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LIFEWAY FOODS INC
Form 10QSB
May 17, 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 March 31, 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 April 30, 2004, the issuer had

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8,441,988 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.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION FOR THE THREE MONTHS ENDED
MARCH 31, 2004 AND 2003 AND THE YEAR ENDED DECEMBER 31, 2003

	(Unaudited) March 31,	
	2004	2003
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 4,632,830	\$ 2,787,724
Marketable securities	6,615,579	5,643,829
Accounts receivable, net of allowance for doubtful accounts of \$15,000	2,006,629	1,730,870

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Other receivables	160,968	58,380
Inventories	795,370	773,684
Prepaid expenses and other current assets	5,485	3,969
Deferred income taxes	27,288	439,754
Prepaid income taxes	343,023	--
	-----	-----
TOTAL CURRENT ASSETS	14,587,172	11,438,210
PROPERTY, PLANT, AND EQUIPMENT, NET	3,617,411	3,903,407
	-----	-----
TOTAL ASSETS	\$ 18,204,583	\$ 15,341,617
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of notes payable	\$ 24,248	\$ 31,271
Accounts payable	739,253	698,259
Accrued expenses	100,634	154,587
Income taxes payable	--	249,694
	-----	-----
Total current liabilities	864,135	1,133,811
NOTES PAYABLE	468,768	492,502
DEFERRED INCOME TAXES	448,590	407,920
STOCKHOLDERS' EQUITY		
Common stock	6,509,267	6,509,267
Stock subscription receivable	(15,000)	(15,000)
Treasury stock, at cost	(679,956)	(679,956)
Retained earnings	10,587,615	8,593,750
Accumulated other comprehensive loss, net of tax	21,164	(1,100,677)
	-----	-----
TOTAL STOCKHOLDERS' EQUITY	16,423,090	13,307,384
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 18,204,583	\$ 15,341,617
	=====	=====

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

	(Unaudited) March 31, 2004	2003
	-----	-----
SALES	\$ 3,935,079	\$ 3,308,557
Cost of goods sold	2,099,198	1,825,956
	-----	-----
GROSS PROFIT	1,835,881	1,482,601
	-----	-----

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Operating expenses	882,029	844,621
	-----	-----
INCOME FROM OPERATIONS	953,852	637,980
Other income (expense):		
Interest and dividend income	41,124	33,447
Interest expense	(7,611)	(7,644)
Gain (loss) on sale of marketable securities, net	268,367	(346,556)
Gain on sale of assets	--	1,246,287
Other income	--	--
	-----	-----
Total other income (expense)	301,880	925,534
	-----	-----
INCOME BEFORE PROVISION FOR INCOME TAXES	1,255,732	1,563,514
Provision for income taxes	490,533	570,241
	-----	-----
NET INCOME	\$ 765,199	\$ 993,273
	=====	=====
EARNINGS PER COMMON SHARE	0.09	0.12
	=====	=====
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING	8,436,888	8,436,888
	=====	=====
COMPREHENSIVE INCOME		
NET INCOME	\$ 765,199	\$ 993,273
Other comprehensive income (loss), net of tax:		
Unrealized gains on marketable securities (net of tax of \$15,072, \$55,882 and \$114,070)	21,422	30,450
Less reclassification adjustment for (gains) losses Included in net income	(156,495)	203,743
	-----	-----
COMPREHENSIVE INCOME	\$ 630,126	\$ 1,227,466
	=====	=====

See accompanying Notes to Financial Statements.

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STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY FOR THE THREE MONTHS ENDED
MARCH 31, 2004 AND THE YEAR ENDED DECEMBER 31, 2003

	COMMON STOCK, NO PAR VALUE 10,000,000 SHARES AUTHORIZED		# OF SHARE OF TREASURY STOCK
	# OF SHARES ISSUED	# OF SHARES OUTSTANDING	
	-----	-----	-----
BALANCES AT DECEMBER 31, 2002	8,636,888	8,436,888	200,000

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Other comprehensive income:			
Unrealized gains (losses) on securities, net of			
Taxes and reclassification adjustment	--	--	--
Net income for the year			
Ended December 31, 2003	--	--	--
BALANCES AT DECEMBER 31, 2003	8,636,888	8,436,888	200,000
Other comprehensive income:			
Unrealized gains (losses) on securities, net of			
Taxes and reclassification adjustment	--	--	--
Net income for the three months			
Ended March 31, 2004	--	--	--
BALANCES AT MARCH 31, 2004 (UNAUDITED)	8,636,888	8,436,888	200,000
			ACCUMULATED
			OTHER
			COMPREHENSIVE
	TREASURY	RETAINED	INCOME,
	STOCK	EARNINGS	NET OF TAXES
BALANCES AT DECEMBER 31, 2002	\$ (679,956)	\$ 7,600,477	\$(1,334,877)
Other comprehensive income:			
Unrealized gains (losses) on securities, net of			
Taxes and reclassification adjustment	--	--	1,491,100
Net income for the year			
Ended December 31, 2003	--	2,221,939	--
BALANCES AT DECEMBER 31, 2003	(679,956)	9,822,416	156,230
Other comprehensive income:			
Unrealized gains (losses) on securities, net of			
Taxes and reclassification adjustment	--	--	(135,070)
Net income for the three months			
Ended March 31, 2004	--	765,199	--
BALANCES AT MARCH 31, 2004 (UNAUDITED)	\$ (679,956)	\$10,587,615	\$ 21,160

See accompanying Notes to Financial Statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS ENDED MARCH 31, 2004
AND 2003 AND THE YEAR ENDED DECEMBER 31, 2003

	(Unaudited) March 31,	
	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME	\$ 765,199	\$ 99,000
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	155,905	16,340
Gain (loss) on sale of marketable securities, net	(268,367)	34,000
Gain on sales of assets	--	(1,240)
Deferred income taxes	75,127	4,000
(Increase) decrease in operating assets:		
Accounts receivable	(206,488)	(29,000)
Other receivables	4,799	
Inventories	16,202	(5,000)
Prepaid income taxes	(36,852)	
Prepaid expenses and other current assets	(4,694)	
Increase (decrease) in operating liabilities:		
Accounts payable	(56,069)	5,000
Accrued expenses	(82,966)	(2,000)
Income taxes payable	--	(14,000)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	361,796	(16,000)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of marketable securities	(3,141,028)	(2,020)
Sales of marketable securities	2,862,610	60,000
Sales of assets	--	1,710
Purchases of property, plant and equipment	(40,585)	(6,000)
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	(319,003)	22,000
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of notes payable	(7,782)	
NET CASH USED IN FINANCING ACTIVITIES	(7,782)	(7,000)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	35,011	5,000
Cash and cash equivalents at the beginning of the year	4,597,819	2,730,000
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 4,632,830	\$ 2,785,000

See accompanying Notes to Financial Statements.

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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 product is sold throughout the United States and in Eastern Canada. During the three month periods ended March 31, 2004 and 2003, export sales of the Company were approximately \$37,050 and \$123,700, respectively. The majority of the Company's revenues are derived from the sale of the Company's principal products.

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. 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.

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

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Insurance Corporation or the Securities Investor Protector Corporation.

BANK BALANCES OF AMOUNTS REPORTED BY FINANCIAL INSTITUTIONS ARE CATEGORIZED AS FOLLOWS AT MARCH 31, 2004.

	March 31, 2004	March 31, 2003	December 31, 2003
	-----	-----	-----
Amounts insured	\$ 400,000	\$ 400,000	\$ 400,000
Uninsured and uncollateralized amounts	4,337,104	2,553,294	4,212,259
	-----	-----	-----
Total bank balances	\$ 4,737,104	\$ 2,953,294	\$ 4,612,259
	=====	=====	=====

Marketable securities

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

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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 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
----------	-------

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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 three months ended March 31, 2004 and 2003, approximately \$629,500, \$214,581, and \$199,534, 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. During the year 2003 and the three month period ended March 31, 2004, diluted and basic earnings per share were the same, 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 available for sale are as follows:

(Unaudited) March 31, 2004	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities/mutual funds	\$ 3,718,091	\$ 95,725	\$ (62,081)	\$ 3,751,735
Preferred securities	75,505	3,925	--	79,430
Certificates of deposit	150,000	--	(2,790)	147,210
Corporate bonds	775,010	2,524	(160)	777,374
Municipal bonds, maturing within five years	907,244	4,544	(9)	911,779

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Government agency obligations, maturing after five years	953,234	--	(5,183)	948,051
Total	\$ 6,579,084	\$ 106,718	\$ (70,223)	\$ 6,615,579

(Unaudited) March 31, 2003	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities	\$ 4,156,822	\$ 18,162	\$(1,520,517)	\$ 2,654,467
Preferred securities	100,000	--	(8,000)	92,000
Municipal bonds, Maturing within five years	2,884,703	12,659	--	2,897,362
Total	\$ 7,141,525	\$ 30,821	\$(1,528,517)	\$ 5,643,829

December 31, 2003	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities	\$ 2,326,722	\$ 315,348	\$(48,837)	\$ 2,593,233
Preferred securities	200,505	2,985	(80)	203,410
Certificates of deposit	150,000	--	--	150,000
Corporate bonds	500,005	--	(1,333)	498,672
Municipal bonds, maturing within five years	2,405,067	1,545	(10)	2,406,602
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, \$2,862,610 and \$608,696 during the year 2003 and for the three months ended March 31, 2004 and 2003, respectively.

Gross gains (losses) of \$(1,293,579), \$268,367, and \$(346,556), were realized on these sales during the year 2003 and for the three months ended March 31, 2004 and 2003, respectively.

NOTE 4 - INVENTORIES

Inventories consist of the following:

	(Unaudited) March 31,		December 31,
	2004	2003	2003
Finished goods	\$ 349,431	\$ 190,947	\$ 436,291
Production supplies	232,432	259,715	231,376
Raw materials	213,507	323,022	143,905
Total inventories	\$ 795,370	\$ 773,684	\$ 811,572

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NOTE 5 - PROPERTY, PLANT, AND EQUIPMENT

Property, plant, and equipment consist of the following:

	March 31,		(Unaudited) December 31,
	2004	2003	2003
Land	\$ 470,900	\$ 470,900	\$ 470,900
Buildings and improvements	2,459,090	2,385,495	2,435,111
Machinery and equipment	5,176,788	4,868,390	5,138,822
Vehicles	359,383	359,383	380,743
Office equipment	78,763	67,783	78,763
	8,544,924	8,151,951	8,504,339
Less accumulated depreciation	4,927,513	4,248,544	4,771,608
	\$ 3,617,411	\$ 3,903,407	\$ 3,732,731

Depreciation expense during the year ended December 31, 2003 and for the three months ended March 31, 2004 and 2003 was \$688,309, \$155,905, and \$165,212, respectively.

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NOTE 6 - NOTES PAYABLE

Notes payable consist of the following:

	(Unaudited) March 31,		Dece
	2004	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.	479,054	487,593	
Notes payable to finance companies, payable in monthly installments of \$1,851, including interest at 0%, due November 2004. Collateralized by vehicles.	13,962	36,180	
Total notes payable	493,016	523,773	
Less current maturities	24,248	31,271	
Total long-term portion	\$ 468,768	\$ 492,502	\$

Maturities of notes payables are as follows:

As of March 31,	
2004	\$ 24,248
2005	10,764

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2006	10,256
2007	447,748

Total	\$ 493,016
	=====

NOTE 7 - PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

	(Unaudited)		Year Ended
	For the Three Months Ended	March 31,	December 31,
	-----	-----	-----
	2004	2003	2003
	-----	-----	-----
Current:			
Federal	\$ 336,538	\$ 427,825	\$ 1,075,623
State	78,868	98,962	269,841
	-----	-----	-----
Total current	415,406	526,787	1,345,464
Deferred	75,127	43,454	9,084
	-----	-----	-----
Provision for income taxes	\$ 490,533	\$ 570,241	\$ 1,354,548
	=====	=====	=====

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

	(Unaudited)		For the
	For the Three Months Ended	March 31,	Year Ended
	-----	-----	December 31,
	2004	2003	2003
	-----	-----	-----
Federal income tax expense	\$ 396,208	\$ 531,594	\$ 1,161,643
computed at the statutory rate			
State taxes, expense	90,413	112,572	257,507
Temporary book/tax differences			
Depreciation	(23,363)	(44,936)	(4,829)
Disallowed (allowed) capital			
Losses	--	--	104,683
Other than temporary reductions			
on marketable securities	--	(8,784)	(97,175)
Other	27,275	--	(58,044)
Permanent book/tax differences	--	(20,205)	(9,237)
	-----	-----	-----
Provision for income taxes	\$ 490,533	\$ 570,241	\$ 1,354,548
	=====	=====	=====

Amounts for deferred tax assets and liabilities are as follows:

	(Unaudited)		For the
	For the Three Months Ended	March 31,	Year Ende
	-----	-----	December 3
	2004	2003	2003
	-----	-----	-----

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	-----	-----	-----
Non-current deferred tax liabilities arising from:			
Temporary differences - principally			
Book/tax, accumulated depreciation	\$ (448,590)	\$ (407,920)	\$ (471,95
	-----	-----	-----
Current deferred tax liability arising from:			
Book/tax, unrealized gains and			
marketable securities	(15,072)	--	(114,07
Current deferred tax assets arising from:			
Book/tax, capital loss carryforward	--	617,050	104,68
Book/tax, other	42,360	42,704	36,42
Less valuation allowance	--	(220,000)	--
	-----	-----	-----
Total deferred tax assets	27,288	439,754	27,03
	-----	-----	-----
Net deferred tax asset (liability)	\$ (421,302)	\$ 31,834	\$ (444,91
	=====	=====	=====

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NOTE 8 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

	(Unaudited)		For the
	For the Three Months Ended		Year Ended
	March 31,		December 31,
	-----		-----
	2004	2003	2003
	-----	-----	-----
Interest	\$ 7,611	\$ 7,643	\$ 41,205
Income taxes	\$ 452,000	\$ 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 a Consulting Service 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 March 31 and December 31, 2003 and at March 31, 2004. The terms of this Plan do not require or permit 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, March 31, 2004 and 2003, there were no stock options outstanding or exercisable.

NOTE 10 - 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,

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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 March 31, 2004:

	Carrying Amount	Fair Value
	-----	-----
Cash and cash equivalents	\$ 4,632,830	\$ 4,632,830
Marketable securities	\$ 6,615,579	\$ 6,615,579
Notes payable	\$ 493,016	\$ 469,069

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.

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

COMPARISON OF QUARTER ENDED MARCH 31, 2004 TO QUARTER ENDED MARCH 31, 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 \$626,522 (approximately 19%) to \$3,935,079 during the three month period ended March 31, 2004 from \$3,308,557 during the same three month period in 2003. We believe that approximately half of the 2004 increase in sales was attributable to a new customer as of June 2003, Sav-A-Lot, Ltd., which represented sales of a significant number of 8 oz. bottles of Lifeway's LaFruta line. Save-A-Lot, the 13th largest grocery chain in the United States, operates more than 1000 Sav-A-Lot and Supervalu food stores nationwide.

While sales increased by about 19%, our operating expenses increased by only about 4% to \$882,029 for the current fiscal quarter from \$844,621 for the same period last year. Such a small increase in operating expenses combined with a significant sales growth this quarter (as compared to the same period in 2003) resulted in an operating income increase of \$315,872 (approximately 50%) to \$953,852 for the three months ended March 31, 2004 from \$637,980 during the same three month period in 2003.

Cost of goods sold as a percentage of sales was 53% for the three months ended March 31, 2004, compared to 55% for the same three month period in 2003. Cost of

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goods sold increased by \$273,242 (approximately 15%) to \$2,099,198 during the three month period ending March 31, 2004 from \$1,825,956 during the same three month period in 2003. The price of milk, our largest cost of goods component, rose approximately 20% during this same three month period.

Income not derived from operations (or "other income") decreased by \$623,654 to \$301,880 during the three month period ended March 31, 2004 from \$925,534 during the same three month period in 2003. During the three month period ended March 31, 2003, Lifeway recognized a one-time gain on the sale of real property in the amount of \$1,246,287 offset by a loss on the sale of marketable securities, net of \$346,556. In the quarter ended March 31, 2003 compared to the same three month period in 2004, the sale of the real property impacted the depreciation and amortization item and both the sale of the real property and the loss on marketable securities, net impacted income tax deferred and income tax payable items.

SOURCES AND USES OF CASH

Net cash used in financing activities was \$7,782 during the quarter ended March 31, 2004, which is essentially unchanged year-over-year from \$7,732 during the same period in 2003. In contrast, our operating activities during the three month period ended March 31, 2004 generated positive net cash flows of \$361,796, whereas during the same period in 2003 our operating net cash flows decreased by \$165,738 due to the gain on the disposition of real property and the subsequent use of all of the cash from such gain for investment in certificates of deposit and other cash equivalents.

A significant portion of our assets are held in marketable securities. The marketable securities are classified as available-for-sale on our balance sheet and thus 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 provided by investing activities decreased by \$319,003 for the three months ended March 31, 2004 as compared to the increase of \$229,538 during the same period in 2003. The positive net investing activity cash flow during the three month period ended March 31, 2003 was attributable to a one-time gain from the sale of real property and investment of substantially all of the proceeds of that sale in cash equivalents. However, during the three month period ended March 31, 2004, Lifeway experienced negative investing cash flows in the amount of \$319,003 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 calendar quarter of 2004 also are reflected by a gain of \$268,367 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.

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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. We anticipate closing an acquisition in 2004 or early 2005. We expect that we will be able to use our available cash and cash equivalents as funding for an acquisition of this size. We are also exploring opportunities in Eastern Canada that will meet our desire to expand sales in that region.

OTHER DEVELOPMENTS

On February 12, 2004, Lifeway's Board of Directors approved awards of an

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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 on the individual grantee. The expense for the awards is measured as of April 1, 2004 at \$20.93 per share for 5100 shares, or a total stock award expense of \$106,743. This expense will be recognized as the stock awards vest beginning on October 1, 2004, which is the earliest vesting date for the awards. In this paragraph, the share numbers and per share expense have been adjusted to reflect the stock split as of March 8, 2004.

Lifeway Foods prices for all its dairy products will be increased by approximately 20% effective June 15, 2004. This price increase is in response to the rising cost of milk, new packaging costs and an overall increase in the cost of doing business. This is Lifeway's first major price increase in almost three years. Lifeway Management does not expect that this price increase will have a negative impact on its sales or gross margins as Lifeway's products are expected to continue to be comparatively less expensive (on a per ounce basis) than many of its competitors' products.

During the quarter ending June 30, 2004, the Company expects to incur a one time expense of approximately \$43,000 for listing additional shares on the Nasdaq National Market System in connection with its March 2004 stock split.

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:

- 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;

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

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- 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 March 31, 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.

PART II - OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES

On March 8, 2004, each issued share of the Company's common stock, no par value, split into two shares pursuant to a stock split dividend declared by the Company Board of Directors on February 12, 2004.

ITEM 5. OTHER INFORMATION

On May 13, 2004, following approval by its Audit Committee, the Company engaged Plante & Moran, PLLC ("Plante Moran") as its independent auditor following the May 1, 2004 merger of Plante Moran with the Company's former auditor, Gleeson, Sklar, Sawyers & Cumpata.

On May 17, 2004, the Company announced its financial results for the fiscal quarter ended March 31, 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

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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).
- 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

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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 May 17, 2004 regarding earnings for the quarter ended March 31, 2004.

(b) Reports on Form 8-K.

On February 13, 2004, the Company filed a Current Report on Form 8-K with disclosures in Items 5 and 7 regarding the stock split which occurred March 8, 2004.

On March 29, 2004, the Company filed a Current Report on Form 8-K with disclosures in Items 7 and 12 regarding the Company's results of operations and financial condition for the year ended December 31, 2003.

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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: May 17, 2004

LIFEWAY FOODS, INC.

By: /s/ Julie Smolyansky

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

