LIFEWAY FOODS INC
Form 10QSB
May 15, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-QSB

(Mark One)

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

For the quarterly period ended March 31, 2008

o 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 for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes þ No o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ

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 March 31, 2008, the issuer had 16,841,021 shares of common stock, no par value, outstanding.

Transitional Small Business Disclosure Format (Check one): Yes o No þ

INDEX

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Financial Condition
March 31, 2008 and 2007 (Unaudited) and December 31, 2007

	(Unaudited) March 31, 2008	(Unaudited) March 31, 2007	December 31, 2007
ASSETS			
Current assets			
Cash and cash equivalents	$ 392,790	$ 1,013,345	$ 595,885
Marketable securities	6,790,850	8,560,756	6,989,474
Inventories	3,669,990	2,883,455	3,506,554
Accounts receivable, net of allowance for doubtful accounts of $39,460 and $39,460 at March 31, 2008 and 2007 and $39,460 at December 31, 2007	4,926,058	4,587,966	4,209,662
Prepaid expenses and other current assets	9,087	9,992	21,253
Other receivables	134,298	50,425	43,111
Deferred income taxes	467,695	-	311,960
Refundable income taxes	—	158,553	240,880
Total current assets	16,390,768	17,264,492	15,918,779
Property and equipment, net	9,854,945	8,554,799	9,678,948
Intangible assets			
Goodwill	5,414,858	3,952,425	5,414,858
Other intangible assets, net of accumulated amortization of $681,837 and $358,985 at March 31, 2008 and 2007 and $601,976 at December 31, 2007	3,175,801	3,498,653	3,255,662
Total intangible assets	8,590,659	7,451,078	8,670,520
Other assets	500,000	—	500,000
Total assets	$ 35,336,372	$ 33,270,369	$ 34,268,247
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities			
Current maturities of notes payable	$ 1,131,725	1,129,004	$ 1,136,126
Accounts payable	1,966,926	1,239,046	1,594,330
Accrued expenses	392,384	341,189	414,039
Accrued income taxes	203,529	---	---
Total current liabilities	3,694,564	2,709,239	3,144,495
Notes payable	3,813,825	5,201,873	4,096,797
Deferred income taxes	1,679,859	485,244	1,712,795

Stockholders' equity			
Common stock, no par value; 20,000,000 shares authorized;17,273,776 shares issued; 16,792,826 shares outstanding at March 31, 2008; 17,273,776 shares issued; 16,889,237 shares outstanding at March 31, 2007; and 17,273,776 shares issues; 16,897,726 shares outstanding at December 31, 2007	6,509,267	6,509,267	6,509,267
Paid-in-capital	1,137,709	1,080,911	1,120,669
Treasury stock, at cost	(2,437,517)	(1,411,195)	(2,078,165)
Retained earnings	21,360,037	18,454,103	20,471,432
Accumulated other comprehensive income (loss), net of taxes	(421,372)	240,927	(209,043)
Total stockholders' equity	26,148,124	24,874,013	25,814,160
Total liabilities and stockholders' equity	$ 35,336,372	$ 33,270,369	$ 34,768,247

See accompanying notes to financial statements.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Income and Comprehensive Income
For the Three Months Ended March 31, 2008 and 2007 (Unaudited)
and the Year Ended December 31, 2007

	(Unaudited) Three Months Ended March 31, 2008	(Unaudited) Three Months Ended March 31, 2007	Year Ended December 31, 2007
Sales	$ 11,122,238	$ 9,022,244	$ 38,729,156
Cost of goods sold	7,442,083	5,284,532	25,582,981
Depreciation expense	189,424	165,293	726,647
Total cost of goods sold	7,631,507	5,449,825	26,309,628
Gross profit	3,490,731	3,572,419	12,419,528
Selling Expenses	1,059,166	770,081	3,744,388
General and Administrative	985,046	920,573	3,914,825
Amortization expense	79,861	80,275	323,266
Total Operating Expenses	2,124,073	1,770,929	7,982,479
Income from operations	1,366,658	1,801,490	4,437,049
Other income (expense):			
Interest and dividend income	103,133	65,799	350,286
Rental Income	11,647	8,600	48,305
Interest expense	(85,956)	(109,529)	(410,180)
Gain (loss) on sale of marketable securities, net	51,029	14,745	539,739
Total other income (Expense)	79,853	(20,385)	528,150
Income before provision for income taxes	1,446,511	1,781,105	4,965,199
Provision for income taxes	557,906	645,774	1,812,539
Net income	$ 888,605	$ 1,135,331	$ 3,152,660
Basic and diluted earnings per common share	0.05	0.07	0.19
Weighted average number of shares outstanding	16,814,740	16,895,351	16,855,611
COMPREHENSIVE INCOME			
Net income	$ 888,605	$ 1,135,331	$ 3,152,660

Other comprehensive income (loss), net of tax:						
Unrealized gains (losses) on marketable securities (net of tax benefits)		(182,376)		95,783		(47,091)
Less reclassification adjustment for (gains) losses included in net income (net of taxes)		(29,954)		(8,626)		(315,721)
Comprehensive income	$	676,275	$	1,222,488	$	2,789,848

See accompanying notes to financial statements.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in STockholders' Equity
For the Three Months Ended March 31, 2008 (Unaudited)
and the Year Ended December 31, 2007

	Common Stock, No Par Value 20,000,000 Shares Authorized							
	# of Shares Issued	# of Shares Outstanding	# of Shares of Treasury Stock	Common Stock	Paid In Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax
Balances at December 31, 2006	17,273,776	16,897,826	375,950	6,509,267	1,080,911	(1,334,313)	17,318,772	153,770
Redemption of stock	—	(75,000)	75,000	—	—	(752,603)	—	—
Issuance of treasury stock for compensation	—	4,900	(4,900)	—	39,758	8,751	—	—
Other comprehensive income (loss): Unrealized losses on securities, net of taxes and reclassification adjustment	—	—	—	—	—	—	—	(362,813)
Net income for the year ended December 31, 2007	—	—	—	—	—	—	3,152,660	—
Balances at December 31, 2007	17,273,776	16,827,726	446,050	6,509,267	1,120,669	(2,078,165)	20,471,432	(209,043)
Redemption of stock	—	(37,000)	37,000	—	—	(363,102)	—	—
Issuance of treasury stock	—	2,100	(2,100)	—	17,040	3,750	—	—

for compensation									
Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment	—	—	—	—	—	—	—	(212,329)	
Net income for the three months ended March 31, 2008	—	—	—	—	—	—	888,605	—	
Balances at March 31, 2008	17,273,776	16,792,826	480,950	$ 6,509,267	$ 1,137,709	$ (2,437,517)	$ 21,360,037	$ (421,372)	$

See accompanying notes to financial statements.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the Three Months Ended March 31, 2008 and 2007 (Unaudited)
and the Year Ended December 31, 2007

	March 31, 2008	March 31, 2007	December 31, 2007
Cash flows from operating activities:			
Net income	$ 888,605	$ 1,135,331	$ 3,152,660
Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition:			
Depreciation and amortization	269,285	245,568	1,049,913
(Gain)Loss on sale of marketable securities, net	(51,029)	(14,745)	(539,739)
Deferred income taxes	(39,280)	6,536	(223,717)
Treasury stock issued for compensation	20,790	---	48,509
Increase (decrease) in allowance for doubtful accounts	---	(40,540)	(40,540)
(Increase) decrease in operating assets:			
Accounts receivable	(716,396)	(604,709)	(226,405)
Other receivables	(91,187)	20,625	27,939
Inventories	(163,436)	(361,259)	(984,358)
Refundable income taxes	240,880	109,218	26,891
Prepaid expenses and other current assets	12,166	1,991	(9,270)
Increase (decrease) in operating liabilities:			
Accounts payable	372,596	(223,968)	131,316
Accrued expenses	(21,655)	(138,912)	(66,062)
Accrued income taxes	203,529	---	
Net cash provided by operating activities	924,868	135,136	2,347,137
Cash flows from investing activities:			
Investment in cost method securities	---	---	(500,000)
Purchases of marketable securities	(1,976,684)	(802,587)	(5,744,697)
Sale of marketable securities	1,864,617	896,419	7,168,246
Purchases of property and equipment	(365,421)	(139,376)	(1,824,879)
Net cash used in investing activities	(477,488)	(45,544)	(901,330)
Cash flows from financing activities:			
Proceeds of note payable	---	---	300,000
Purchases of treasury stock, net	(363,102)	(76,882)	(752,603)
Repayment of notes payable	(287,373)	(547,177)	(1,945,131)
Net cash used in financing activities	(650,475)	(624,059)	(2,397,734)
Net decrease in cash and cash equivalents	(203,095)	(534,467)	(951,927)
Cash and cash equivalents at the beginning of the period	595,885	1,547,812	1,547,812
Cash and cash equivalents at the end of the period	$ 392,790	$ 1,013,345	$ 595,885

See accompanying notes to financial statements.

- 6 -

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

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 and various cities in the East Coast 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.

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 subsidiaries, LFI Enterprises, Inc., Helios Nutrition, Ltd., Pride of Main Street, L.L.C. and Starfruit, L.L.C. 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. Significant estimates made in preparing the consolidated financial statements include the allowance for doubtful accounts, the valuation of goodwill, intangible assets and deferred taxes.

Revenue Recognition
Sales represent sales of Company produced dairy products that are recorded at the time of shipment and the following four criteria have been met: (i) The product has been shipped and the Company has no significant remaining obligations; (ii) Persuasive evidence of an agreement exists; (iii) The price to the buyer is fixed or determinable and (iv) Collection is probable. 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 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.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

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

	March 31, 2008	March 31, 2007	December 31, 2007
Amounts insured	$ 280,180	$ 244,029	$ 576,563
Uninsured and uncollateralized amounts	762,102	1,045,160	523,295
Total bank balances	$ 1,042,282	$ 1,289,189	$ 1,099,858

Marketable securities
All investment securities are classified as either as available-for-sale or trading, and are carried at fair value or quoted market prices. Unrealized gains and on available-for-sale securities losses are reported as a separate component of stockholders' equity. Amortization, accretion, interest and dividends, realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are recorded in other income. Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities, Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) 59, Accounting for Noncurrent Marketable Equity Securities, and Emerging Issue Task Force Abstract 03-01 The Meaning of Other-than-temporary Impairment and its Application to Certain Investments, provide guidance on determining when an investment is other-than-temporarily impaired. This evaluation depends on the specific facts and circumstances. Factors that we consider in determining whether an other-than-temporary decline in value has occurred include: the market value of the security in relation to its cost basis; the financial condition of the investee; and the intent and ability to retain the investment for a sufficient period of time to allow for possible recovery in the market value of the investment.

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 the 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.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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

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 and is reviewed for impairment at least annually. The Company amortizes other intangible assets over their estimated useful lives, as disclosed in the table below.

The Company reviews 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. The Company conducts 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	15
Lease agreement	7
Trade names	15
Formula	10
Customer relationships	12

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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.

As of January 1, 2007, the Company adopted FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109” (FIN 48), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. Pursuant to FIN 48, the Company has analyzed filing positions in all of the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The only periods subject to examination for the Company’s federal return are the 2003 through 2006 tax years. The Company believes that its income tax filing positions and deductions would be sustained on audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

The Company’s policy for recording interest and penalties associated with audits is to record such items as a component of income before taxes. There were no such items during the periods covered in this report.

Treasury stock
Treasury stock is recorded using the cost method.

Advertising costs
The Company expenses advertising costs as incurred. During the year ended December 31, 2007 and for the three months ended March 31, 2008 and 2007, approximately $1,642,114, $403,623 and $322,636 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 the three months ended March 31, 2008 and 2007 and the year ended December 31, 2007, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

Reclassification
Certain 2007 amounts have been reclassified to conform to the 2008 presentation.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

Recent accounting pronouncements adopted
In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 permits entities to elect to measure many financial instruments and certain other items at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for the Company beginning February 3, 2008. The adoption of SFAS No. 159 will not impact the financial condition or results of operations of the Company.

Note 3 – INTANGIBLE ASSETS

Intangible assets, and the related accumulated amortization, consist of the following:

	March 31, 2008		March 31, 2007		December 31, 2007	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Recipes	$ 43,600	$ 38,831	$ 43,600	$ 29,067	$ 43,600	$ 37,242
Customer lists and other customer related intangibles	305,200	151,873	305,200	110,453	305,200	141,518
Lease acquisition	87,200	45,676	87,200	33,219	87,200	42,562
Other	6,638	3,651	6,638	2,323	6,638	3,319
Customer relationship	985,000	136,806	985,000	54,723	985,000	116,285
Contractual backlog	12,000	12,000	12,000	12,000	12,000	12,000
Trade names	1,980,000	220,000	1,980,000	88,000	1,980,000	187,000
Formula	438,000	73,000	438,000	29,200	438,000	62,050
	$ 3,857,638	$ 681,837	$ 3,857,638	$ 358,985	$ 3,857,638	$ 601,976

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

2009	$ 317,857
2010	307,275
2011	303,372
2012	294,735
2013	268,783
Thereafter	1,683,779
	$ 3,175,801

Amortization expense during the three months March 31, 2008 and 2007 and for the year ended December 31, 2007 was $79,861, $80,275 and $323,266, respectively.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 4 – MARKETABLE SECURITIES

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

MARCH 31, 2008	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities	$ 3,074,223	$ 114,067	$ (481,142)	$ 2,707,148
Mutual Funds	927,055	3,744	(144,622)	786,177
Preferred Securities	1,655,421	7,680	(167,259)	1,495,842
Corporate Bonds	1,249,426	1,586	(55,070)	1,195,942
Municipal Bonds	4,586	330	—	4,916
Government agency Obligations	597,978	2,955	(108)	600,825
Total	$ 7,508,689	$ 130,362	$ (848,201)	$ 6,790,850

MARCH 31, 2007	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities	$ 2,810,733	$ 507,649	$ (92,378)	$ 3,226,004
Mutual Funds	595,823	7,064	(9,323)	593,564
Preferred Securities	1,637,458	5,865	(15,833)	1,627,490
Private Investment LP	600,000	94,507	—	694,507
Certificates of Deposit	75,000	—	(2,392)	72,608
Corporate Bonds	2,137,085	2,906	(90,985)	2,049,006
Municipal Bonds	160,757	3,776	(417)	164,116
Government agency	134,776	—	(1,315)	133,461
Total	$ 8,151,632	$ 621,767	$ (212,643)	$ 8,560,756

DECEMBER 31, 2007	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities	$ 3,037,507	$ 331,776	$ (309,014)	$ 3,060,269
Mutual Funds	946,357	4,978	(104,529)	846,806
Preferred Securities	1,776,750	40,020	(241,726)	1,575,044
Corporate Bonds	1,480,433	1,556	(79,433)	1,402,556
Municipal Bonds	4,586	253	—	4,839
Government agency Obligations	100,000	—	(40)	99,960
Total	$ 7,345,633	$ 378,583	$ (734,742)	$ 6,989,474

Proceeds from the sale of marketable securities were $7,168,246, $1,864,617 and $896,419 during the year ended December 31, 2007 and for the three months ended March 31, 2008 and 2007, respectively.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 4 – MARKETABLE SECURITIES - Continued

Gross gains of $876,527, $217,112, and $23,822 and gross losses of $336,788, $166,083, and $9,686 were realized on these sales during the year ended December 31, 2007 and for the three months ended March 31, 2008 and 2007, respectively.

The following table shows the gross unrealized losses and fair value of Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2008:

Description of Securities	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or Greater Fair Value	12 Months or Greater Unrealized Losses	Total Fair Value	Total Unrealized Losses
Equities	$ 1,844,460	$ (400,927)	$ 205,483	$ (80,215)	$ 2,049,943	$ (481,142)
Mutual Funds	566,022	(133,645)	118,911	(10,977)	684,933	(144,622)
Preferred Securities	518,106	(40,162)	870,085	(127,097)	1,388,191	(167,259)
Corporate Bonds	229,348	(4,349)	678,252	(50,721)	907,600	(55,070)
Government Agency Obligations	33,846	(108)	—	—	33,846	(108)
	$ 3,191,782	$ (579,191)	$ 1,872,731	$ (269,010)	$ 5,064,513	$ (848,201)

Equities, Mutual Funds and Corporate Bonds - The Company's investments in equity securities, mutual funds and corporate bonds consist of investments in common stock and debt securities of companies in various industries. The Company evaluated the near-term prospects of the issuer in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider any material investments to be other-than-temporarily impaired at March 31, 2008.

Preferred Securities - The Company's investments in preferred securities consist of investments in preferred stock of companies in various industries. The Company evaluated the near-term prospects of the security in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider any material investments to be other-than-temporarily impaired at March 31, 2008.

Municipal Bonds - The unrealized losses on the Company's investments in mutual bonds were caused by interest rate increases since the date of purchase. Because the Company has the ability and intent to hold these investments until maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2008.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 5 – INVENTORIES

Inventories consist of the following:

	March 31, 2008	March 31, 2007	December 31, 2007
Finished goods	$ 1,201,472	$ 1,084,748	$ 1,296,985
Production supplies	1,357,834	1,134,987	1,383,384
Raw materials	1,110,684	663,720	826,185
Total inventories	$ 3,669,990	$ 2,883,455	$ 3,506,554

Note 6 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	March 31, 2008	March 31, 2007	December 31 2007
Land	$ 969,232	$ 969,232	$ 969,232
Buildings and improvements	6,772,762	6,713,743	6,743,647
Machinery and equipment	8,166,465	7,274,990	8,159,199
Vehicles	581,458	534,365	581,458
Office equipment	102,830	97,115	101,583
Construction in process	1,047,623		719,830
	17,640,370	$ 15,589,445	17,274,949
Less accumulated depreciation	7,785,425	7,034,646	7,596,001
Total property and equipment	$ 9,854,945	$ 8,554,799	$ 9,678,948

Depreciation expense during the years ended December 31, 2007 and for the three months ended March 31, 2008 and 2007 was $726,647, $189,424 and $165,293, respectively.

Note 7 – ACCRUED EXPENSES

Accrued expenses consist of the following:

	March 31, 2008	March 31, 2007	December 31, 2007
Accrued payroll and payroll taxes	$ 101,670	$ 93,727	$ 58,395
Accrued property tax	220,253	206,000	285,279
Other	70,461	41,458	70,365
	$ 392,384	$ 341,185	$ 414,039

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 8 – NOTES PAYABLE

Notes payable consist of the following:

	March 31, 2008	March 31, 2007	December 31, 2007
Mortgage note payable to a bank, payable in monthly installments of $3,273 including interest at 7%, with a balloon payment of $416,825 due September 25, 2011. Collateralized by real estate.	$ 444,499	$ 451,542	$ 446,450
Mortgage note payable to a bank, payable in monthly installments of $19,513 including interest at 5.6%, with a balloon payment of $2,652,143 due July 14, 2010. Collateralized by real estate.	2,816,481	2,888,051	2,834,970
Note payable to Amani Holding LLC, payable in quarterly installments of $262,500 plus interest at the floating prime rate per annum (7.25% at December 31, 2007) due September 1, 2010 secured by letter of credit	1,684,570	2,991,284	1,951,503
Total notes payable	4,945,550	6,330,877	5,232,923
Less current maturities	1,131,725	1,129,004	1,136,126
Total long-term portion	$ 3,813,825	$ 5,201,873	$ 4,096,797

Maturities of notes payables are as follows:

For the Year Ended March 31,	
2009	$ 1,131,725
2010	708,435
2011	2,684,815
2012	420,575
Total	$ 4,945,550

Note 9 – PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

	For the Three Months Ended March 31, 2008	For the Three Months Ended March 31, 2007	For the Year Ended December 31, 2007
Current:			
Federal	$ 488,599	$ 537,138	$ 1,699,408
State and local	108,587	102,100	336,848
Total current	597,186	639,238	2,036,256
Deferred	(39,280)	6,536	(223,717)
Provision for income taxes	$ 557,906	$ 645,774	$ 1,812,539

- 15 -

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 9 – PROVISION FOR INCOME TAXES - Continued

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

	For the Three Months Ended March 31, 2008	For the Three Months Ended March 31, 2007	For the Year Ended December 31, 2007
Federal income tax expense computed at the statutory rate	$ 491,814	$ 605,576	$ 1,688,168
State and local tax expense, net	69,433	85,493	238,330
Permanent differences	(3,341)	(45,295)	(113,959)
Provision for income taxes	$ 557,906	$ 645,774	$ 1,812,539

Amounts for deferred tax assets and liabilities are as follows:

	March 31, 2008	March 31, 2007	December 2007
Non-current deferred tax liabilities arising from:			
Temporary differences - accumulated depreciation and amortization	$ (1,679,859)	$ (454,212)	$ (1,712,795)
Current deferred tax assets (liabilities) arising from:			
Unrealized losses (gains) on marketable securities	296,468	(169,511)	147,077
Inventory	154,930	122,183	148,586
Allowance for doubtful accounts	16,297	16,296	16,297
Total current deferred tax assets (liabilities)	467,695	(31,032)	311,960
Net deferred tax liability	$ (1,212,164)	$ (485,244)	$ (1,400,835)

Note 10 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

	For the Years Ended March 31, 2008	For the Years Ended March 31, 2007	For the Year Ended December 31, 2007
Interest	$ 85,956	$ 96,908	$ 430,098
Income taxes	$ 133,250	$ 551,386	$ 2,026,031

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 11 – STOCK AWARD AND 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, 2007 and March 31, 2008 and 2007. 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, 2007 and at March 31, 2008 and 2007, there were no stock options outstanding or exercisable.

On May 18, 2007, Lifeway's Board of Directors approved awards of an aggregate amount of 8,400 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain key employees and consultants for services rendered to the Company. The stock awards were made on June 1, 2007 and have vesting periods of one year. The expense for the awards is measured as of June 1, 2007 at $9.90 per share for 8,400 shares, or a total stock award expense of $83,160. This expense will be recognized as the stock awards vest in 12 equal portions of $6,930, or 700 shares per month for one year.

Note 12 – FAIR VALUE MEASUREMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP, and expands disclosures about fair value measurements. The Statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The statement emphasizes that fair value is a market-based measurement and not an entity-specific measurement. The statement establishes a fair value hierarchy used in fair value measurements and expands the required disclosures of assets and liabilities measured at fair value.

Level 1 – Inputs use quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.

Level 2 – Inputs use other inputs that are observable, either directly or indirectly. These inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 – Inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Company's assessment of the significance of particular inputs to these fair measurements requires judgment and considers factors specific to each asset or liability.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2008 and 2007
and December 31, 2007

Note 12 – FAIR VALUE MEASUREMENTS - Continued

Disclosures concerning assets and liabilities measured at fair value are as follows:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at March 31, 2008
Assets				
Investment securities- available - for - sale	$ 6,790,850	$ —	$ —	$ 6,790,850

The Company's fair value disclosures exclude certain nonfinancial assets and liabilities which are deferred under the provisions of FASB Staff Position 157-2. These include long-lived assets, goodwill, and intangible assets, which are recorded at fair value only upon impairment. The FASB's deferral is intended to allow additional time to consider the effect of various implementation issues relating to these non-financial instruments, and defers disclosures under SFAS No. 157 until January 1, 2009.

Note 13 – RECENT ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB issued SFAS No. 141(R) "Business Combinations." SFAS No. 141(R) states that all business combinations (whether full, partial or step acquisitions) will result in all assets and liabilities of an acquired business being recorded at their acquisition date fair values. Earn-outs and other forms of contingent consideration and certain acquired contingencies will also be recorded at fair value at the acquisition date. SFAS No. 141(R) also states acquisition costs will generally be expensed as incurred; in-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date; changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense; and restructuring costs will be expensed in periods after the acquisition date. This statement is effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company will apply the provisions of this standard to any acquisitions that it completes on or after December 15, 2008.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51." This statement amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest (minority interest) in a subsidiary and for the deconsolidation of a subsidiary. Upon its adoption, noncontrolling interests will be classified as equity in the consolidated balance sheets. This statement also provides guidance on a subsidiary deconsolidation as well as stating that entities need to provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective for financial statements issued for fiscal years beginning after December 15, 2008. The adoption of this standard is not expected to have a material impact on the Company's financial condition, results of operations or liquidity.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" ("SFAS No. 161"). This statement requires enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 also requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation and requires cross-referencing within the footnotes. This statement also suggests disclosing the fair values of derivative instruments and their gains and losses in a tabular format. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of this standard is not expected to have a material impact on the Company's financial condition, results of operations or liquidity.

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

Comparison of Quarter Ended March 31, 2008 to Quarter Ended March 31, 2007

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, 2007.

Results of Operations

Sales increased by $2,099,994, (approximately 23%) to $11,122,238 during the three month period ended March 31, 2008 from $9,022,244 during the same three month period in 2007. This increase is primarily attributable to increased sales and awareness of Lifeway's flagship line, Kefir, as well as ProBugs™ Organic Kefir for kids. Lifeway's "Helios Organic" brand kefir, which was acquired in 2006, accounted for revenues of $1,207,237 during the first quarter 2008, compared with revenues of $1,138,882 during the first quarter 2007. Lifeway's "Pride of Main Street Milk" line, also acquired in 2006, accounted for revenues of $427,870 during the first quarter 2008, compared with revenues of $181,149 during the first quarter 2007. This represents an increase of 236% for the Pride of Main Street Milk line in the first quarter 2008 when compared to the same period in 2007.

Cost of goods sold as a percentage of sales was approximately 69% during the first quarter 2008, compared to about 60% during the same period in 2007. The increase was primarily attributable to the increased cost of milk, our largest raw material, and the cost of transportation. The cost of milk was approximately 30% higher in the first quarter 2008 when compared to the same quarter in 2008. Despite these increases in cost of goods sold, gross profit declined 2%. In April 2008 and May 2008, the cost of milk was approximately 10% lower when compared to the average cost in the first quarter 2008.

Operating expenses as a percentage of sales was approximately 19% during the first quarter 2008, compared to about 20% during the same period in 2007. Despite incurring several one time expenses related to Sarbanes Oxley 404 compliance, we were able to lower our overall operating expenses as a percentage of sales in the first quarter 2008. Total operating expenses increased by $353,144 (approximately 20%) to $2,124,073 during the three month period ended March 31, 2008 from $1,770,929 during the same three month period in 2007. The increase is primarily attributable to increased selling and advertising expenses, which increased by $289,085 (approximately 38%) to $1,059,166 during the three month period ended March 31, 2008 from $770,081 during the same three month period in 2007

Total other income for the first quarter ended March 31, 2008 was $79,853, compared with other expenses of $20,385 during the same period in 2007. This increase in other income is attributable to a $37,334 increase in interest and dividend income, as well as an increase in the gain on the sale of marketable securities of $36,284.

Provision for income taxes was $557,906, or a 39% tax rate during the first quarter 2008 compared with $645,774, or a 36% tax rate, during the same period in 2007. Income taxes are discussed in Note 9 of the Notes to Consolidated Financial Statements.

Total net income was $888,605 or $.05 per share for the first quarter ended March 31, 2008, compared with $1,135,331, or $.07 per share in the same period in 2007.

Sources and Uses of Cash

Net cash provided by operating activities was $924,868 during the three months ended March 31, 2008, which is an increase of $789,732 when compared to the same period in 2007. This increase is primarily attributable to the increase in accounts payable of $596,564.

Net cash used in investing activities was $477,488 during the three months ended March 31, 2008, which is an increase of $431,944 when compared to the same period in 2007. This increase is primarily due to the Company's purchase of machinery and equipment related to its expansion in 2008, which was $365,421, compared with the Company's purchase of machinery and equipment in 2007, which was $139,376.

Significant portions 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 18, 2007, Lifeway's Board of Directors approved awards of an aggregate amount of 8,400 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, 2007 and have vesting periods of one year. The expense for the awards is measured as of June 1, 2007 at $9.90 per share for 8,400 shares, or a total stock award expense of $83,160. This expense will be recognized as the stock awards vest in 12 equal portions of $6,930, or 700 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

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934 (the "Exchange Act"). Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

There was no change in our internal control over financial reporting during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is currently a defendant in the following litigation: United States of America v. Lifeway Foods, Inc., et al., 08cv02469 (the "Action"). The Action was filed by the U.S. Department of Justice Office of Consumer Litigation on behalf of the U.S. Food and Drug Administration ("FDA") on April 30, 2008, seeking a permanent injunction against the Company and its principles, for alleged violations of the Federal Food, Drug and Cosmetics Act (the "Act") with regard to certain cream cheese, cream cheese spreads that were allegedly adulterated and/or misbranded within the meaning of the Act. Prior to the filing of the Action, the Company and the FDA had engaged in negotiations to address the alleged violations and ultimately agreed to a Consent Decree that was submitted to the court on May 9, 2008. The Consent Decree provides that the Company will cease the production of certain food products at two locations unless certain requirements are met, to ensure compliance with the Act. The Consent Decree is being presented to the Court on May 15, 2008 for approval and entry. On May 14, 2008, the First Amended Complaint for Permanent Injunction was filed and the Answer to the same was filed the same day. It is believed the entry of the Consent Decree will resolve this Action.

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)
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.

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 15, 2008

LIFEWAY FOODS, INC.

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

/s/ Edward P. Smolyansky
Chief Financial and Accounting
Officer
and Treasurer

EXHIBIT INDEX

Exhibit Number	Description
31.1	Rule 13a-14(a)/15d-14(a) Certification of Julie Smolyansky.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Edward P. Smolyansky.
32.1	Section 1350 Certification of Julie Smolyansky.
32.2	Section 1350 Certification of Edward P. Smolyansky.