LIFEWAY FOODS INC
Form 10QSB
May 16, 2005

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

FORM 10-QSB

(Mark One)

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

For the quarterly period ended March 31, 2005

[ ] 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 it 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 [X] 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 April 15, 2005, the issuer had 8,412,388 shares of common stock, no par value, outstanding.

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

==

INDEX

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

LIFEWAY FOODS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
MARCH 31, 2005 AND 2004
AND DECEMBER 31, 2004

	(UNAUDITED) THREE MONTHS ENDED MARCH 31,	
	2005	2004
ASSETS		
Current assets		

Cash and cash equivalents	$ 5,434,032	$ 4,632,830
Marketable securities	6,895,472	6,615,579
Accounts receivable, net of allowance for doubtful accounts of $15,000 at March 31, 2005 and 2004 and December 31, 2004	2,522,971	2,006,629
Other receivables	105,759	160,968
Inventories	996,245	795,370
Prepaid expenses and other current assets	--	5,485
Deferred income taxes	89,535	27,288
Refundable income taxes	103,451	343,023
TOTAL CURRENT ASSETS	16,147,465	14,587,172
PROPERTY AND EQUIPMENT, NET	3,432,149	3,617,411
Intangible assets		
Goodwill	75,800	--
Other intangible assets, net of amortization of $43,185 and $26,990 at March 31, 2005 and December 31, 2004	392,815	--
TOTAL INTANGIBLE ASSETS	468,615	--
TOTAL ASSETS	$ 20,048,229	$ 18,204,583
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of notes payable	$ 8,934	$ 24,248
Accounts payable	789,247	739,253
Accrued expenses	125,017	100,634
Deferred income taxes - current portion	--	--
TOTAL CURRENT LIABILITIES	923,198	864,135
NOTES PAYABLE	460,940	468,768
DEFERRED INCOME TAXES	406,468	448,590
STOCKHOLDERS' EQUITY		
Common stock	6,509,267	6,509,267
Paid-in-capital	72,089	--
Stock subscription receivable	--	(15,000)
Treasury stock, at cost	(870,831)	(679,956)
Retained earnings	12,599,866	10,587,615
Accumulated other comprehensive income (loss), net of taxes	(52,768)	21,164
TOTAL STOCKHOLDERS' EQUITY	18,257,623	16,423,090
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 20,048,229	$ 18,204,583

See accompanying notes to financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED MARCH 31, 2005 AND 2004
AND THE YEAR ENDED DECEMBER 31, 2004

	(UNAUDITED) THREE MONTHS ENDED MARCH 31,	
	2005	2004
Sales	$ 4,656,860	$ 3,935,079
Cost of goods sold	2,577,956	2,099,198
GROSS PROFIT	2,078,904	1,835,881
Operating expenses	1,155,180	882,029
INCOME FROM OPERATIONS	923,724	953,852
Other income (expense):		
Interest and dividend income	65,276	41,124
Interest expense	(7,442)	(7,611)
Gain (loss) on sale of marketable securities, net	198,140	268,367
Gain (loss) on marketable securities classified as trading	3,516	--
Total other income (expense)	259,490	301,880
INCOME BEFORE PROVISION FOR INCOME TAXES	1,183,214	1,255,732
Provision for income taxes	457,823	490,533
NET INCOME	$ 725,391	$ 765,199
BASIC AND DILUTED EARNINGS PER COMMON SHARE	0.09	0.09
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	8,432,653	8,436,888
COMPREHENSIVE INCOME		
NET INCOME	$ 725,391	$ 765,199
Other comprehensive income (loss), net of tax:		
Unrealized gains (losses) on marketable securities (net of taxes)	(56,722)	21,422
Less reclassification adjustment for (gains) losses included in net income (net of taxes)	(115,226)	(156,495)
COMPREHENSIVE INCOME	$ 553,443	$ 630,126

See accompanying notes to financial statements

4

LIFEWAY FOODS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2005
AND THE YEAR ENDED DECEMBER 31, 2004

	COMMON STOCK, NO PAR VALUE 10,000,000 SHARES AUTHORIZED				
	# OF SHARES ISSUED	# OF SHARES OUTSTANDING	# OF SHARES OF TREASURY STOCK	COMMON STOCK	PA CA
BALANCES AT DECEMBER 31, 2003	$ 8,636,888	$ 8,436,888	$ 200,000	$ 6,509,267	$
Issuance of treasury stock	--	4,550	(4,550)	--	
Other comprehensive income: Unrealized losses on securities, net of taxes and reclassification adjustment	--	--	--	--	
Payment on subscription receivable	--	--	--	--	
Net income for the year ended December 31, 2004	--	--	--	--	
BALANCES AT DECEMBER 31, 2004	$ 8,636,888	$ 8,441,438	$ 195,450	$ 6,509,267	$
Issuance of treasury stock	--	550	(550)	--	
Redemption of stock	--	(29,600)	29,600	--	
Other comprehensive income: Unrealized losses on securities, net of taxes and reclassification adjustment	--	--	--	--	
Net income for the three months ended March 31, 2005	--	--	--	--	
BALANCES AT MARCH 31, 2005 (UNAUDITED)	8,636,888	8,412,388	224,500	$ 6,509,267	$

	STOCK SUBSCRIPTION	TREASURY	RETAINED	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS),

	RECEIVABLE	STOCK	EARNINGS	NET OF TAX	T
BALANCES AT DECEMBER 31, 2003	$ (15,000)	$ (679,956)	$ 9,822,416	$ 156,237	$ 15,
Issuance of treasury stock	--	30,917	--	--	
Other comprehensive income: Unrealized losses on securities, net of taxes and reclassification adjustment	--	--	--	(37,057)	
Payment on subscription receivable	15,000	--	--	--	
Net income for the year ended December 31, 2004	--	--	2,052,059	--	2,
BALANCES AT DECEMBER 31, 2004	$ --	$ (649,039)	$ 11,874,475	$ 119,180	$ 17,
Issuance of treasury stock	--	3,737	--	--	
Redemption of stock	--	(225,529)	--	--	(
Other comprehensive income: Unrealized losses on securities, net of taxes and reclassification adjustment	--	--	--	(171,948)	(
Net income for the three months ended March 31, 2005	--	--	725,391	--	
BALANCES AT MARCH 31, 2005 (UNAUDITED)	$ --	$ (870,831)	$ 12,599,866	$ (52,768)	$ 18,

See accompanying notes to financial statements

5

LIFEWAY FOODS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2005 AND 2004
AND THE YEAR ENDED DECEMBER 31, 2004

	(UNAUDITED) THREE MONTHS ENDED MARCH 31,	
	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME	$ 725,391	$ 765,199
Adjustments to reconcile net income to net		

cash flows from operating activities:		
Depreciation and amortization	140,742	155,905
Gain on sale of marketable securities, net	(198,140)	(268,367)
(Gain)/Loss on marketable securities classified as trading	(3,516)	--
Deferred income taxes	(22,343)	75,127
Treasury stock issued for services	11,512	--
(Increase) decrease in operating assets:		
Accounts receivable	(498,935)	(206,488)
Other receivables	(33,622)	4,799
Inventories	(90,548)	16,202
Refundable income taxes	155,166	(36,852)
Prepaid expenses and other current assets	7,260	(4,694)
Increase (decrease) in operating liabilities:		
Accounts payable	147,596	(56,069)
Accrued expenses	(70,524)	(82,966)
NET CASH PROVIDED BY OPERATING ACTIVITIES	270,039	361,796
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of marketable securities	(1,910,623)	(3,141,028)
Sales of marketable securities	1,665,869	2,862,610
Purchases of property and equipment	(136,558)	(40,585)
Acquisition of Ilya's Farms, Inc. net of assets acquired	--	--
NET CASH USED IN INVESTING ACTIVITIES	(381,312)	(319,003)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from stock subscription receivable	--	--
Purchases of treasury stock	(225,529)	--
Repayment of notes payable	(2,451)	(7,782)
NET CASH USED IN FINANCING ACTIVITIES	(227,980)	(7,782)
Net increase/(decrease) in cash and cash equivalents	(339,253)	35,011
Cash and cash equivalents at the beginning of the period	5,773,285	4,597,819
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	$ 5,434,032	$ 4,632,830

See accompanying notes to financial statements

6

LIFEWAY FOODS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2005 AND 2004
AND DECEMBER 31, 2004

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 by distributors. The Company also distributes some of its products to Eastern Europe. During the year ended December 31, 2004 and for the three months ended March 31, 2005 and 2004, export sales of the Company were approximately $37,050, $0 and $221,000, respectively.

On July 23, 2004, LFIE acquired certain assets and inventory of Ilya's Farms, Inc., a Pennsylvania corporation, for a total purchase price of $575,600. The asset acquisition included approximately $63,800 of tangible assets (including certain manufacturing equipment, a delivery truck and inventory) as well as intangible assets such as the brand name "Ilya's Farms" and the recipes and manufacturing processes previously used by Ilya's Farms, Inc. At present, LFIE manufactures and distributes certain cream cheese products under the brand names "Ilya's Farms" and under Lifeway Foods in the Philadelphia, Pennsylvania metropolitan area.

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 cost in cost of sales.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

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 and Philadelphia, Pennsylvania metropolitan areas. 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:

	(UNAUDITED) MARCH 31,		DECEMBER 31,
	2005	2004	2004
Amounts insured	$ 500,000	$ 400,000	$ 472,341
Uninsured and uncollateralized amounts	5,303,533	4,337,104	5,456,188
Total bank balances	$5,803,533	$4,737,104	$ 5,928,529

Marketable securities

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

Accounts receivable

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 invoice amounts, and reduced to their estimated net realizable value by recognition 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 specific 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 depreciated cost or fair value where depreciated cost is not recoverable. 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

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Intangible assets

The Company accounts for intangible assets at historical cost. Intangible assets acquired in a business combination are recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. Goodwill represents the excess purchase price over the fair value of the net tangible and other intangible assets acquired. Goodwill is not amortized. The Company amortizes other intangible assets over their estimated useful lives, as disclosed in the table below.

Goodwill is reviewed for impairment at least annually. The Company will perform its annual impairment test on July 23 (or the first business day immediately following that date). Since the Company only has one reporting unit, the test is based on a fair value approach applied for the entire company.

The Company will review intangible assets and their related useful lives at least once a year to determine if any adverse conditions exist that would indicate the carrying value of these assets may not be recoverable. This review is called an impairment assessment. The Company will conduct more frequent impairment assessments if certain conditions exist, including: a change in the competitive landscape, any internal decisions to pursue new or different strategies, a loss of a significant customer, or a significant change in the market place including changes in the prices paid for the Company's products or changes in the size of the market for the Company's products.

If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset is amortized prospectively over the revised remaining useful life.

Intangible assets are being amortized over the following useful lives:

CATEGORY	YEARS

Recipes	4
Customer lists and other customer related intangibles	8
Lease agreement	7

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 and amortization methods for financial statement and tax purposes, unrealized gains or losses related to marketable securities, capitalization of indirect costs for tax purposes, and the recognition of an allowance for doubtful accounts for financial statement purposes.

Treasury stock

Treasury stock is recorded using the cost method.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Advertising costs

The Company expenses advertising costs as incurred. During the years ended December 31, 2004 and for the three months ended March 31, 2005 and 2004, approximately $909,179, $272,191 and $214,581, of such costs 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 period. For all periods presented, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

NOTE 3 - ACQUISITION OF ILYA'S FARMS, INC.

On July 23, 2004, LFI Enterprises, Inc., an Illinois corporation and wholly owned subsidiary of Lifeway ("LFIE"), acquired certain assets of Ilya's Farms, Inc., a Pennsylvania corporation. The aggregate purchase price was $575,600, paid by LFIE in cash from its current assets.

As a result of the acquisition LFIE now manufactures and distributes certain cream cheese products under the brand name "Ilya's Farms" in the Philadelphia, Pennsylvania metropolitan area. The results of operations of the acquired business have been included in the consolidated financial statements since the acquisition date.

The following table summarizes the values of the assets and inventory acquired at the date of acquisition, July 23, 2004.

ASSETS AND INVENTORY ACQUIRED	VALUE
Machinery and equipment	$ 38,200
Inventory	25,600
Intangible assets	511,800
Total aggregate purchase price	$ 575,600

Intangible assets, and the related accumulated amortization, consist of the following as of March 31, 2005:

	COST	ACCUMULATED AMORTIZATION
Recipes	$ 43,600	$ 7,267
Customer lists and other customer related intangibles	305,200	27,613
Lease acquisition	87,200	8,305
Goodwill	75,800	--
	$ 511,800	$ 43,185

NOTE 3 - ACQUISITION OF ILYA'S FARMS, INC. - CONTINUED

Amortization expense is expected to be as follows for the 12 months ending March 31:

2006	$ 64,777
2007	64,777
2008	64,777
2009	60,235
2010	50,244
Thereafter	88,005
	$ 392,815

Amortization expense during the three months ended March 31, 2005 and year ended December 31, 2004 was $16,195 and $26,990. Goodwill amortization, for tax purposes, totaled $8,530 and $2,527 for the three months ended March 31, 2005 and year ended December 31, 2004.

NOTE 4 - MARKETABLE SECURITIES

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

MARCH 31, 2005 (UNAUDITED)	COST	UNREALIZED GAINS	UNREALIZED LOSSES	LOSS ON MARKETABLE SECURITIES CLASSIFIED AS TRADING
Equities and Mutual Funds	$ 3,824,477	$ 152,989	$ (184,109)	--
Preferred Securities	65,000	200	(2,262)	--
Certificates of Deposit	150,000	--	(7,530)	--
Corporate Bonds	2,333,986	50	(49,948)	--
Municipal bonds, maturing within five years	24,875	715	--	--
Government agency obligations, maturing after five years	600,000	--	--	(12,971)
Total	$ 6,998,338	$ 153,954	$ 243,849	(12,971)

11

LIFEWAY FOODS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2005 AND 2004
AND DECEMBER 31, 2004

NOTE 4 - MARKETABLE SECURITIES - CONTINUED

MARCH 31, 2004 (UNAUDITED)	COST	UNREALIZED GAINS	UNREALIZED LOSSES	LOSS ON MARKETABLE SECURITIES CLASSIFIED AS TRADING
Equities/Mutual Funds	$ 3,718,091	$ 95,725	$ (62,081)	$ --
Preferred Securities	75,505	3,925	--	--
Certificates of Deposit	150,000	--	(2,790)	--
Corporate Bonds	775,010	2,524	(160)	--
Municipal bonds, maturing within five years	907,244	4,544	(9)	--
Government agency Obligations, maturing After five years	953,234	--	(5,183)	--
Total	$ 6,579,084	$ 106,718	$ (70,223)	$ --

DECEMBER 31, 2004	COST	UNREALIZED GAINS	UNREALIZED LOSSES	LOSS ON MARKETABLE SECURITIES CLASSIFIED AS TRADING
Equities and Mutual Funds	$ 3,414,459	$ 341,230	$ (120,991)	$ --
Preferred Securities	65,000	596	--	--
Certificates of Deposit	150,000	--	(4,935)	--
Corporate Bonds	1,639,275	--	(14,862)	--
Municipal bonds, maturing				

within five years	132,226	1,992	--	--
Government agency obligations, maturing after five years	1,154,484	--	--	(16,487)
Total	$ 6,555,444	$ 343,818	$ (140,788)	$ (16,487)

Proceeds from the sale of marketable securities were $6,096,652, $1,665,869 and $2,862,610 during the year ended December 31, 2004 and for the three months ended March 31, 2005 and 2004, respectively.

12

LIFEWAY FOODS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2005 AND 2004
AND DECEMBER 31, 2004

NOTE 4 - MARKETABLE SECURITIES - CONTINUED

Gross gains of $354,128, $198,140 and $268,367 were realized on these sales during the year ended December 31, 2004 and for the three months ended March 31, 2005 and 2004, respectively.

NOTE 5 - INVENTORIES

Inventories consist of the following:

	(UNAUDITED) MARCH 31,		DECEMBER 31,
	2005	2004	2004
Finished goods	$ 444,519	$ 349,431	$ 404,206
Production supplies	326,986	232,432	297,791
Raw materials	224,740	213,507	203,700
Total inventories	$ 996,245	$ 795,370	$ 905,697

NOTE 6 - PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	(UNAUDITED) MARCH 31,		DECEMBER 31,
	2005	2004	2004
Land	$ 470,900	$ 470,900	$ 470,900
Buildings and improvements	2,483,007	2,459,090	2,481,257
Machinery and equipment	5,476,656	5,176,788	5,394,932
Vehicles	459,815	359,383	408,898
Office equipment	80,930	78,763	78,763
	8,971,308	8,544,924	8,834,750
Less accumulated depreciation	5,539,159	4,927,513	5,414,612
Total property and equipment	$ 3,432,149	$ 3,617,411	$ 3,420,138

Depreciation expense during the year ended December 31, 2004 and for the three months ended March 31, 2005 and 2004 was $643,004, $124,547 and $155,905, respectively.

NOTE 7 - NOTES PAYABLE

Notes payable consist of the following:

	(UNAUDITED) MARCH 31, 2005	(UNAUDITED) MARCH 31, 2004	DECEMBER 31, 2004
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	$ 469,874	$ 479,054	$ 472,325
Notes payable to finance companies; paid in full November 2004	--	13,962	--
Total notes payable	469,874	493,016	472,325
Less current maturities	8,934	24,248	8,784
Total long-term portion	$ 460,940	$ 468,768	$ 463,541

Maturities of notes payables are as follows:

As of March 31,	
2005	$ 8,934
2006	460,940
Total	$ 469,874

NOTE 8 - PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

	(UNAUDITED) FOR THE THREE MONTHS ENDED MARCH 31, 2005	(UNAUDITED) FOR THE THREE MONTHS ENDED MARCH 31, 2004	FOR THE YEAR ENDED DECEMBER 31, 2004
Current:			
Federal	$ 384,812	$ 336,538	$ 1,084,557
State	95,354	78,868	260,050

Total current	480,166	415,406	1,334,607
Deferred	(22,343)	75,127	45,560
Provision for income taxes	$ 457,823	$ 490,533	$ 1,390,167

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

	(UNAUDITED) FOR THE THREE MONTHS ENDED MARCH 31,		FOR THE YEAR ENDED DECEMBER 31,
	2005	2004	2004
Federal income tax expense computed at the statutory rate	$ 372,925	$ 395,782	$ 1,084,921
State taxes, expense	86,375	91,668	251,283
Permanent book/tax differences	(1,477)	3,083	53,963
Provision for income taxes	$ 457,823	$ 490,533	$ 1,390,167

14

LIFEWAY FOODS, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2005 AND 2004
AND DECEMBER 31, 2004

Amounts for deferred tax assets and liabilities are as follows:

	(UNAUDITED) FOR THE THREE MONTHS ENDED MARCH 31,		FOR THE YEAR ENDED DECEMBER 31,
	2005	2004	2004
Non-current deferred tax liabilities arising from:			
Temporary differences - principally Book/tax, accumulated depreciation	$ (406,468)	$ (448,590)	$ (424,039)
Current deferred tax liability arising from:			
Book/tax, unrealized losses (gains) on marketable securities	37,127	(15,072)	(83,850)
Current deferred tax assets arising from:			
Book/tax, inventory	52,408	42,360	47,636
Total current deferred tax assets (liabilities)	89,535	27,288	(36,214)
Net deferred tax asset (liability)	$ (316,933)	$ (421,302)	$ (460,253)

NOTE 9 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

	(UNAUDITED) FOR THE THREE MONTHS ENDED MARCH 31,		FOR THE YEAR ENDED DECEMBER 31,
	2005	2004	2004
Interest	$ 7,442	$ 7,611	$ 31,441
Income taxes	$ 325,372	$ 452,000	$ 1,298,348

NOTE 10 - STOCK OPTION PLANS

The Company has a registration statement filed with the Securities and Exchange Commission in connection with a Consulting Service Compensation Plan covering up to 600,000 of the Company's common stock shares. Pursuant to such 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 468,000 shares available for issuance under the Plan at December 31, 2004 and at March 31, 2005 and 2004. 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, 2004 and at March 31, 2005 and 2004, there were no stock options outstanding or exercisable.

NOTE 10 - STOCK OPTION PLANS - CONTINUED

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 is being recognized as the stock awards vest beginning with the recognition of $41,860 for 2,000 shares vested on April 1, 2004. There were a total of 4,550 vested shares resulting in a stock award expense of $95,231 for the year ended December 31, 2004, and an additional 550 shares vested during the quarter ended March 31, 2005 for an additional expense of $11,512.

NOTE 11 - STOCK SPLIT

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 12 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value of the Company's financial instruments is as follows at:

	(UNAUDITED) MARCH 31, 2005		DECEMBER 31, 2004	
	CARRYING AMOUNT	FAIR VALUE	CARRYING AMOUNT	FAIR VALUE
Cash and cash equivalents	$ 5,434,032	$ 5,434,032	$ 5,773,285	$ 5,773,285
Marketable securities	$ 6,895,472	$ 6,895,472	$ 6,741,987	$ 6,741,987
Notes payable	$ 469,874	$ 466,069	$ 472,325	$ 469,696

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 13 - PENDING LITIGATION

On December 4, 2004 a former employee requested a Motion for Summary Judgment on the issue of Liability in a lawsuit filed against the Company by the former employee. The motion was granted on February 10, 2005 and on February 18, 2005 the case was referred to a Magistrate Judge for a settlement conference.

The lawsuit alleges non payment of overtime wages in violation of federal employment laws, with an estimated amount between $7,500 and $15,000. The suit was filed in the United States District Court for the Northern District of Illinois on behalf of all employees who were classified as non-exempt during 2001 through 2003. Outside counsel for the company has advised that at this stage in the proceedings he cannot offer an opinion as to the probable outcome.

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

COMPARISON OF QUARTER ENDED MARCH 31, 2005 TO QUARTER ENDED MARCH 31, 2004

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, for the fiscal year ended December 31, 2004.

RESULTS OF OPERATIONS

Sales increased by $721,781 (approximately 18%) to $4,656,860 during the three month period ended March 31, 2005 from $3,935,079 during the same three month period in 2004. This increase is primarily attributable to increased sales and awareness of Lifeway existing drinkable dairy product, including La Fruta, and its flagship line, Kefir. Sav a Lot, which was one of Lifeway's largest customers, and accounted for $362,000 in sales in the first quarter 2004, ceased ordering in the second quarter of 2004, and therefore was absent from the first quarter of 2005.

Lifeway's wholly-owned subsidiary, LFI Enterprises, Inc. ("LFIE") accounted for $213,644 of total sales revenues during the first quarter 2005. Of the total $213,644 revenues from LFIE, $97,275 was earned due to sales of Lifeway's Kefir and Farmer Cheese products sent from our Morton Grove, Illinois facility to Philadelphia, Pennsylvania for distribution in the tri-state area of Pennsylvania, New Jersey and New York. The remaining $116,369 of LFIE revenues for the first quarter 2005 were earned from sales of the Cream Cheese Gourmet line of products acquired from Ilya's Farms, Inc. in the third quarter of 2004.

Cost of goods sold as a percentage of sales was approximately 55% during the first quarter 2005, compared to about 53% during the same period in 2004. This increase is directly related to the increased cost of milk during this period. The average cost of milk, Lifeway's largest cost of goods sold component, increased approximately 25% in the first quarter 2005 compared to the same period in 2004. Even though the price of milk experienced such a dramatic increase, Lifeway was able to maintain strong relative gross margins by more efficiently using our other material components.

Operating expenses as a percentage of sales was approximately 25% during the first quarter 2005, compared to about 22% during the same period in 2004. This increase is primarily attributable to an overall increase in utility expenses and rising insurance and professional fees associated with the Sarbanes-Oxley Act of 2002 and other regulatory compliance requirements.

Provision for income taxes was $457,823 during the first quarter 2005 compared with $490,533 during the same period in 2004. Income taxes are discussed in Note 8 of the Notes to Consolidated Financial Statements.

SOURCES AND USES OF CASH

Net cash used in financing activities was $227,980 during the quarter ended March 31, 2005, which is an increase of $220,198 compared to the same period in 2004. This increase is primarily attributable to the purchase of treasury stock. The Company purchased 29,600 shares of its treasury stock at a cost of $225,529 in the first quarter 2005.

During the quarter ended March 31, 2005, Lifeway's cash used in investing activities totalled $381,312 due to a rebalancing of our portfolio in 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 calendar quarter of 2005 also are reflected by a gain of $198,140 on the sale of marketable securities evident on the Company's consolidated income statement, which appears in this quarterly report. We believe, given the current market conditions, this asset allocation strategy offers a positive risk-reward ratio for our Company.

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.

We anticipate being able to fund the Company's foreseeable liquidity requirements internally. We continue to explore potential acquisition opportunities in our industry in order to boost sales while leveraging our distribution system to consolidate and lower costs.

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 vested in the third quarter of 2004. 550 shares vested in the fourth quarter of 2004. The remaining 550 shares vested in the first quarter of 2005 and resulted in an expense of $11,512.

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 -- Summary of 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 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:

- Changes in economic conditions, commodity prices;
- Shortages of and price increase for fuel, labor strikes or work stoppages, market acceptance of the Company's new products;

- Significant changes in the competitive environment;
- Changes in laws, regulations, and tax rates; and
- 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.

18

ITEM 3. CONTROLS AND PROCEDURES

The Chief Executive Officer and the Chief Accounting 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 March 31, 2005. The Company has historically operated on strictly monitored cost constraints; with that perspective, the Chief Executive Officer and the Chief Accounting 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 them. 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 over financial reporting in 2005. Specifically, an enhanced accounting software package has been identified and continues to be evaluated which will permit enhanced data recording and internal reporting as well as additional on-site accounting staff and some changes to the Company's internal control procedures over financial reporting.

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.

PART II - OTHER INFORMATION

ITEM 5. OTHER INFORMATION

On May 16, 2005, the Company announced its financial results for the fiscal quarter ended March 31, 2005 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-dated and filed on December 10, 2002). (File No. 000-17363)
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). (File No. 000-17363)

11	Statement re: Computation of per share earnings (incorporated by reference to Note 2 of the Consolidated Financil Statements).
31.1	Rule 13a-14(a)/15d-14(a) Certification of Julie Smolyansky.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Edward P. Smolyansky.
32.1	Section 1350 Certification of Julie Smolyansky.
32.2	Section 1350 Certification of Edward P. Smolyansky.
99.1	Press Release dated May 16, 2005- "Lifeway Foods, Inc. Reports First Quarter Results: Sales up 18%"

(b) Reports on Form 8-K

Current Report on Form 8-K dated January 13, 2005 and filed January 14, 2005 (File No 000-17363)

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: May 16, 2005

LIFEWAY FOODS, INC.

By: /s/ Julie Smolyansky
Julie Smolyansky
Chief Executive Officer, President, and Director

/s/ Edward P. Smolyansky

Chief Financial and Accounting Officer
and Treasurer

EXHIBIT INDEX

Exhibit Number	Description
31.1	Rule 13a-14(a)/15d-14(a) Certification of Julie Smolyansky.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Edward P. Smolyansky.
32.1	Section 1350 Certification of Julie Smolyansky.
32.2	Section 1350 Certification of Edward P. Smolyansky.
99.1	Press Release dated May 16, 2005- "Lifeway Foods Announces First Quarter Results."