LIFEWAY FOODS INC
Form 10QSB
August 15, 2005

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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 June 30, 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 June 30, 2005, the issuer had 8,392,455 shares of common stock, no par value, outstanding.

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

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIFEWAY FOODS, INC. AND SUBSIDIARY
CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005 and 2004
AND DECEMBER 31, 2004

	June 30, 2005	June 30, 2004
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 2,024,384	$ 5,241,815
Marketable securities	6,301,790	6,548,911
Accounts receivable, net of allowance for doubtful accounts of $15,000 at June 30, 2005 and 2004 and December 31, 2004	2,556,808	1,921,537
Other receivables	106,896	87,473
Inventories	1,106,211	991,041
Prepaid expenses and other current assets	102,448	524
Deferred income taxes	55,352	51,480
Refundable income taxes	172,635	376,808
TOTAL CURRENT ASSETS	12,426,524	15,219,589
PROPERTY AND EQUIPMENT, NET	7,757,150	3,531,856
INTANGIBLE ASSETS		
Goodwill	75,800	--
Other intangible assets, net of amortization of $59,379 and $26,990 at June 30, 2005 and December 31, 2004	376,621	--
TOTAL INTANGIBLE ASSETS	452,421	--
TOTAL ASSETS	$ 20,636,095	$ 18,751,445
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of notes payable	$ 12,662	$ 38,198
Accounts payable	659,351	802,035
Accrued expenses	427,307	151,667
Deferred income taxes	--	--
TOTAL CURRENT LIABILITIES	1,099,320	991,900
NOTES PAYABLE	454,046	447,084
DEFERRED INCOME TAXES	381,049	434,837
STOCKHOLDERS' EQUITY		
Common stock	6,509,267	6,509,267
Paid-in-capital	74,751	28,270

Stock subscription receivable	--	(5,000)
Treasury stock, at cost	(1,043,685)	(666,366)
Retained earnings	13,156,711	11,019,724
Accumulated other comprehensive income (loss), net of taxes	4,636	(8,271)
TOTAL STOCKHOLDERS' EQUITY	18,701,680	16,877,624
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 20,636,095	$ 18,751,445

See accompanying notes to financial statements.

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	(Unaudited) Three Months Ended June 30,		(Unaudi Six Months June
	2005	2004	2005
SALES	$ 5,072,567	$ 4,002,093	$ 9,729,427
Cost of goods sold	2,956,267	2,265,802	$ 5,534,223
GROSS PROFIT	2,116,300	1,736,291	4,195,204
Operating expenses	1,279,043	1,049,402	$ 2,434,223
INCOME FROM OPERATIONS	837,257	686,889	1,760,981
Other income (expense):			
Interest and dividend income	75,289	34,085	140,565
Interest expense	(6,876)	(7,907)	(14,318)
Gain (loss) on sale of marketable securities, net	(36,153)	40,962	161,987
Gain (loss) on marketable securities classified as trading	11,520	(27,758)	15,036
Total other income	43,780	39,382	303,270
INCOME BEFORE PROVISION FOR INCOME TAXES	881,037	726,271	2,064,251
Provision for income taxes	324,192	294,162	782,015
NET INCOME	$ 556,845	$ 432,109	$ 1,282,236
BASIC AND DILUTED EARNINGS PER COMMON SHARE	0.07	0.05	0.15
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	8,397,699	8,437,544	8,415,080

COMPREHENSIVE INCOME			
NET INCOME	$ 556,845	$ 432,109	$ 1,282,236
Other comprehensive income (loss), net of tax:			
Unrealized gains (losses) on marketable securities (net of tax benefits)	36,251	(47,050)	(20,471)
Less reclassification adjustment for gains (losses) included in net income (net of taxes)	21,153	17,615	(94,073)
COMPREHENSIVE INCOME	$ 614,249	$ 402,674	$ 1,167,692

See accompanying notes to financial statements.

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	Common Stock, No Par Value 10,000,000 Shares Authorized		
	# of Shares Issued	# of Shares Outstanding	# of Shares of Treasury Stock
BALANCES AT DECEMBER 31, 2003	8,636,888	8,436,888	200,000
Issuance of treasury stock	--	4,550	(4,550)
Other comprehensive income (loss): 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
Issuance of treasury stock	--	1,017	(1,017)
Redemption of treasury stock	--	(50,000)	50,000
Other comprehensive income (loss): Unrealized losses on securities, net of taxes and reclassification adjustment	--	--	--
Net income for the six months ended June 30, 2005	--	--	--

BALANCES AT JUNE 30, 2005	8,636,888	8,392,455	244,433

	Stock Subscription Receivable	Treasury Stock	Retained Earnings
BALANCES AT DECEMBER 31, 2003	$ (15,000)	$ (679,956)	$ 9,822,416
Issuance of treasury stock	--	30,917	--
Other comprehensive income (loss):			
Unrealized losses on securities, net of taxes and reclassification adjustment	--	--	--
Payment on subscription receivable	15,000	--	--
Net income for the year ended December 31, 2004	--	--	2,052,059
BALANCES AT DECEMBER 31, 2004	$ --	$ (649,039)	$ 11,874,475
Issuance of treasury stock	--	6,908	--
Redemption of treasury stock	--	(401,554)	--
Other comprehensive income (loss):			
Unrealized losses on securities, net of taxes and reclassification adjustment	--	--	--
Net income for the six months ended June 30, 2005	--	--	1,282,236
BALANCES AT JUNE 30, 2005	$ --	$ (1,043,685)	$ 13,156,711

See accompanying notes to financial statements.

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	Six Months Ended June 30,	
	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME	$ 1,282,236	$ 1,197,3
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	318,346	315,3

Gain on sale of marketable securities, net	(161,987)	(309,3
(Gain)/Loss on marketable securities classified as trading	(15,036)	27,7
Deferred income taxes	(53,968)	58,3
Treasury stock issued for services	17,345	--
(Increase) decrease in operating assets:		
Accounts receivable	(532,772)	(121,3
Other receivables	(34,759)	78,2
Inventories	(200,514)	(179,4
Refundable income taxes	85,982	(70,6
Prepaid expenses and other current assets	(95,188)	2
Increase (decrease) in operating liabilities:		
Accounts payable	17,700	6,7
Accrued expenses	231,766	(31,9
NET CASH PROVIDED BY OPERATING ACTIVITIES	859,151	971,2
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of marketable securities	(2,454,680)	(5,111,0
Sale of marketable securities	2,876,669	4,861,9
Purchases of property and equipment	(4,622,870)	(114,4
Acquisition of Ilya's Farms, Inc. net of assets acquired	--	--
NET CASH USED IN INVESTING ACTIVITIES	(4,200,881)	(363,5
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from stock subscription receivable	--	41,8
Purchases of treasury stock	(401,554)	10,0
Repayment of notes payable	(5,617)	(15,5
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	(407,171)	36,3
NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	(3,748,901)	643,9
Cash and cash equivalents at the beginning of the period	5,773,285	4,597,8
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	$ 2,024,384	$ 5,241,8

See accompanying notes to financial statements.

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LIFEWAY FOODS, INC. AND SUBSIDIARY
Notes to Consolidated Financial Statements
June 30, 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 six months ended June 30, 2005 and 2004, export sales of the Company were approximately $37,050, $0 and $37,050, respectively.

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 the Public Company Accounting Oversight Board (PCAOB) 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:

	June 30,		December 3
	2005	2004	2004
Amounts insured	$ 403,372	$ 400,000	$ 472,34
Uninsured and uncollateralized amounts	1,916,182	5,069,650	5,456,18
Total bank balances	$2,319,554	$5,469,650	$5,928,52

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 six months ended June 30, 2005 and 2004, approximately $909,179, $544,189 and $409,461, 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
	$ 575,600
Total aggregate purchase price	

Intangible assets, and the related accumulated amortization, consist of the following as of June 30, 2005:

	Cost	Accumulated Amortization
Recipes	$ 43,600	$ 9,992
Customer lists and other customer related intangibles	305,200	37,968
Lease acquisition	87,200	11,419
Goodwill	75,800	--
	$ 511,800	$ 59,379

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LIFEWAY FOODS, INC. AND SUBSIDIARY
Notes to Consolidated Financial Statements
June 30, 2005 and 2004
and December 31, 2004

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

Amortization expense is expected to be as follows for the 12 months ending June 30:

2006	$ 64,777
2007	64,777
2008	64,777
2009	60,235
2010	50,244
Thereafter	71,811
	$ 376,621

Amortization expense during the six months ended June 30, 2005 and year ended December 31, 2004 was $32,389 and $26,990. Goodwill amortization, for tax purposes, totaled $2,527 and $2,527 for the six months ended June 30, 2005 and year ended December 31, 2004, respectively.

Note 4 - MARKETABLE SECURITIES

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

June 30, 2005	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading
Equities and Mutual Funds	$3,693,256	$ 200,374	$ (142,171)	--
Preferred Securities	40,000	--	(2,600)	--
Certificates of Deposit	150,000	--	(6,270)	--
Corporate Bonds	2,287,211	--	(42,900)	--
Municipal bonds, maturing within five years	24,875	1,466	--	--
Government agency obligations, maturing after five years	100,000	--	--	(1,451)
Total	$6,295,342	$ 201,840	$ (193,941)	(1,451)

Note 4 - MARKETABLE SECURITIES - Continued

June 30, 2004	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading
Equities/Mutual Funds	$3,605,678	$ 113,749	$ (90,838)	$ --
Preferred Securities	75,505	820	(2,245)	--
Certificates of Deposit	150,000	--	(8,460)	--
Corporate Bonds	1,474,120	--	(26,309)	--
Municipal bonds, maturing within five years	132,224	--	(808)	--
Government agency Obligations, maturing After five years	1,153,234	--	--	(27,759)
Total	$6,590,761	$ 114,569	$ (128,660)	$ (27,759)

Loss on
Marketable

December 31, 2004	Cost	Unrealized Gains	Unrealized Losses	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, $2,876,669 and $4,861,951 during the year ended December 31, 2004 and for the six months ended June 30, 2005 and 2004, respectively.

LIFEWAY FOODS, INC. AND SUBSIDIARY
Notes to Consolidated Financial Statements
June 30, 2005 and 2004
and December 31, 2004

Note 4 - MARKETABLE SECURITIES - Continued

Gross gains of $354,128, $161,987 and $309,329 were realized on these sales during the year ended December 31, 2004 and for the six months ended June 30, 2005 and 2004, respectively.

Note 5 - INVENTORIES

Inventories consist of the following:

	June 30,	
	2005	
Finished goods	$ 489,160	$
Production supplies	359,625	
Raw materials	257,426	
Total inventories	$ 1,106,211	$

Note 6 - PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	June 30,
	2005

Land	$ 909,232	$
Buildings and improvements	6,427,993	
Machinery and equipment	5,578,369	
Vehicles	459,815	
Office equipment	82,211	
	13,457,620	
Less accumulated depreciation	5,700,470	
Total property and equipment	$ 7,757,150	$

On May 27, 2005, the Company acquired a 100,000 sq. ft. distribution & warehouse facility at a total cost of $4,380,000 cash. Subsequent to June 30, 2005, the Company obtained a long-term mortgage with a domestic bank.

Depreciation expense during the year ended December 31, 2004 and for the six months ended June 30, 2005 and 2004 was $643,004, $285,957 and $315,315, respectively.

Note 7 - NOTES PAYABLE

Notes payable consist of the following:

	June 30,	
	2005	
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	$ 466,708	$
Notes payable to finance companies; paid in full November 2004	--	
Total notes payable	466,708	
Less current maturities	12,662	
Total long-term portion	$ 454,046	$

Maturities of notes payables are as follows:

As of June 30,	
2005	$ 12,662
2006	454,046
Total	$ 466,708

Note 8 - PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

	For the Six Mont June 30,	
	2005	
Current:		
Federal	$ 681,731	$
State	154,252	
Total current	835,983	
Deferred	(53,968)	
Provision for income taxes	$ 782,015	$

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

	For the Six Mont June 30,	
	2005	
Federal income tax expense computed at the statutory rate	$ 701,846	$
State taxes, expense	99,455	
Permanent book/tax differences	(19,286)	
Provision for income taxes	$ 782,015	$

Amounts for deferred tax assets and liabilities are as follows:

	For the Six Mont June 30,	
	2005	
Non-current deferred tax liabilities arising from:		
Temporary differences - principally Book/tax, accumulated depreciation	$ (381,049)	$

Current deferred tax liability arising from:		
Book/tax, unrealized losses (gains) on marketable securities	(3,262)	
Current deferred tax assets arising from:		
Book/tax, inventory	58,614	
Total current deferred tax assets (liabilities)	55,352	
Net deferred tax liability	$ (325,697)	$

Note 9 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

	(Unaudited) For the Six Mont June 30,	
	2005	
Interest	$ 14,318	$
Income taxes	$ 751,757	$

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 June 30, 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 June 30, 2005 and 2004, there were no stock options outstanding or exercisable.

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LIFEWAY FOODS, INC. AND SUBSIDIARY
Notes to Consolidated Financial Statements
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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 June 30, 2005 for an additional expense of $11,512.

On May 23, 2005, Lifeway's Board of Directors approved awards of an aggregate amount of 5,600 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 June 1, 2005 and have vesting periods of one year. The expense for the awards is measured as of June 1, 2005 at $12.50 per share for 5,600 shares, or a total stock award expense of $70,000. This expense will be recognized as the stock awards vest in 12 equal portions of $5,833, or 466 shares per month for one year.

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:

	June 30, 2005		June 30, 2004		
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	
Cash and cash equivalents	$2,024,384	$2,024,384	$5,241,815	$5,241,815	$
Marketable securities	$6,301,790	$6,301,790	$6,548,911	$6,548,911	$
Notes payable	$ 466,708	$ 464,169	$ 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 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 $40,000 and $50,000. 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. The Company has accrued a $45,000 liability in anticipation of a settlement.

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

COMPARISON OF QUARTER ENDED JUNE 30, 2005 TO QUARTER ENDED JUNE 30, 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, and in the Management's Discussion and Analysis contained in our Form 10-QSB, for the fiscal quarter ended March 31, 2005.

RESULTS OF OPERATIONS

Sales increased by $1,070,474 (approximately 27%) to $5,072,567 during the three month period ended June 30, 2005 from $4,002,093 during the same three month period in 2004. This increase is primarily attributable to increased sales and awareness of Lifeway's existing drinkable dairy products including La Fruta, and its flagship line, Kefir. Sav a Lot, which was one of Lifeway's largest customers, and that accounted for $160,617 in sales in the second quarter 2004, ceased ordering at the end of the second quarter of 2004, and therefore was absent from the second quarter of 2005.

Lifeway's wholly-owned subsidiary, LFI Enterprises, Inc. ("LFIE") accounted for $264,807 of total sales revenues during the second quarter of 2005. Of the total $264,807 revenues from LFIE, $133,147 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 $131,660 of LFIE revenues for the second quarter of 2005 was 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 58% during the second quarter 2005, compared to about 57% during the same period in 2004. The average cost of milk, Lifeway's largest cost of goods sold component, was similar in the second quarter 2005 compared to the same period in 2004. Beginning January 1, 2005, the minimum wage payable to Company's employees in Illinois increased approximately 18%. This higher wage increase (and indirect pressure for additional increases) has had a negative impact on our gross margins in 2005, when compared to 2004. We intend to primarily offset these wage increases by continuing to invest in the automation of our production processes.

As we increased our shipments, the rise in fuel and transportation costs in the second quarter, when compared to the same period a year ago, had a negative impact on our gross margins. We intend to primarily offset these higher transportation costs by streamlining our operations and thereby decreasing our operating expenses as a percentage of sales.

Operating expenses as a percentage of sales was approximately 25% during the second quarter 2005, compared to about 26% during the same period in 2004. This decrease is primarily attributable to our continuing efforts to improve our production automation, through capital investments, thereby improving our overall operating income. Lifeway also recognized an expense related to an increase in a reserve established with respect to a lawsuit brought by a previous employee, as discussed in Part II, Item 3 of this report.

Provision for income taxes was $324,192 during the second quarter 2005 compared with $294,162 during the same period in 2004. Income taxes are discussed in Note 8 of the Notes to Consolidated Financial Statements.

COMPARISON OF SIX MONTH PERIOD ENDED JUNE 30, 2005 TO SIX MONTH PERIOD ENDED JUNE 30, 2004

RESULTS OF OPERATIONS

Sales increased by $1,792,255 (approximately 23%) to $9,729,427 during the six month period ended June 30, 2005 from $7,937,172 during the same six month period in 2004. This increase is primarily attributable to increased sales and awareness of Lifeway's existing drinkable dairy products including La Fruta, and its flagship line, Kefir. Sav a Lot, which was one of Lifeway's largest

customers, and that accounted for $522,617 in sales during the first six months of 2004, ceased ordering at the end of the second quarter of 2004, and therefore was absent from this six month period.

Cost of goods sold as a percentage of sales was approximately 57% during the six month period ended June 30, 2005, compared to about 55% during the same period in 2004. The average cost of milk, Lifeway's largest cost of goods sold component, was approximately 20% higher in the first quarter 2005, compared to the same period in 2004, but was similar in the second quarter 2005 compared to the same period in 2004. Beginning January 1, 2005, the minimum wage payable to Company's employees in Illinois increased approximately 18%. This higher wage increase (and indirect pressure for additional increases) has had a negative impact on our gross margins in 2005, when compared to 2004. We intend to primarily offset these wage increases by continuing to invest in the automation of our production processes.

Total other income for the six months ended June 30, 2005 was $303,270, compared with $341,262 during the same period in 2004. This decrease is primarily attributable to a higher gain on the sale of marketable securities in 2004, when compared to the same period in 2005.

SOURCES AND USES OF CASH

Net cash used in investing activities was $4,200,881 during the six months ended June 30,2005, which is an increase of $3,837,306 compared to the same period in 2004. This increase is primarily due to the Company's purchase of a storage and distribution facility.

Net cash used in financing activities was $407,171 during the six months June 30, 2005, which is an increase of $443,515 compared to the same period in 2004. This increase is primarily attributable to the purchase of treasury stock. The Company purchased 50,000 shares of its treasury stock at a total cost of

$401,554 in the first six months of 2005.

During the six month period ended June 20, 2005, Lifeway experienced positive investing cash flows in the amount of $421,989. Our efforts in this regard during the first two calendar quarters of 2005 also are reflected by a gain of $177,023 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, our asset allocation strategy offers a positive risk-reward ratio for the 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 May 23, 2005, Lifeway's Board of Directors approved awards of an aggregate amount of 5,600 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 June 1, 2005 and have vesting periods of one year. The expense for the awards is measured as of June 1, 2005 at $12.50 per share for 5,600 shares, or a total stock award expense of $70,000. This expense will be recognized as the stock awards vest in 12 equal portions of $5,833, or 466 shares per month for one year.

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 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.

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 June 30, 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 2. LEGAL PROCEEDINGS

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 $40,000 and $50,000. 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 it cannot offer an opinion as to the probable outcome. The Company continues to vigorously defend this matter. While the Company still believes the matter to be without merit, the Company believes the current estimate exposure to have increased from the initial range of $7,500 to $15,000 to approximately $45,000. The Company has accrued a $45,000 liability in anticipation of a settlement.

On April 14, 2003, Vera Smolyansky filed a complaint seeking unspecified damages in the Circuit Court of Cook County, Illinois naming Lifeway as a defendant. This case was dismissed, with prejudice on June 30, 2005.

ITEM 5. OTHER INFORMATION

On August 15, 2005, the Company announced its financial results for the fiscal quarter and six months ended June, 30, 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

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). (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 Financial 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 August 15, 2005- "Lifeway Foods, Inc. Reports Second Quarter and Six Months Results: Sales up 27% Net Income Up 29%"

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 15, 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

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