LIFEWAY FOODS INC
Form 10QSB
November 15, 2004

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 September 30, 2004

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

For the transition period from __________ to __________

Commission file number: 0-17363

LIFEWAY FOODS, INC.
(Exact name of small business issuer as specified in 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 November 12, 2004, the issuer had 8,440,888 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 AS OF SEPTEMBER 30, 2004 AND 2003 AND D

	(Unaudited) September 30, 2004	2003
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 5,348,135	$ 4,246
Marketable securities	6,727,867	6,272
Accounts receivable, net of allowance for doubtful accounts of $15,000 at September 30, 2004 and 2003 and December 31, 2003	1,943,032	1,878
Other receivables	80,582	57
Inventories	915,951	875

Prepaid expenses and other current assets	8,344	
Deferred income taxes	90,937	240
Prepaid income taxes	68,042	
TOTAL CURRENT ASSETS	15,182,890	13,571
PROPERTY AND EQUIPMENT, NET	3,482,524	3,805
INTANGIBLE ASSETS	511,800	
TOTAL ASSETS	$ 19,177,214	$ 17,376
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of notes payable	$ 11,716	$ 30
Accounts payable	701,145	771
Accrued expenses	186,591	94
Income taxes payable	--	647
TOTAL CURRENT LIABILITIES	899,452	1,543
NOTES PAYABLE	465,796	478
DEFERRED INCOME TAXES	426,895	398
STOCKHOLDERS' EQUITY		
Common stock	6,509,267	6,509
Paid-In-Capital	56,540	
Stock subscription receivable	(5,000)	(15
Treasury stock, at cost	(652,776)	(679
Retained earnings	11,534,832	9,991
Accumulated other comprehensive income (loss), net of tax	(57,792)	(849
TOTAL STOCKHOLDERS' EQUITY	17,385,071	14,956
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 19,177,214	$ 17,376

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

	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2004	2003	2004	200
SALES	$ 4,138,606	$ 3,837,100	$ 12,075,778	$ 10,92
Cost of goods sold	2,239,553	1,907,802	6,604,554	5,46
GROSS PROFIT	1,899,053	1,929,298	5,471,224	5,45
Operating expenses	1,157,906	871,192	3,089,336	2,65

INCOME FROM OPERATIONS	741,147	1,058,106	2,381,888	2,79
Other income (expense):				
Interest and dividend income	49,689	24,595	124,897	9
Interest expense	(7,584)	(7,743)	(23,103)	(2
Gain (loss) on sale of marketable securities, net	12,386	39,711	321,716	(29
Gain on sale of assets	--	--	--	1,24
Gain (loss) on marketable securities classified as trading	15,681	--	(12,077)	
Other income	--	--	--	
Total other income	70,172	56,563	411,433	1,02
INCOME BEFORE PROVISION FOR INCOME TAXES	811,319	1,114,669	2,793,321	3,82
Provision for income taxes	296,210	405,473	1,080,905	1,43
NET INCOME	$ 515,109	$ 709,196	$ 1,712,416	$ 2,39
EARNINGS PER COMMON SHARE	0.06	0.08	0.20	
WEIGHTED AVERAGE SHARES OUTSTANDING	8,440,207	8,436,888	8,438,433	8,43
COMPREHENSIVE INCOME				
NET INCOME	$ 515,109	$ 709,196	$ 1,712,416	$ 2,39
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on marketable securities (net of tax benefits)	(11,245)	33,092	(25,827)	1,07
Less reclassification adjustment for (gains) losses included in net income (net of tax benefits)	(5,140)	(4,954)	(188,202)	(37
COMPREHENSIVE INCOME	$ 498,724	$ 737,334	$ 1,498,387	$ 3,09

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CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY FOR THE NINE MONTHS ENDED SE
AND THE YEAR ENDED DECEMBER 31, 2003

	COMMON STOCK, NO PAR VALUE 10,000,000 SHARES AUTHORIZED			
	# OF SHARES ISSUED	# OF SHARES OUTSTANDING	# OF SHARES OF TREASURY STOCK	COMMON STOCK
BALANCES AT DECEMBER 31, 2002	8,636,888	8,436,888	200,000	$ 6,509,267

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	$ 6,509,267
Issuance of treasury stock	4,000	4,000	(4,000)	--
Other comprehensive income:				
Unrealized gains (losses) on securities, net of taxes and reclassification	(214,029)	(214,029)		
adjustment	--	--	--	--
Payment on subscription receivable	--	--	--	--
Net income for the nine months ended September 30, 2004	--	--	--	--
BALANCES AT SEPTEMBER 30, 2004 (UNAUDITED)	8,640,888	8,440,888	196,000	$ 6,509,267

	TREASURY STOCK	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX	TOTAL
BALANCES AT DECEMBER 31, 2002	$ (679,956)	$ 7,600,477	$(1,334,870)	$12,079,918
Other comprehensive income:				
Unrealized gains (losses) on securities, net of taxes and reclassification adjustment	--	--	1,491,107	1,491,107
Net income for the year ended December 31, 2003	--	2,221,939	--	2,221,939
BALANCES AT DECEMBER 31, 2003	$ (679,956)	$ 9,822,416	$ 156,237	$15,792,964
Issuance of treasury stock	27,180	--	--	83,720
Other comprehensive income:				
Unrealized gains (losses) on securities, net of taxes and reclassification adjustment	--	--	--	--

Payment on subscription receivable	--	--	--	10,000
Net income for the nine months ended September 30, 2004	--	1,712,416	--	1,712,416
BALANCES AT SEPTEMBER 30, 2004 (UNAUDITED)	$ (652,776)	$11,534,832	$ (57,792)	$17,385,071

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CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003 AND DECEMBER 31, 2003

	(Unaudited) Nine Months Ended September 30,	
	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME	$ 1,712,416	$ 2,391,197
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	474,876	514,523
(Gain) loss on sale of marketable securities, net	(321,716)	293,348
Loss on marketable securities classified as trading	12,077	--
Gain on sale of assets	--	(1,246,287)
Deferred income taxes	45,779	31,466
(Increase) decrease in operating assets:		
Accounts receivable	(142,891)	(442,908)
Other receivables	85,184	2,714
Inventories	(104,379)	(154,969)
Prepaid income taxes	238,129	344
Prepaid expenses and other current assets	(7,553)	--
Increase (decrease) in operating liabilities:		
Accounts payable	(94,176)	131,908
Accrued expenses	2,991	(89,291)
Income taxes payable	--	249,358
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,900,737	1,681,403
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of marketable securities	(5,790,781)	(6,913,611)
Sales of marketable securities	5,306,395	5,371,415
Sales of assets	--	1,712,660
Purchases of property and equipment	(224,669)	(313,728)
Acquisition of Ilya's Farms, Inc., net of assets acquired	(511,800)	--
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	(1,220,855)	(143,264)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of treasury stock	83,720	--
Receipt of stock subscription receivable	10,000	--
Repayment of notes payable	(23,286)	(22,960)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	70,434	(22,960)

NET INCREASE IN CASH AND CASH EQUIVALENTS	750,316	1,515,179
Cash and cash equivalents at the beginning of the period	4,597,819	2,731,656
CASH AND CASH EQUIVALENTS AT END OF THE PERIOD	$ 5,348,135	$ 4,246,835

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NOTES TO FINANCIAL STATEMENTS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003 AND THE YEAR ENDED DECEMBER 31, 2003.

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 by distributors. The Company also distributes some of its products internationally by exporting to Eastern Europe. During the year 2003 and for the nine months ended September 30, 2004 and 2003, export sales of the Company were approximately $221,000, $37,050, and $164,282, respectively.

On September 30, 1992, the Company formed a wholly owned subsidiary corporation, LFI Enterprises, Inc., (LFIE) incorporated in the state of Illinois. LFIE was formed for the purpose of operating a "Russian" theme restaurant and supper club on property acquired by the Company on October 9, 1992. The restaurant/supper club commenced operations in late November 1992. As of July 2001, the restaurant/supper club terminated all operations. In January 2003, the Company sold the building and the land that housed LFIE for $1,712,659 and recognized a gain of $1,246,287 on this transaction. On July 23, 2004, LFIE acquired certain assets and inventory of Ilya's Farms, Inc., a Pennsylvania corporation, for a total purchase consideration of $575,600. The asset acquisition transaction between LFIE and Ilya's Farms, Inc. included approximately $64,000 of tangible assets (including certain manufacturing equipment, a delivery truck and inventory) as well 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 name "Ilya's Farms" in the Philadelphia, Pennsylvania metropolitan area.

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, 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 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.

Cash and cash equivalents

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

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

Bank balances of amounts reported by financial institutions are categorized as follows:

	(Unaudited) September 30,		December 3
	2004	2003	2003
Amounts insured	$ 500,000	$ 400,000	$ 400,00
Uninsured and uncollateralized amounts	5,041,913	4,029,060	4,212,25
Total bank balances	$5,541,913	$4,429,060	$4,612,25

Marketable securities

Marketable securities are classified as both available-for-sale and as trading, depending on the type of security and management's intent, and are stated at market value. Gains and losses related to marketable securities sold are determined by the specific identification method.

Accounts receivable

The allowance for doubtful accounts is based on management's evaluation of outstanding accounts receivable at the end of the year.

Inventories

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

Property and equipment

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

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

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

Income taxes

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

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

Treasury stock

Treasury stock is recorded using the cost method.

Advertising costs

The Company expenses advertising costs as incurred. During the year 2003 and for the nine months ended September 30, 2004 and 2003, approximately $629,500, $619,852, and $488,656, 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. For each of 2004 and 2003, diluted and basic earnings per share were the same, respectively, as the effect of dilutive securities options outstanding was not significant.

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Note 3 - MARKETABLE SECURITIES

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

September 30, 2004	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading	Fair Value
Equities/Mutual Funds	$3,713,163	$ 101,144	$ (188,299)	$ --	$3,626,
Preferred Securities	75,505	1,825	--	--	77,
Certificates of Deposit	150,000	--	(7,440)	--	142,
Corporate Bonds	1,614,275	--	(8,177)	--	1,606,
Municipal bonds, maturing within five years	132,224	2,490	--	--	134,
Government agency obligations, maturing after five years	1,153,234	--	--	(12,077)	1,141,
Total	$6,838,401	$ 105,459	$ (203,916)	$ (12,077)	$6,727,

September 30, 2003	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading	Fair Value
Equities	$4,253,095	$ 192,142	$(1,199,398)	$ --	$3,245,
Preferred securities	150,505	700	(25)	--	151,
Corporate Bonds	475,005	444	--	--	475,
Municipal bonds, maturing within five years	2,406,478	401	(6,859)	--	2,400,
Total	$7,285,083	$ 193,687	$(1,206,282)	$ --	$6,272,

December 30, 2003	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading	Fair Value
Equities	$2,326,722	$ 315,348	$ (48,837)	$ --	$2,593,
Preferred securities	200,505	2,985	(80)	--	203,
Certificates of Deposit	150,000	--	--	--	150,
Corporate Bonds	500,005	--	(1,333)	--	498,
Municipal bonds, maturing within five years	2,405,067	1,545	(10)	--	2,406,
Government agency obligation	450,000	689	--	--	450,
Total	$6,032,299	$ 320,567	$ (50,260)	$ --	$6,302,

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Proceeds from the sale of marketable securities were $3,025,285, $5,306,395, and $5,371,416 during the year 2003 and for the nine months ended September 30, 2004 and 2003, respectively.

Gross gains (losses) of $(1,293,579), $321,716, and $(293,348), were realized on these sales during the year 2003 and for the nine months ended September 30, 2004 and 2003, respectively.

Note 4 - INVENTORIES

Inventories consist of the following:

	(Unaudited) September 30, 2004	(Unaudited) September 30, 2003	December 31, 2003
Finished goods	$ 386,700	$ 398,548	$ 436,291
Production supplies	308,766	283,212	231,376
Raw materials	220,485	193,712	143,905
Total inventories	$ 915,951	$ 875,472	$ 811,572

Note 5 - PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	(Unaudited) September 30, 2004	(Unaudited) September 30, 2003	December 31, 2003
Land	$ 470,900	$ 470,900	$ 470,900
Buildings and improvements	2,453,681	2,423,812	2,435,111
Machinery and equipment	5,316,766	5,049,938	5,138,822

	(Unaudited) September 30, 2004	(Unaudited) September 30, 2003	December 31, 2003
Vehicles	408,898	380,743	380,743
Office equipment	78,763	77,645	78,763
	8,729,008	8,403,038	8,504,339
Less accumulated depreciation	5,246,484	4,597,855	4,771,608
	$3,482,524	$3,805,183	$3,732,731

Depreciation expense during the year ended December 31, 2003 and for the nine months ended September 30, 2004 and 2003 was $688,309, $474,876, and $514,523, respectively.

Note 6 - NOTES PAYABLE

Notes payable consist of the following:

	(Unaudited) September 30, 2004	(Unaudited) September 30, 2003	December 31, 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	$474,659	$483,474	$481,281
Notes payable to finance companies, payable in monthly installments of $1,851, including interest at 0%, due November 2004. Collateralized by vehicles	2,853	25,071	19,517

Total notes payable	477,512	508,545	500,798
Less current maturities	11,716	30,521	28,289
Total long-term portion	$465,796	$478,024	$472,509

Maturities of notes payables are as follows:

As of September 30,

2005	$ 11,716
2006	465,796
Total	$ 477,512

Note 7 - PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

	(Unaudited) For the Nine Months Ended September 30, 2004	(Unaudited) For the Nine Months Ended September 30, 2003	For the Year Ended December 31, 2003

Current:			
Federal	$ 841,895	$1,139,107	$1,075,623
State	193,231	262,618	269,841
Total current	1,035,126	1,401,725	1,345,464
Deferred	45,779	31,466	9,084
Provision for income taxes	$1,080,905	$1,433,191	$1,354,548

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

	(Unaudited) For the Nine Months Ended September 30,		For the Year Ended December 31,
	2004	2003	2003
Federal income tax expense computed at the statutory rate	$ 880,399	$ 1,300,292	$ 1,216,006
State taxes, expense	203,912	183,571	171,671
Permanent book/tax differences	(3,406)	(50,672)	(33,129)
Provision for income taxes	$ 1,080,905	$ 1,433,191	$ 1,354,548

Amounts for deferred tax assets and liabilities are as follows:

	(Unaudited) For the Nine Months Ended September 30,		Y D
	2004	2003	
Non-current deferred tax liabilities arising from:			
Temporary differences - principally Book/tax, accumulated depreciation	$ (426,895)	$ (398,788)	
Current deferred tax liability arising from:			
Book/tax, unrealized gains on marketable securities	$ --	$ --	
Current deferred tax assets arising from:			
Book/tax, unrealized losses on marketable securities	40,665	415,014	
Book/tax, capital loss carryforward	--	--	
Book/tax, inventory	50,272	45,194	
Less: valuation allowance	--	(220,000)	
Total deferred tax assets	90,937	240,208	

Net deferred tax liability	$ (335,958)	$ (158,580)

Note 8 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

	(Unaudited) For the Nine Months Ended September 30,		For the Year Ended December 31,
	2004	2003	2003
Interest	$ 23,103	$ 23,164	$ 41,205
Income taxes	$ 798,147	$1,152,000	$2,055,000

Note 9 - 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 300,000 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 468,600 shares available for issuance under the Plan at December 31, 2003 and at September 30, 2004 and 2003.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, September 30, 2004 and 2003, there were no stock options outstanding or exercisable.

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

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, 2004.

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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 values of the Company's financial instruments are as follows at September 30, 2004:

	Carrying Amount	Fair Value
Cash and cash equivalents	$5,348,135	$5,348,135
Marketable securities	$6,727,867	$6,727,867
Notes payable	$ 477,512	$ 454,773

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

Note 12 - 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 of the 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 manufactures and distributes certain cream cheese products under the brand name "Ilya's Farms" in the Philadelphia, Pennsylvania metropolitan area. The results of LFIE's operations have been included in the consolidated financial statements since that 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

PART II - OTHER INFORMATION

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

COMPARISON OF QUARTER AND NINE MONTHS ENDED SEPTEMBER 30, 2004 TO QUARTER AND NINE MONTHS ENDED SEPTEMBER 30, 2003

The following analysis should be read in conjunction with the unaudited financial statements of the Company and related notes included elsewhere in this quarterly report and the audited financial statements and Management's Discussion and Analysis contained in our Form 10-KSB, as amended by

Form 10-KSB/A, for the fiscal year ended December 31, 2003.

RESULTS OF OPERATIONS

Sales increased by $301,506 (approximately 8%) to $4,138,606 during the three month period ended September 30, 2004, from $3,837,100 during the same three month period in 2003. In the nine months ended September 30, 2004, sales increased $1,154,268 over the same nine month period in 2003. This increase was primarily attributable to continued growth in sales of Lifeway's products to existing customers. Sav-A-Lot, the 13th largest grocery chain in the United States which operates more than 1000 Sav-A-Lot and Supervalu food stores nationwide, ceased all product orders from Lifeway during the second calendar quarter of 2004. During the third quarter of 2003, sales by Lifeway to Sav-A-Lot accounted for approximately $210,000 (about 5.5%) of the total sales revenue of $3,837,100 for the three month period ended September 30, 2003. At present, it is unknown to Lifeway's management whether Sav-A-Lot will make any further product orders.

Cost of goods sold as a percentage of sales was 54% for the three months ended September 30, 2004, compared to 50% for the same three month period in 2003. Cost of goods sold increased by $331,751 to $2,239,553 during the three month period ending September 30, 2004 (approximately 17%) from $1,907,802 during the same three month period in 2003. In the nine months ended September 30, 2004, cost of goods sold increased $1,136,862 (approximately 21%) over the same nine month period in 2003. The price of milk, our largest cost of goods component, rose approximately 70% during this same nine month period. The largest component of the increase in the cost of goods sold during the first nine months of 2004 was a milk price increase of approximately 110% during the three months ended June 30, 2004. While the price of milk decreased slightly during the three months ended September 30, 2004, it remained substantially higher than during the same three month period in 2003 and continued to be the largest component of the cost of goods for the third quarter of 2004.

Operating expenses increased approximately 33% during the three month period ended September 30, 2004 compared to the same three month period in 2003. For the nine month period ended September 30, 2004, operating expenses increased approximately 16% compared to the same nine month period in 2003. This increase is primarily attributable to two expenses: (1) a $41,860 expense recognized in connection with the vesting in the third quarter 2004 of 2,000 shares (valued at $20.93 per share at the time of grant) of a total of 5,100 shares of Company stock granted to Lifeway employees on February 12, 2004 and (2) 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. Lifeway also experienced increased professional expenses in connection with the acquisition by LFI Enterprises, Inc. of substantially all of the assets of Ilya's Farms, Inc. on July 23, 2004.

Net income decreased approximately 28% during the three month period ended September 30, 2004 as compared to the same three month period in 2003. In the opinion of Lifeway's management, several factors contributed to the 28% decrease in third quarter net income for 2004 as compared to 2003: (1) the lack of further orders from Sav-A-Lot, which accounted for about 5.5% of sales revenues for the same three month period last year; (2) increased professional expenses in connection with the acquisition by LFI Enterprises, Inc. of substantially all of the assets of Ilya's Farms, Inc. on July 23, 2004.; and (3) the increase in the cost of goods sold associated with higher milk prices. In the nine month period ended September 30, 2004, net income decreased approximately 28% compared to the same nine month period in 2003. This decrease is primarily attributable to the fact that during the first nine months of 2003 Lifeway had a one-time gain from the sale of property of $1,246,287 while during the first nine months of 2004, as discussed above, LFI Enterprises, Inc. entered into the Ilya's Farms, Inc. acquisition discussed above and Lifeway ceased to receive orders from a substantial customer.

SOURCES AND USES OF CASH

A significant portion of our assets are held in marketable securities. The majority of our marketable securities are classified as available-for-sale on our balance sheet, while the mortgage-backed securities are classified as trading. All of these securities are stated thereon at market value as of the end of the applicable period. Gains and losses on the portfolio are determined by the specific identification method.

Net cash used in investing activities increased by $1,220,885 for the nine months ended September 30, 2004 as compared to the increase of $143,264 during the same period in 2003. The increase in the net investing activity cash flow during the nine month period ended September 30, 2004 relative to the same period in 2003 was attributable the purchase by LFI Enterprises, Inc. of substantially all of the assets of Ilya's Farms, Inc. in exchange for $575,600 paid in cash. Of the total cash amount of $575,600 used by LFI Enterprises, Inc. in connection with the Ilya's Farms, Inc. asset acquisition, $511,800 will be recognized by Lifeway as intangible assets, while $63,800 is accounted for as part of the "Purchases of Property and Equipment" line item on the Consolidated Statement of Cash Flows for the Third Quarter of 2004. In the opinion of Lifeway's management, the acquisition by LFI Enterprises, Inc. of substantially all of the assets of Ilya's Farms, Inc. is a positive step to broaden Lifeway's presence in the market for manufactured dairy products.

During the nine month period ended September 30, 2004, Lifeway also experienced net negative investing cash flows in the amount of $484,386 ($5,790,781 used for purchases less $5,306,395 used for sales) used for the purchase and sale of marketable securities 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 three calendar quarters of 2004 also are reflected in a gain of $321,716 on the sale of marketable securities. We believe, given the current market conditions, this asset allocation strategy offers a positive risk-reward ratio for our Company.

OTHER DEVELOPMENTS

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

CRITICAL ACCOUNTING POLICIES

Lifeway's analysis and discussion of its financial condition and results of operations are based upon its consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States ("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 (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 September 30, 2004. The Company has historically operated on strictly monitored cost constraints; with that perspective, the Chief Executive Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to her.

During the calendar quarter ended September 30, 2004, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to affect, the Company's internal control over financial reporting. 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 its internal controls over financial reporting 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 Lifeway's internal control procedures.

ITEM 6. EXHIBITS.

Exhibits

Exhibit No.	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).
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 Lifeway'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 Lifeway's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999).
10.12	Extension to Stockholders' Agreement with Danone Foods, Inc. dated September 28, 2004 (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated October 1, 2004 and filed October 18, 2004).
10.13	Second Extension to Stockholders' Agreement with Danone Foods, Inc. dated October 29, 2004 (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated October 29, 2004 and filed November 4, 2004).
10.14	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 Lifeway's Current Report on Form 8-K dated December 24, 1999 and filed January 11, 2000).
10.15	Support Agreement with The Dannon Company, Inc. dated December 24, 1999 (incorporated by reference to Exhibit 10.13 of Lifeway's Current Report on Form 8-K dated December 24, 1999 and filed January 11, 2000).

10.16	First Amendment to Support Agreement with The Dannon

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

10.17	Employment Agreement, dated September 12, 2002, between Lifeway Foods, Inc. and Julie Smolyansky (incorporated by reference to Exhibit 10.14 of Amendment No. 2 filed April 30, 2003 to Lifeway's Quarterly Report on Form 10-QSB/A for the quarter ended September 30, 2002).
11	Statement re: computation of per share earnings (incorporated by reference to Note 2 of the Consolidated Financial Statements).
31.1	Rule 13a-14(a)/15d-14(a) Certification.
32.1	Section 1350 Certification.

SIGNATURE

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

Date: November 15, 2004

LIFEWAY FOODS, INC.

By: /s/ Julie Smolyansky

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

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