBER 31, 2003

|                           | (Unaudited)<br>June 30, |              |
|---------------------------|-------------------------|--------------|
|                           | 2004                    | 2003         |
| ASSETS                    |                         |              |
| CURRENT ASSETS            |                         |              |
| Cash and cash equivalents | \$ 5,241,815            | \$ 3,615,000 |
| Marketable securities     | 6,548,911               | 6,548,911    |

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|   |               |        |
|---|---------------|--------|
| Accounts receivable, net of allowance for doubtful accounts of \$15,000 | 1,921,537     | 1,     |
| Other receivables   | 63,535        |        |
| Inventories   | 991,041       |        |
| Prepaid expenses and other current assets                               | 791           |        |
| Deferred income taxes   | 286,334       |        |
| Prepaid income taxes  | 376,808       |        |
| TOTAL CURRENT ASSETS  | 15,219,589    | 12,    |
| PROPERTY, PLANT, AND EQUIPMENT, NET                                     | 3,531,856     | 3,     |
| TOTAL ASSETS  | \$ 18,751,445 | \$ 16, |
| LIABILITIES AND STOCKHOLDERS' EQUITY                                    |               |        |
| CURRENT LIABILITIES   |               |        |
| Current maturities of notes payable                                     | \$ 38,198     | \$     |
| Accounts payable  | 802,035       |        |
| Accrued expenses  | 151,667       |        |
| Income taxes payable  | --            |        |
| Total current liabilities   | 991,900       | 1,     |
| NOTES PAYABLE   | 447,084       |        |
| DEFERRED INCOME TAXES   | 434,837       |        |
| STOCKHOLDERS' EQUITY  |               |        |
| Common stock  | 6,509,267     | 6,     |
| Paid-in capital   | --            |        |
| Stock subscription receivable   | (5,000)       |        |
| Treasury stock, at cost   | (666,366)     | (      |
| Retained earnings   | 11,019,724    | 9,     |
| Accumulated other comprehensive income (loss), net of tax               | (8,271)       | (      |
| TOTAL STOCKHOLDERS' EQUITY  | 16,877,624    | 14,    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY                              | \$ 18,751,445 | \$ 16, |

See accompanying Notes to Financial Statements.

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CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME FOR THE  
THREE AND SIX MONTHS ENDED JUNE 30, 2004 AND 2003 AND THE YEAR ENDED  
DECEMBER 31, 2003

| (Unaudited)        |       | Si    |
|--------------------|-------|-------|
| Three Months Ended |       |       |
| June 30,           |       |       |
| 2004               | 2003  | 200   |
| -----              | ----- | ----- |

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|  |              |              |          |
|--|--------------|--------------|----------|
| SALES  | \$ 4,002,093 | \$ 3,775,853 | \$ 7,937 |
| Cost of goods sold   | 2,265,802    | 1,733,935    | 4,365    |
| GROSS PROFIT   | 1,736,291    | 2,041,918    | 3,572    |
| Operating expenses   | 1,049,402    | 938,160      | 1,931    |
| INCOME FROM OPERATIONS   | 686,889      | 1,103,758    | 1,640    |
| Other income (expense):  |              |              |          |
| Interest and dividend income   | 34,085       | 36,730       | 75       |
| Interest expense   | (7,907)      | (7,777)      | (15)     |
| Gain (loss) on sale of marketable securities, net  | 40,962       | 15,848       | 309      |
| Gain on sale of assets   | --           | --           | --       |
| Loss on marketable securities classified as trading  | (27,758)     | --           | (27)     |
| Other income   | --           | --           | --       |
| Total other income (expense)   | 39,382       | 44,801       | 341      |
| INCOME BEFORE PROVISION FOR INCOME TAXES   | 726,271      | 1,148,559    | 1,982    |
| Provision for income taxes   | 294,162      | 457,477      | 784      |
| NET INCOME   | \$ 432,109   | \$ 691,082   | \$ 1,197 |
| EARNINGS PER COMMON SHARE  | 0.05         | 0.08         |          |
| WEIGHTED AVERAGE NUMBER OF<br>COMMON SHARES OUTSTANDING  | 8,437,544    | 8,436,888    | 8,437    |
| COMPREHENSIVE INCOME   |              |              |          |
| NET INCOME   | \$ 432,109   | \$ 691,082   | \$ 1,197 |
| Other comprehensive income (loss), net of tax:   |              |              |          |
| Unrealized (gains) losses on marketable<br>securities (net of tax benefits)                            | (47,050)     | 790,315      | (25)     |
| Less reclassification adjustment for (gains)<br>losses included in net income<br>(net of tax benefits) | 17,615       | (569,743)    | (138)    |
| COMPREHENSIVE INCOME   | \$ 402,674   | \$ 911,654   | \$ 1,032 |

See accompanying Notes to Financial Statements.

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ENDED JUNE 30, 2004 AND THE YEAR

ENDED DECEMBER 31, 2003

|   | COMMON STOCK, NO PAR VALUE<br>10,000,000 SHARES<br>AUTHORIZED |                            | #<br>OF SHARES<br>OF<br>TREASURY<br>STOCK | COMMON<br>STOCK | PAID-IN<br>CAPITAL |
|---|---|----------------------------|---|-----------------|--------------------|
|   | # OF SHARES<br>ISSUED   | # OF SHARES<br>OUTSTANDING |   |                 |                    |
| BALANCES AT DECEMBER 31, 2002   | 8,636,888   | 8,436,888                  | 200,000                                   | \$6,509,267     | \$ --              |
| Other comprehensive income:<br>Unrealized gains (losses)<br>on securities, net of<br>taxes and reclassification<br>adjustment | --  | --                         | --  | --              | --                 |
| Net income for the year<br>Ended December 31, 2003  | --  | --                         | --  | --              | --                 |
| BALANCES AT DECEMBER 31, 2003   | 8,636,888   | 8,436,888                  | 200,000                                   | \$6,509,267     | --                 |
| Issuance of treasury stock  | --  | 2,000                      | (2,000)                                   | --              | 28,270             |
| Other comprehensive income:<br>Unrealized gains (losses)<br>on securities, net of<br>taxes and reclassification<br>adjustment | --  | --                         | --  | --              | --                 |
| Payment on subscription<br>receivable   | --  | --                         | --  | --              | --                 |
| Net income for the six<br>months Ended June 30, 2004  | --  | --                         | --  | --              | --                 |
| BALANCES AT JUNE 30, 2004<br>(UNAUDITED)  | 8,636,888   | 8,438,888                  | 198,000                                   | \$6,509,267     | \$28,270           |

|   | RETAINED<br>EARNINGS | ACCUMULATED<br>OTHER<br>COMPREHENSIVE<br>INCOME (LOSS),<br>NET OF TAX | TOTAL        |
|---|----------------------|---|--------------|
|   | -----                | -----   | -----        |
| BALANCES AT DECEMBER 31, 2002   | \$7,600,477          | \$ (1,334,870)  | \$12,079,918 |
| Other comprehensive income:<br>Unrealized gains (losses)<br>on securities, net of<br>taxes and reclassification<br>adjustment | --                   | 1,491,107   | 1,491,107    |

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|  |              |            |              |
|--|--------------|------------|--------------|
| Net income for the year<br>Ended December 31, 2003   | 2,221,939    | --         | 2,221,939    |
|  | -----        | -----      | -----        |
| BALANCES AT DECEMBER 31, 2003  | \$9,822,416  | \$156,237  | \$15,792,964 |
| Issuance of treasury stock   | --           | --         | 41,860       |
| Other comprehensive income:  |              |            |              |
| Unrealized gains (losses)<br>on securities, net of<br>taxes and reclassification<br>adjustment | --           | (164,508)  | (164,508)    |
| Payment on subscription<br>receivable  | --           | --         | 10,000       |
| Net income for the six<br>months Ended June 30, 2004   | 1,197,308    | --         | 1,197,308    |
|  | -----        | -----      | -----        |
| BALANCES AT JUNE 30, 2004<br>(UNAUDITED)   | \$11,019,724 | \$ (8,271) | \$16,877,624 |
|  | =====        | =====      | =====        |

See accompanying Notes to Financial Statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED JUNE 30, 2004 AND  
2003 AND THE YEAR ENDED DECEMBER 31, 2003

|   | (Unaudited)<br>June 30, |           |
|---|-------------------------|-----------|
|   | 2004                    | 2003      |
|   | -----                   | -----     |
| CASH FLOWS FROM OPERATING ACTIVITIES:   |                         |           |
| NET INCOME  | \$ 1,197,308            | \$ 1,684, |
| Adjustments to reconcile net income to net<br>cash flows from operating activities: |                         |           |
| Depreciation and amortization   | 315,315                 | 340,      |
| Gain (loss) on sale of marketable securities, net                                   | (309,329)               | 330,      |
| Loss on marketable securities classified as trading                                 | 27,758                  |           |
| Gain on sales of assets   | --                      | (1,246,   |
| Deferred income taxes   | 58,335                  | 57,       |
| (Increase) decrease in operating assets:  |                         |           |
| Accounts receivable   | (121,396)               | (295,     |
| Other receivables   | 78,294                  | (3,       |
| Inventories   | (179,469)               | (73,      |
| Prepaid income taxes  | (70,637)                |           |
| Prepaid expenses and other current assets   | 267                     |           |
| Increase (decrease) in operating liabilities:                                       |                         |           |
| Accounts payable  | 6,714                   | 9,        |
| Accrued expenses  | (31,933)                | (         |
| Income taxes payable  | --                      | 295,      |

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|  |              |           |
|--|--------------|-----------|
| NET CASH PROVIDED BY OPERATING ACTIVITIES              | 971,227      | 1,099,    |
| CASH FLOWS FROM INVESTING ACTIVITIES:                  |              |           |
| Purchase of marketable securities                      | (5,111,087)  | (4,555,   |
| Sales of marketable securities                         | 4,861,951    | 2,867,    |
| Sales of assets  | ---          | 1,712,    |
| Purchases of property and equipment                    | (114,439)    | (240,     |
| NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES    | (363,575)    | (216,     |
| CASH FLOWS FROM FINANCING ACTIVITIES:                  |              |           |
| Reissuance of treasury stock                           | 41,860       |           |
| Payment on stock subscription receivable               | 10,000       |           |
| Repayment of notes payable                             | (15,516)     | (15,      |
| NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES    | 36,344       | (15,      |
| NET INCREASE IN CASH AND CASH EQUIVALENTS              | 643,996      | 867,      |
| Cash and cash equivalents at the beginning of the year | 4,597,819    | 2,731,    |
| CASH AND CASH EQUIVALENTS AT END OF YEAR               | \$ 5,241,815 | \$ 3,599, |

See accompanying Notes to Financial Statements.

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### NOTES TO FINANCIAL STATEMENTS FOR THE SIX MONTHS ENDED JUNE 30, 2004 AND 2003 AND THE YEAR ENDED DECEMBER 31, 2004

These financial statements include all adjustments which, in the opinion of management, are necessary in order to make the financial statements not misleading.

#### NOTE 1 - NATURE OF BUSINESS

Lifeway Foods, Inc. (the "Company") commenced operations in February 1986 and incorporated under the laws of the state of Illinois on May 19, 1986. The Company's principal business activity is the production of dairy products. Specifically, the Company produces Kefir, a drinkable product which is similar to but distinct from yogurt, in several flavors sold under the name "Lifeway's Kefir;" a plain farmer's cheese sold under the name "Lifeway's Farmer's Cheese;" a fruit sugar-flavored product similar in consistency to cream cheese sold under the name of "Sweet Kiss;" and a dairy beverage, similar to Kefir, with increased protein and calcium, sold under the name "Basics Plus." The Company also produces several soy-based products under the name "Soy Treat" and a vegetable-based seasoning under the name "Golden Zesta." The Company currently distributes its products throughout the Chicago Metropolitan area through local food stores. In addition, the products are sold throughout the United States and Ontario, Canada. The Company also distributes some of its products internationally by exporting to Eastern Europe. During the year 2003 and for the six months ended June 30, 2004 and 2003, export sales of the Company were approximately \$221,000, \$37,050, and \$108,857, respectively.

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### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of the significant accounting policies applied in the preparation of the accompanying financial statements follows:

#### Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, LFI Enterprises, Inc. All significant intercompany accounts and transactions have been eliminated.

#### Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### Revenue recognition

Sales represent sales of Company-produced dairy products that are recorded at the time of shipment. In addition, shipping costs invoiced to the customers are included in net sales and the related costs in cost of sales.

#### Cash and cash equivalents

All highly liquid investments purchased with an original maturity of three months or less are considered to be cash equivalents.

The Company maintains cash deposits at several institutions located in the greater Chicago, Illinois metropolitan area. Deposits at each institution are insured up to \$100,000 by the Federal Deposit Insurance Corporation or the Securities Investor Protector Corporation.

BANK BALANCES OF AMOUNTS REPORTED BY FINANCIAL INSTITUTIONS ARE CATEGORIZED AS FOLLOWS AT JUNE 30, 2004.

|  | June 30,<br>2004    | June 30,<br>2003    | December 31,<br>2003 |
|--|---------------------|---------------------|----------------------|
| Amounts insured                        | \$ 400,000          | \$ 400,000          | \$ 400,000           |
| Uninsured and uncollateralized amounts | 5,069,650           | 3,238,984           | 4,212,259            |
| Total bank balances                    | <u>\$ 5,469,650</u> | <u>\$ 3,638,984</u> | <u>\$ 4,612,259</u>  |

#### Marketable securities

Marketable securities are classified as available-for-sale and trading and are stated at market value. Gains and losses related to marketable securities sold are determined by the specific identification method.

#### Accounts receivable



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Credit terms are extended to customers in the normal course of business. The Company performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral.

Accounts receivable are recorded at their estimated net realizable value, net of an allowance for doubtful accounts. The Company's estimate of the allowance for doubtful accounts is based upon historical experience, its evaluation of the current status of receivables, and unusual circumstances, if any. Accounts are considered past due if payment is not made on a timely basis in accordance with the Company's credit terms. Accounts considered uncollectible are charged against the allowance.

### Inventories

Inventories are stated at lower of cost or market, cost being determined by the first-in, first-out method.

### Property and equipment

Property and equipment are stated at lower of depreciated cost or fair value. Depreciation is computed using the straight-line method. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to income as incurred; significant renewals and betterments are capitalized.

Property and equipment are being depreciated over the following useful lives:

| Category                   | Years     |
|----------------------------|-----------|
| Buildings and improvements | 31 and 39 |
| Machinery and equipment    | 5 - 12    |
| Office equipment           | 5 - 7     |
| Vehicles                   | 5         |

### Income taxes

Deferred income taxes arise from temporary differences resulting from income and expense items reported for financial accounting and tax purposes in different periods. Deferred taxes are classified as current or non-current, depending on the classification of the assets and liabilities to which they relate. Deferred taxes arising from temporary differences that are not related to an asset or liability are classified as current or non-current depending on the periods in which the temporary differences are expected to reverse.

The principal sources of temporary differences are different depreciation methods for financial statement and tax purposes, unrealized gains or losses related to marketable securities, capitalization of indirect costs for tax purposes, and the use of an allowance for doubtful accounts for financial statement purposes.

### Treasury stock

Treasury stock is recorded using the cost method.

### Advertising costs

The Company expenses advertising costs as incurred. During the year 2003 and for the six months ended June 30, 2004 and 2003, approximately

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\$629,500, \$409,461, and \$327,863, respectively, were expensed.

Earning per common share

Earnings per common share were computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the year. Because the Company has no stock options outstanding, diluted and basic earnings per share were the same during the year 2003 and the six month period ended June 30, 2004, as no dilutive effect was caused by outstanding options.

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NOTE 3 - MARKETABLE SECURITIES

The cost and fair value of marketable securities classified as available for sale and trading are as follows:

| (Unaudited)<br>June 30, 2004                                   | Cost                | Unrealized<br>Gains | Unrealized<br>Losses | Loss on<br>Marketable<br>Securities<br>Classified<br>as Trading | Fair<br>Value    |
|--|---------------------|---------------------|----------------------|---|------------------|
| Equities/mutual funds  | \$ 3,605,678        | \$ 113,749          | \$ (90,838)          | \$ --   | \$ 3,628,        |
| Preferred securities   | 75,505              | 820                 | (2,245)              | --  | 74,              |
| Certificates of deposit  | 150,000             | --                  | (8,460)              | --  | 141,             |
| Corporate bonds  | 1,474,120           | --                  | (26,309)             | --  | 1,447,           |
| Municipal bonds,<br>maturing within five<br>years              | 132,224             | --                  | (808)                | --  | 131,             |
| Government agency<br>obligations, maturing<br>after five years | 1,153,234           | --                  | --                   | (27,758)  | 1,125,           |
| <b>Total</b>   | <b>\$ 6,590,761</b> | <b>\$ 114,569</b>   | <b>\$ (128,660)</b>  | <b>\$ (27,758)</b>  | <b>\$ 6,548,</b> |

| (Unaudited)<br>June 30, 2003                      | Cost                | Unrealized<br>Gains | Unrealized<br>Losses  | Loss on<br>Marketable<br>Securities<br>Classified<br>as Trading | Fair<br>Value    |
|---|---------------------|---------------------|-----------------------|---|------------------|
| Equities  | \$ 4,213,620        | \$ 157,134          | \$ (1,285,615)        | \$ --   | \$ 3,085,        |
| Preferred securities                              | 100,000             | 2,430               | --                    | --  | 102,             |
| Certificates of deposit                           | 180,000             | --                  | (15)                  | --  | 179,             |
| Municipal bonds,<br>Maturing within<br>five years | 2,931,477           | 3,492               | --                    | --  | 2,934,           |
| <b>Total</b>                                      | <b>\$ 7,425,097</b> | <b>\$ 163,056</b>   | <b>\$ (1,285,630)</b> | <b>\$ --</b>  | <b>\$ 6,302,</b> |

Loss on  
Marketable  
Securities

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| December 31, 2003                                 | Cost         | Unrealized Gains | Unrealized Losses | Classified as Trading | Fair Value   |
|---|--------------|------------------|-------------------|-----------------------|--------------|
| Equities  | \$ 2,326,722 | \$ 315,348       | \$ (48,837)       | \$ --                 | \$ 2,593,233 |
| Preferred securities                              | 200,505      | 2,985            | (80)              | --                    | 203,400      |
| Certificates of deposit                           | 150,000      | --               | --                | --                    | 150,000      |
| Corporate bonds                                   | 500,005      | --               | (1,333)           | --                    | 498,672      |
| Municipal bonds,<br>maturing within<br>five years | 2,405,067    | 1,545            | (10)              | --                    | 2,406,592    |
| Government agency obligation                      | 450,000      | 689              | --                | --                    | 450,689      |
| Total   | \$ 6,032,299 | \$ 320,567       | \$ (50,260)       | --                    | \$ 6,302,606 |

Proceeds from the sale of marketable securities were \$3,025,285, \$4,861,951, and \$2,867,678 during the year 2003 and for the six months ended June 30, 2004 and 2003, respectively.

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Gross gains (losses) of \$(1,293,579), \$309,329, and \$(330,709), were realized on these sales during the year 2003 and for the six months ended June 30, 2004 and 2003, respectively.

NOTE 4 - INVENTORIES

Inventories consist of the following:

|                     | (Unaudited)<br>June 30, |            | December 31,<br>2003 |
|---------------------|-------------------------|------------|----------------------|
|                     | 2004                    | 2003       |                      |
| Finished goods      | \$ 510,352              | \$ 331,506 | \$ 436,291           |
| Production supplies | 244,197                 | 266,606    | 231,376              |
| Raw materials       | 236,492                 | 195,974    | 143,905              |
| Total inventories   | \$ 991,041              | \$ 794,086 | \$ 811,572           |

NOTE 5 - PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

|                               | (Unaudited)<br>June 30, |            | December 31,<br>2003 |
|-------------------------------|-------------------------|------------|----------------------|
|                               | 2004                    | 2003       |                      |
| Land                          | \$ 470,900              | \$ 470,900 | \$ 470,900           |
| Buildings and improvements    | 2,439,321               | 2,419,592  | 2,435,111            |
| Machinery and equipment       | 5,249,052               | 4,984,660  | 5,138,822            |
| Vehicles                      | 380,743                 | 380,743    | 380,743              |
| Office equipment              | 78,763                  | 74,315     | 78,763               |
|                               | 8,618,779               | 8,330,210  | 8,504,339            |
| Less accumulated depreciation | 5,086,923               | 4,424,135  | 4,771,608            |

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|             |             |             |
|-------------|-------------|-------------|
| -----       | -----       | -----       |
| \$3,531,856 | \$3,906,075 | \$3,732,731 |
| =====       | =====       | =====       |

Depreciation expense during the year ended December 31, 2003 and for the six months ended June 30, 2004 and 2003 was \$688,309, \$315,315, and \$340,803, respectively.

NOTE 6 - NOTES PAYABLE

Notes payable consist of the following:

|   | (Unaudited)<br>June 30, |            | December 31 |
|---|-------------------------|------------|-------------|
|   | 2004                    | 2003       | 2003        |
|   | -----                   | -----      | -----       |
| Mortgage note payable to a bank, payable in monthly installments of \$3,273 including interest at 6.25%, with a balloon payment of \$454,275 due September 25, 2006. Collateralized by real estate. | \$ 476,874              | \$ 485,551 | \$ 481,281  |
| Notes payable to finance companies, payable in monthly installments of \$1,851, including interest at 0%, due November 2004. Collateralized by vehicles.  | 8,408                   | 30,625     | 19,517      |
| Total notes payable   | 485,282                 | 516,176    | 500,978     |
| Less current maturities   | 38,198                  | 30,387     | 28,289      |
| Total long-term portion   | \$ 447,084              | \$ 485,789 | \$ 472,509  |
|   | =====                   | =====      | =====       |

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Maturities of notes payables are as follows:

|                |    |         |
|----------------|----|---------|
| As of June 30, |    |         |
| 2004           | \$ | 38,198  |
| 2005           |    | 29,180  |
| 2006           |    | 417,904 |
|                |    | -----   |
| Total          | \$ | 485,282 |
|                |    | =====   |

NOTE 7 - PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

|                          |              |
|--------------------------|--------------|
| (Unaudited)              | For the      |
| For the Six Months Ended | Year Ended   |
| June 30,                 | December 31, |

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|                            | 2004       | 2003         | 2003         |
|----------------------------|------------|--------------|--------------|
| Current:                   |            |              |              |
| Federal                    | \$ 591,271 | \$ 788,330   | \$ 1,075,623 |
| State                      | 135,089    | 181,967      | 269,841      |
| Total current              | 726,360    | 970,297      | 1,345,464    |
| Deferred                   | 58,335     | 57,421       | 9,084        |
| Provision for income taxes | \$ 784,695 | \$ 1,027,718 | \$ 1,354,548 |

A reconciliation of the provision for income taxes and the income tax computed at the statutory rate are as follows:

|   | (Unaudited)<br>For the Six Months Ended<br>June 30, | For the<br>Year Ended<br>December 31, |              |
|---|---|---------------------------------------|--------------|
|   | 2004  | 2003                                  | 2003         |
| Federal income tax expense<br>computed at the statutory<br>rate | \$ 673,881  | \$ 922,105                            | \$ 1,216,005 |
| State taxes, expense  | 95,493  | 130,722                               | 172,387      |
| Permanent book/tax differences                                  | 15,321  | (25,109)                              | (33,844)     |
| Provision for income taxes                                      | \$ 784,695  | \$ 1,027,718                          | \$ 1,354,548 |

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Amounts for deferred tax assets and liabilities are as follows:

|   | (Unaudited)<br>For the Six Months Ended<br>June 30, | For the<br>Year Ended<br>December 31, |              |
|---|---|---------------------------------------|--------------|
|   | 2004  | 2003                                  | 2003         |
| Non-current deferred tax liabilities<br>arising from:                     |   |                                       |              |
| Temporary differences - principally<br>Book/tax, accumulated depreciation | \$ (434,837)  | \$ (423,064)                          | \$ (471,953) |
| Current deferred tax liability arising from:                              |   |                                       |              |
| Book/tax, unrealized gains on<br>marketable securities                    | --  | --                                    | (114,070)    |
| Current deferred tax assets arising from:                                 |   |                                       |              |

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|  |             |             |             |
|--|-------------|-------------|-------------|
| Book/tax, unrealized losses on marketable securities | 5,820       | 462,500     | --          |
| Book/tax, capital loss carryforward                  | --          | --          | 104,683     |
| Book/tax, other                                      | 45,660      | 43,834      | 36,425      |
| Less valuation allowance                             | --          | (220,000)   | --          |
|  | -----       | -----       | -----       |
| Total deferred tax assets                            | 51,480      | 286,334     | 27,038      |
|  | -----       | -----       | -----       |
| Net deferred tax asset (liability)                   | \$(383,357) | \$(136,730) | \$(444,915) |
|  | =====       | =====       | =====       |

### NOTE 8 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

|              | (Unaudited)<br>For the Six Months<br>Ended June 30, | For the Year<br>Ended<br>December 31, |             |
|--------------|---|---------------------------------------|-------------|
|              | -----   | -----                                 |             |
|              | 2004  | 2003                                  | 2003        |
|              | -----   | -----                                 | -----       |
| Interest     | \$ 15,518   | \$ 15,421                             | \$ 41,205   |
| Income taxes | \$ 797,687  | \$ 675,000                            | \$2,055,000 |

### NOTE 9 - STOCK OPTION PLANS

The Company has a registration statement on file with the Securities and Exchange Commission in connection with an Employee and Consulting Services and Compensation Plan covering up to 300,000 of the Company's common stock shares. Pursuant to the Plan, the Company may issue common stock or options to purchase common stock to certain consultants, service providers, and employees of the Company. There were 234,300 shares available for issuance under the Plan at June 30 and December 31, 2003 and at June 30, 2004. The terms of this Plan do not require an adjustment in the number of shares as a result of the stock split; therefore, no adjustment has been made.

The option price, number of shares, grant date, and vesting terms are determined at the discretion of the Company's Board of Directors.

As of December 31, 2003, June 30, 2004 and 2003, there were no stock options outstanding or exercisable.

On February 12, 2004, Lifeway's Board of Directors approved awards of an aggregate amount of 5,100 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain employees and consultants for services rendered to the Company. The stock awards were made on April 1, 2004 and have vesting periods that vary from six months to one year, depending upon the individual grantee. The expense for the awards is measured as of April 1, 2004 at \$20.93 per share for 5,100 shares, or a total stock award expense of \$106,743. This expense will be recognized as the stock awards vest beginning with the recognition of \$41,860 for 2,000 shares vested on April 1, 2004. An additional 2,000 shares of the total 5,100 shall vest in the third quarter of 2004.

### NOTE 10 - STOCK SPLIT

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On February 12, 2004, the Board of Directors of the Company declared a two-for-one stock split of the common stock of the Company payable on March 8, 2004 to all of the Company's shareholders of record as of February 27, 2004.

As a result of the stock split, shareholders received two shares of common stock for every one share held on the record date. Upon completion of the split, the total number of shares of common stock outstanding increased from 4,218,444 to 8,436,888.

The earnings per share calculations as presented on the consolidated statements of income and comprehensive income and the number of shares issued and outstanding per statement of changes in stockholders' equity have been adjusted to reflect split adjusted share amounts.

### NOTE 11 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value of the Company's financial instruments, none of which are held for trading purposes, are as follows at June 30, 2004:

|                           | Carrying<br>Amount | Fair<br>Value |
|---------------------------|--------------------|---------------|
|                           | -----              | -----         |
| Cash and cash equivalents | \$ 5,241,815       | \$ 5,241,815  |
| Marketable securities     | \$ 6,548,911       | \$ 6,548,911  |
| Notes payable             | \$ 485,282         | \$ 461,711    |

The carrying values of cash and cash equivalents, and marketable securities approximate fair values. The fair value of the notes payable is based on the discounted value of contractual cash flows. The discount rate is estimated using rates currently offered for debt with similar maturities.

### NOTE 12 - SUBSEQUENT EVENTS

On July 26, 2004 the wholly-owned subsidiary of the Company (LFI Enterprises, Inc.) purchased the assets of Ilya's Farms, Inc. for \$575,600. The acquisition included approximately \$64,000 of tangible assets (including certain manufacturing equipment, a delivery truck) and inventory and the recipes and manufacturing processes previously used by Ilya's Farms, Inc. As a post-closing matter, Ilya's Farms, Inc. also is expected to assign to the Company the rights to the brand name "Ilya's Farms." The Company provided a guaranty of payment for the transaction.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### COMPARISON OF QUARTER ENDED JUNE 30, 2004 TO QUARTER ENDED JUNE 30, 2003

The following analysis should be read in conjunction with the unaudited financial statements of the Company and related notes included elsewhere in this quarterly report and the audited financial statements and Management's Discussion and Analysis contained in our Form 10-KSB, as amended by Form 10-KSB/A, for the fiscal year ended December 31, 2003.

### RESULTS OF OPERATIONS

Sales increased by \$226,240 (approximately 6%) to \$4,002,093 during the three month period ended June 30, 2004, from \$3,775,853 during the same three month period in 2003. In the six months ended June 30, 2004, sales increased \$852,762 over the same six month period in 2003. This increase was primarily attributable to continued growth in sales of Lifeway's products to existing customers. In

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June 2003, Lifeway's new customer Sav-A-Lot placed its initial orders of Lifeway's products in order to stock its shelves. Therefore, the initial Sav-A-Lot orders were substantially larger than the re-stocking orders Lifeway received and fulfilled during the three months ended June 30, 2004. Save-A-Lot, the 13th largest grocery chain in the United States, operates more than 1,000 Sav-A-Lot and Supervalu food stores nationwide.

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Cost of goods sold as a percentage of sales was 56% for the three months ended June 30, 2004, compared to 46% for the same three month period in 2003. Cost of goods sold increased by \$531,867 to \$2,265,802 during the three month period ending June 30, 2004 (approximately 31%) from \$1,733,935 during the same three month period in 2003. In the six months ended June 30, 2004, cost of goods sold increased \$805,109 (approximately 23%) over the same six month period in 2003. The price of milk, our largest cost of goods component, rose approximately 80% during this same six month period. The largest component of the increase in the cost of goods sold during the first six months of 2004 was a milk price increase of approximately 110% during the three months ended June 30, 2004

Lifeway anticipates improved gross profit margins for the balance of 2004 as the price of milk has sharply declined in July and thus far in August 2004, and expects milk prices to continue to decline to levels seen in periods prior to this one.

Operating expenses increased approximately 12% during the three month period ended June 30, 2004 compared to the same three month period in 2003. For the six month period ended June 30, 2004, operating expenses increased approximately 8.3% compared to the same six month period in 2003. This increase is primarily attributable to two expenses: (1) a \$41,860 expense recognized in connection with the vesting in the second quarter 2004 of 2,000 shares (valued at \$20.93 per share at the time of grant) of a total of 5,100 shares of Company stock granted to Lifeway employees on February 12, 2004 and (2) a one-time expense of approximately \$42,185 to list additional Company shares on The Nasdaq Stock Market following the stock split declared by Lifeway's Board of Directors on February 12, 2004. The \$41,860 stock grant expense is also accounted for as a positive cash flow associated with the reissuance of treasury stock for the purposes of employee equity awards, as discussed below. Lifeway will recognize the same expense in the third quarter of 2004 due to the vesting of a further 2,000 shares of the total 5,100 shares awarded.

Net income decreased approximately 38% during the three month period ended June 30, 2004 compared to the same three month period in 2003. This decrease is primarily attributable to the increase in the cost of goods sold due to the 110% increase in the price of milk discussed above. In the six month period ended June 30, 2004, net income decreased approximately 29% compared to the same six month period in 2003. This decrease is primarily attributable to the fact that in 2003 Lifeway had a one-time gain from the sale of property of \$1,246,287.

### SOURCES AND USES OF CASH

A significant portion of our assets are held in marketable securities. The majority of our marketable securities are classified as available-for-sale on our balance sheet, while the mortgage-backed securities are classified as trading. All of these securities are stated thereon at market value as of the end of the applicable period. Gains and losses on the portfolio are determined by the specific identification method. Net cash used in investing activities increased by \$363,575 for the six months ended June 30, 2004 as compared to the increase of \$216,125 during the same period in 2003. The increase in the negative net investing activity cash flow during the six month period ended June 30, 2004 relative to the same period in 2003 was attributable to the recognition



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in 2003 of a one-time gain from the sale of real property and investment of substantially all of the proceeds of that sale in cash equivalents, thus providing positive cash flow from investing. During the six month period ended June 30, 2004, Lifeway experienced negative cash flows from investing in the amount of \$363,575 due to our continued efforts to move away from higher-risk securities towards large cap value, higher dividend yielding and tax-advantaged equities. Our efforts in this regard during the first two calendar quarters of 2004 also are reflected in a gain of \$309,329 on the sale of marketable securities. We believe, given the current market conditions, this asset allocation strategy offers a positive risk-reward ratio for our Company.

### OTHER DEVELOPMENTS

On February 12, 2004, Lifeway's Board of Directors approved awards of an aggregate amount of 5,100 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain employees and consultants for services rendered to the Company. The stock awards were made on April 1, 2004 and have vesting periods that vary from six months to one year, depending upon the individual grantee. The expense for the awards is measured as of April 1, 2004 at \$20.93 per share for 5,100 shares, or a total stock award expense of \$106,743. This expense will be recognized as the stock awards vest beginning with the recognition of \$41,860 for 2,000 shares vested on April 1, 2004. An additional 2,000 shares of the total 5,100 shall vest in the third quarter of 2004. In this paragraph, the share numbers and per share expense have been adjusted to reflect the stock split as of March 8, 2004. The vesting of certain of the restricted stock awards had the effect of positively impacting financing activities because the shares were awarded out of

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treasury shares. The stock award was recognized as a \$41,860 expense (\$20.93 per share, reflecting fair market value on the date of grant) but also is treated as a positive cash flow from financing activities because it was a reissuance of treasury shares.

### CRITICAL ACCOUNTING POLICIES

Lifeway's analysis and discussion of its financial condition and results of operations are based upon its consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). The preparation of financial statements in accordance with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. US GAAP provides the framework from which to make these estimates, assumptions and disclosures. Lifeway chooses accounting policies within US GAAP that management believes are appropriate to accurately and fairly report Lifeway's operating results and financial position in a consistent manner. Management regularly assesses these policies in light of current and forecasted economic conditions and has discussed the development and selection of critical accounting policies with its audit committee of the Board of Directors. For further information concerning accounting policies, refer to Note 2 -- Nature of Business and Significant Accounting Policies in the notes to the consolidated financial statements.

### FORWARD LOOKING STATEMENTS

In this report, in reports subsequently filed by Lifeway with the SEC on Form 10-QSB and filed or furnished on Form 8-K, and in related comments by management, our use of the words "believe," "expect," "anticipate," "estimate," "forecast," "objective," "plan," "goal," "project," "explore," "priorities/targets," and similar expressions is intended to identify

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forward-looking statements. While these statements represent our current judgment on what the future may hold, and we believe these judgments are reasonable, actual results may differ materially due to numerous important factors that are described in this report and other factors that may be described in subsequent reports which Lifeway may file with the SEC on Form 10-QSB and filed or furnished on Form 8-K, including but not limited to:

- o Changes in economic conditions, commodity prices;
- o Shortages of and price increase for fuel, labor strikes or work stoppages, market acceptance of the Company's new products;
- o Significant changes in the competitive environment;
- o Changes in laws, regulations, and tax rates; and
- o Management's ability to achieve reductions in cost and employment levels, to realize production efficiencies and to implement capital expenditures, all at of the levels and times planned by management.

### ITEM 3. CONTROLS AND PROCEDURES

The Chief Executive Officer (who serves as the principal executive and financial officer) conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures pursuant to Rule 13a-14 under the Securities Exchange Act of 1934 as of June 30, 2004. The Company has historically operated on strictly monitored cost constraints; with that perspective, the Chief Executive Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to her. However, based upon the Company's recent growth and improved cash position, as well as consultation with its auditors, management intends to implement additional procedures to improve internal controls in 2004. Specifically, an enhanced accounting software package has been identified which will permit enhanced data recording and internal reporting as well as additional on-site accounting staff and some changes to internal control procedures.

As of the date of this quarterly report, there have been no known significant changes in internal controls or in other factors that could significantly affect these controls subject to the date of such evaluation.

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## PART II - OTHER INFORMATION

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

On June 12, 2004, Lifeway held its annual meeting of shareholders of record as of April 13, 2004. The shareholders voted to elect Lifeway's directors and to ratify the appointment of Plante & Moran, PLLC as the Company's independent auditors for 2004. The results of the shareholder vote were as follows:

| MATTER VOTED UPON<br>-----                      | VOTES IN FAVOR<br>----- | VOTES WITHHELD<br>----- | ABSTENTIONS<br>----- |
|---|-------------------------|-------------------------|----------------------|
| (1) ELECTION OF DIRECTORS<br>Ludmila Smolyansky | 8,193,820               | 50,868                  | N/A                  |

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|  |               |            |               |
|--|---------------|------------|---------------|
| Julie Smolyansky                             | 8,200,120     | 44,568     | N/A           |
| Pol Sikar                                    | 8,195,377     | 49,311     | N/A           |
| Rick D. Salm                                 | 8,201,377     | 43,311     | N/A           |
| Renzo Bernardi                               | 8,195,377     | 49,311     | N/A           |
| Thomas Kunz                                  | 8,201,377     | 43,311     | N/A           |
| <br>(2) RATIFICATION OF PLANTE & MORAN, PLLC | <br>6,480,163 | <br>36,707 | <br>1,727,818 |

### ITEM 5. OTHER INFORMATION

On July 1, 2004, Thomas Kunz resigned from the board of directors of Lifeway. Mr. Kunz was also the President of Danone Foods, Inc. ("Danone") and has been a director pursuant to the terms of that certain Stockholders Agreement dated as of October 1, 1999 among Danone, Lifeway and certain individual Lifeway stockholders (the "Stockholders Agreement"). Under the Stockholders Agreement, Danone is entitled to designate one of the directors on the Lifeway board. Effective July 1, 2004, Mr. Kunz ceased to be the President of Danone, Inc. and was no longer designated to represent Danone on the Lifeway board of directors. Danone has designated its new President, Juan Carlos, to occupy the board seat formerly held by Mr. Kunz. Accordingly, the Lifeway board of directors has approved Mr. Carlos to fill the vacancy on the board created as a result of Mr. Kunz's resignation.

On August 16, 2004, the Company announced its financial results for the fiscal quarter ended June 30, 2004 and certain other information. A copy of the Company's press release announcing these financial results and certain other information is attached as Exhibit 99.1 hereto. The information contained in Exhibit 99.1 hereto is being furnished, and should not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities imposed by that Section. The information contained in Exhibit 99.1 shall not be incorporated by reference into any registration statement or other document or filing under the Securities Act of 1933, as amended, except as may be expressly set forth in a specific filing. The press release filed as an exhibit to this report includes "safe harbor" language pursuant to the Private Securities Litigation Reform Act of 1995, as amended, indicating that certain statements about the Company's business and other matters contained in the press release are "forward-looking." The press release also cautions investors that "forward-looking" statements may be different from actual operating results. Finally, the press release states that a more thorough discussion of risks and uncertainties which may affect the Company's operating results is included in the Company's reports on file with the Securities and Exchange Commission.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

#### (a) Exhibits

| Exhibit Number | Description  |
|----------------|--|
| 3.4            | Amended and Restated By-laws (incorporated by reference to Exhibit No. 3.5 of Lifeway's Current Report on Form 8-K dated and filed on December 10, 2002).  |
| 3.5            | Articles of Incorporation, as amended and currently in effect (incorporated by reference to Exhibit 3.5 of Lifeway's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2000 and filed on August 8, 2000). |

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10.1 Lifeway Foods, Inc. Consulting and Services Compensation Plan, dated June 5, 1995 (incorporated by reference to Lifeway's Registration Statement on Form S-8, File No. 33-93306).

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10.10 Stock Purchase Agreement with Danone Foods, Inc., dated October 1, 1999 (incorporated by reference to Exhibit 10.10 of the Registrant's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999).

10.11 Stockholders' Agreement with Danone Foods, Inc. dated October 1, 1999 (incorporated by reference to Exhibit 10.11 of the Registrant's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999).

10.12 Letter Agreement dated December 24, 1999 amending the Stockholders' Agreement with Danone Foods, Inc. dated October 1, 1999 (incorporated by reference to Exhibit 10.12 of the Registrant's Current Report on Form 8-K dated December 24, 1999 and filed January 11, 2000).

10.13 Support Agreement with The Dannon Company, Inc. dated December 24, 1999 (incorporated by reference to Exhibit 10.13 of the Registrant's Current Report on Form 8-K dated December 24, 1999 and filed January 11, 2000).

10.14 First Amendment to Support Agreement with The Dannon Company, Inc., dated February 11, 2003 (incorporated by reference to Exhibit 10.14 of the Registrant's Quarterly Report for the quarter ended March 31, 2003 on Form 10-QSB dated and filed May 15, 2003).

10.15 Employment Agreement, dated September 12, 2002, between Lifeway Foods, Inc. and Julie Smolyansky (incorporated by reference to Exhibit 10.14 of Amendment No. 2 filed April 30, 2003 to Lifeway's Quarterly Report on Form 10-QSB/A for the quarter ended September 30, 2002).

11 Statement re: computation of per share earnings (incorporated by reference to Note 2 of the Consolidated Financial Statements).

31.1 Rule 13a-14(a)/15d-14(a) Certification.

32.1 Section 1350 Certification.

99.1 Press release dated August 16, 2004 regarding earnings for the quarter ended June 30, 2004.

(b) Reports on Form 8-K.

On June 3, 2004, the Company filed a Current Report on Form 8-K with disclosures in Items 4 and 7 regarding the merger of the Company's certifying accountant, Gleeson, Sklar, Sawyers & Cumpata, LLP, into Plante & Moran, PLLC on May 13, 2004.

On June 10, 2004 and June 15, 2004, the Company filed amendments on Forms 8-K/A to its Current Report on Form 8-K filed on June 3, 2004 with amendments to its disclosures in Item 4 regarding the merger of the Company's certifying accountant, Gleeson, Sklar, Sawyers & Cumpata, LLP, into Plante & Moran, PLLC on May 13, 2004.

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SIGNATURE

In accordance with the requirements of the Exchange Act, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: August 16, 2004

LIFEWAY FOODS, INC.

By: /s/ Julie Smolyansky

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Julie Smolyansky  
Chief Executive Officer, Chief Financial  
and Accounting Officer, President,  
Treasurer and Director

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