

LIFEWAY FOODS INC
Form 10-Q
May 16, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended: March 31, 2011

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

For the transition period from _____ to _____

Commission File Number: 000-17363

LIFEWAY FOODS, INC.
(Exact Name of Registrant as Specified in its Charter)

Illinois
(State or Other Jurisdiction of
Incorporation or Organization)

36-3442829
(I.R.S. Employer
Identification No.)

6431 West Oakton, Morton Grove, IL 60053
(Address of Principal Executive Offices, Zip Code)

(847-967-1010)
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer or a smaller reporting company. See definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

As of March 31, 2011, the issuer had 16,443,809 shares of common stock, no par value, outstanding.

LIFEWAY FOODS, INC.
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PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Financial Condition
March 31, 2011 and 2010 (Unaudited) and December 31, 2010

| | (Unaudited) | | |
|---|--------------|--------------|--------------|
| | March 31, | | December 31, |
| | 2011 | 2010 | 2010 |
| ASSETS | | | |
| Current assets | | | |
| Cash and cash equivalents | \$2,075,791 | \$652,177 | \$3,229,939 |
| Investments | 1,314,382 | 4,397,781 | 1,079,232 |
| Certificates of deposits in financial institutions | 250,000 | 550,000 | 250,000 |
| Inventories | 4,752,054 | 3,869,825 | 3,985,374 |
| Accounts receivable, net of allowance for doubtful accounts and discounts | 8,346,560 | 7,726,348 | 6,793,276 |
| Prepaid expenses and other current assets | 126,919 | 38,447 | 158,315 |
| Other receivables | 74,879 | 49,081 | 104,680 |
| Deferred income taxes | 368,176 | 303,431 | 328,470 |
| Refundable income taxes | --- | 476,915 | 906,748 |
| Total current assets | 17,308,761 | 18,064,005 | 16,836,034 |
| Property and equipment, net | 15,129,655 | 14,481,822 | 15,152,713 |
| Intangible assets | | | |
| Goodwill and other non amortizable brand assets | 14,068,091 | 13,806,091 | 14,068,091 |
| Other intangible assets, net of accumulated amortization of \$2,500,066 and \$1,773,968 at March 31, 2011 and 2010 and \$2,304,107 at December 31, 2010, respectively | 5,805,934 | 6,083,670 | 6,001,893 |
| Total intangible assets | 19,874,025 | 19,889,761 | 20,069,984 |
| Other assets | --- | 500,000 | --- |
| Total assets | \$52,312,441 | \$52,935,588 | \$52,058,731 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | |
| Current liabilities | | | |
| Checks written in excess of bank balances | \$1,067,073 | \$533,458 | \$1,341,210 |
| Current maturities of notes payable | 2,364,774 | 4,733,354 | 2,851,610 |
| Accounts payable | 3,781,059 | 3,116,627 | 4,183,481 |
| Accrued expenses | 595,841 | 637,263 | 509,459 |
| Accrued income taxes | 430,246 | --- | --- |
| Total current liabilities | 8,238,993 | 9,020,702 | 8,885,760 |
| Notes payable | 5,995,558 | 6,502,222 | 6,122,225 |

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| | | | |
|--|---------------|---------------|---------------|
| Deferred income taxes | 3,332,473 | 3,318,273 | 3,401,728 |
| Total liabilities | 17,567,024 | 18,841,197 | 18,409,713 |
| Stockholders' equity | | | |
| Common stock, no par value; 20,000,000 shares authorized; 17,273,776 shares issued; 16,443,809 shares outstanding at March 31, 2011; 17,273,776 shares issued; 16,754,572 shares outstanding at March 31, 2010; 17,273,776 shares issued; 16,536,657 shares outstanding at December 31, 2010 | | | |
| | 6,509,267 | 6,509,267 | 6,509,267 |
| Paid-in-capital | 2,032,516 | 1,992,257 | 2,032,516 |
| Treasury stock, at cost | (7,271,836) | (4,182,190) | (6,425,546) |
| Retained earnings | 33,501,646 | 29,722,098 | 31,575,875 |
| Accumulated other comprehensive income (loss), net of taxes | (26,176) | 52,959 | (43,094) |
| Total stockholders' equity | 34,745,417 | 34,094,391 | 33,649,018 |
| Total liabilities and stockholders' equity | \$52,312,441 | \$52,935,588 | \$52,058,731 |

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, 2011 and 2010 (Unaudited)
and for the Year Ended December 31, 2010

| | 2011 | (Unaudited) March 31 | 2010 | December 31, 2010 |
|--|---------------|-------------------------|---------------|----------------------|
| Sales | \$ 19,047,266 | | \$ 15,964,159 | \$ 63,543,445 |
| Less: discounts and allowances | (1,743,363) | | (1,075,013) | (5,043,552) |
| Net Sales | 17,303,903 | 17,303,903 | 14,889,146 | 14,889,146 |
| Cost of goods sold | | 9,651,272 | | 8,076,612 |
| Depreciation expense | | 376,513 | | 403,375 |
| Total cost of goods sold | | 10,027,785 | | 8,479,987 |
| Gross profit | | 7,276,118 | | 6,409,159 |
| Selling expenses | | 2,221,808 | | 1,994,847 |
| General and administrative | | 1,592,729 | | 1,490,157 |
| Amortization expense | | 195,959 | | 175,760 |
| Total Operating Expenses | | 4,010,496 | | 3,660,764 |
| Income from operations | | 3,265,622 | | 2,748,395 |
| Other income (expense): | | | | |
| Interest and dividend income | | 17,593 | | 54,508 |
| Rental income | | --- | | 1,235 |
| Interest expense | | (62,130) | | (95,942) |
| Gain (loss) on sale of investments, net | | (2,597) | | (29,259) |
| Total other income (expense) | | (47,134) | | (69,458) |
| Income before provision for income taxes | | 3,218,488 | | 2,678,937 |
| Provision for income taxes | | 1,292,717 | | 910,248 |
| | | | | 6,446,452 |
| | | | | 2,823,986 |

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| | | | |
|---|--------------|--------------|--------------|
| Net income | \$ 1,925,771 | \$ 1,768,689 | \$ 3,622,466 |
| Basic and diluted earnings per common share | 0.12 | 0.11 | 0.22 |
| Weighted average number of shares outstanding | 16,489,954 | 16,761,774 | 16,663,557 |
| COMPREHENSIVE INCOME | | | |
| Net income | \$ 1,925,771 | \$ 1,768,689 | \$ 3,622,466 |
| Other comprehensive income (loss), net of tax: | | | |
| Unrealized gains on investments (net of tax) | 15,451 | 46,143 | 114,297 |
| Less reclassification adjustment for (gains) losses included in net income (net of taxes) | 1,467 | 17,175 | (147,032) |
| Comprehensive income | \$ 1,942,689 | \$ 1,832,007 | \$ 3,589,731 |

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, 2011 and 2010 (Unaudited)
 and for the Year Ended December 31, 2010

| | Common Stock, No Par Value | | # of Shares of | Treasury Stock | Common Stock | Paid In Capital | Treasury Stock | Retained Earnings | Accumulated |
|--|---------------------------------|----------------------------|----------------------|-------------------|-----------------|--------------------|-------------------|----------------------|----------------------------------|
| | 20,000,000 Shares Authorized | | | | | | | | Other Comprehensive Income |
| | # of Shares Issued | # of Shares Outstanding | | | | | | | (Loss), Net of Tax |
| | | | | | | | | | |
| Balances at December 31, 2009 | 17,273,776 | 16,778,555 | 495,221 | \$6,509,267 | \$1,965,786 | \$(3,846,773) | \$27,953,409 | \$(10,359) | 3 |
| Redemption of stock | --- | (252,398) | 252,398 | --- | --- | (2,666,288) | --- | --- | (|
| Issuance of treasury stock for compensation | --- | 10,500 | (10,500) | --- | 66,730 | 87,515 | --- | --- | 1 |
| Issuance of treasury stock for Fresh Made acquisition | --- | | | --- | | | --- | --- | - |
| Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment | --- | --- | --- | --- | --- | --- | --- | (32,735) | (|
| Net income for the year ended December 31, 2010 | --- | --- | --- | --- | --- | --- | 3,622,466 | --- | 3 |

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| | | | | | | | | | |
|--|------------|------------|----------|-------------|-------------|----------------|--------------|-------------|--------------|
| Balances at December 31, 2010 | 17,273,776 | 16,536,657 | 737,119 | \$6,509,267 | \$2,032,516 | \$(6,425,546) | \$31,575,875 | \$(43,094) | \$31,532,781 |
| Balances at January 1, 2010 | 17,273,776 | 16,778,555 | 495,221 | \$6,509,267 | \$1,965,786 | \$(3,846,773) | \$27,953,409 | \$(10,359) | \$27,843,050 |
| Redemption of stock | --- | (28,365) | 28,365 | --- | --- | (340,105) | --- | --- | (368,470) |
| Issuance of treasury stock for compensation | --- | 4,382 | (4,382) | --- | 26,471 | 4,688 | --- | --- | 35,832 |
| Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment | --- | --- | --- | --- | --- | --- | --- | 63,318 | 63,318 |
| Net income for the three months ended March 31, 2010 | --- | --- | --- | --- | --- | --- | 1,768,689 | --- | 1,768,689 |
| Balances at March 31, 2010 | 17,273,776 | 16,754,572 | 519,204 | \$6,509,267 | \$1,992,257 | \$(4,182,190) | \$29,722,098 | \$52,959 | \$29,669,139 |
| Balances at January 1, 2011 | 17,273,776 | 16,536,657 | 737,119 | \$6,509,267 | \$2,032,516 | \$(6,425,546) | \$31,575,875 | \$(43,094) | \$31,532,781 |
| Redemption of stock | --- | (92,848) | 92,848 | --- | --- | (846,290) | --- | --- | (939,138) |
| Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment | --- | --- | --- | --- | --- | --- | --- | 16,918 | 16,918 |
| | --- | --- | --- | --- | --- | --- | 1,925,771 | --- | 1,925,771 |

Net income for
the three
months ended
March 31, 2011

Balances at

March 31, 2011 17,273,776 16,443,809 829,967 \$6,509,267 \$2,032,516 \$(7,271,836) \$33,501,646 \$(26,176) \$3

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the Three Months Ended March 31, 2011 and 2010 (Unaudited)
and for the Year Ended December 31, 2010

| | (Unaudited) | | December |
|--|---------------|---------------|---------------|
| | March 31, | | 2010 |
| | 2011 | 2010 | 2010 |
| Cash flows from operating activities: | | | |
| Net income | \$1,925,771 | \$1,768,689 | \$3,622,466 |
| Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition: | | | |
| Depreciation and amortization | 572,472 | 579,135 | 2,118,282 |
| Loss (Gain) on sale of investments, net | 2,597 | 29,259 | (250,480) |
| Deferred income taxes | (119,129) | (222,915) | (96,918) |
| Treasury stock issued for compensation | --- | 31,159 | 154,245 |
| Increase in allowance for doubtful accounts | 20,000 | --- | 17,754 |
| (Increase) decrease in operating assets: | | | |
| Accounts receivable | (1,573,284) | (1,726,610) | (811,292) |
| Other receivables | 29,801 | 677 | (54,922) |
| Inventories | (766,680) | (572,849) | (682,398) |
| Refundable income taxes | 906,748 | 832,063 | 402,230 |
| Prepaid expenses and other current assets | 31,396 | 2,250 | (117,618) |
| Increase (decrease) in operating liabilities: | | | |
| Accounts payable | (402,422) | 352,627 | 1,419,479 |
| Accrued expenses | 86,382 | 22,919 | (104,885) |
| Income taxes payable | 430,246 | --- | --- |
| Net cash provided by operating activities | 1,143,898 | 1,096,404 | 5,615,943 |
| Cash flows from investing activities: | | | |
| Purchases of investments | (445,049) | (356,498) | (2,161,552) |
| Proceeds from sale of investments | 234,388 | 531,455 | 5,669,158 |
| Proceeds from redemption of certificates of deposit | --- | --- | 402,005 |
| Purchases of property and equipment | (353,455) | (603,015) | (2,229,274) |
| Acquisition of the assets of First Juice | --- | --- | (270,000) |
| Net cash provided by (used in) investing activities | (564,116) | (428,058) | 1,410,337 |
| Cash flows from financing activities: | | | |
| Proceeds of note payable | --- | --- | 250,000 |
| Checks written in excess of bank balances | (274,137) | 190,482 | 998,234 |
| Purchases of treasury stock | (846,290) | (340,105) | (2,666,288) |
| Repayment of notes payable | (613,503) | (496,953) | (3,008,694) |
| Net cash used in financing activities | (1,733,930) | (646,576) | (4,426,748) |
| Net (decrease) increase in cash and cash equivalents | (1,154,148) | 21,770 | 2,599,532 |
| Cash and cash equivalents at the beginning of the period | 3,229,939 | 630,407 | 630,407 |
| Cash and cash equivalents at the end of the period | \$2,075,791 | \$652,177 | \$3,229,939 |

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

March 31, 2011 and 2010

and December 31, 2010

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 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:

Basis of presentation

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, such information reflects all adjustments (consisting of normal recurring adjustments), which are, in the opinion of Management, necessary for fair statement of results for the interim periods.

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., Starfruit, L.L.C., Fresh Made, Inc. and Starfruit Franchisor, L.L.C. In 2010, the Company acquired the assets of First Juice and consolidated the operations into the operations of the Company. All significant intercompany accounts and transactions have been eliminated. The financial statements include the results of operations from the acquisition of the assets of First Juice from October 14, 2010 through the end of the period (see Note 3).

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 and discounts, the valuation of investment securities, the valuation of goodwill, intangible assets, and deferred taxes.

Revenue Recognition

Sales of Company produced dairy products 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. Discounts and allowances are reported as a reduction of gross sales unless the allowance is attributable to an identifiable benefit separable from the purchase of the product, the value of which can be reasonably estimated, which would be charged to the appropriate expense account.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2011 and 2010
and December 31, 2010

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Cash and cash equivalents

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

The Company maintains cash deposits at several institutions located in the greater Chicago, Illinois and Philadelphia, Pennsylvania metropolitan areas.

Investments

All investment securities are classified as available-for-sale and are carried at fair value. Unrealized gains and losses on available-for-sale securities 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. All of the Company's securities are subject to a periodic impairment evaluation. 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 and anticipated discounts. The Company's estimate of the allowances for doubtful accounts and anticipated discounts are based upon historical experience, its evaluation of the current status and contract terms 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 is stated at depreciated cost or fair value where depreciated cost is not recoverable. Depreciation is computed using the straight-line method. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to income as incurred; significant renewals and betterments are capitalized.

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

| Category | Years |
|----------------------------|-----------|
| Buildings and improvements | 31 and 39 |

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| | |
|-------------------------|--------|
| Machinery and equipment | 5 – 12 |
| Office equipment | 5 – 7 |
| Vehicles | 5 |

LIFEWAY FOODS, INC. AND SUBSIDIARIES
 Notes to Consolidated Financial Statements
 March 31, 2011 and 2010
 and December 31, 2010

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

Intangible assets acquired in business combinations

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 identifiable intangible assets acquired. Goodwill is not amortized, but is reviewed for impairment at least annually. Brand assets represent the fair value of brands acquired. Brand assets have an indefinite life and therefore are not amortized, rather are reviewed periodically for impairment. 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 per 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 | 7-10 |
| Lease agreement | 7 |
| Trade names | 15 |
| Formula | 10 |
| Customer relationships | 12 |

Income taxes

Deferred income taxes are the result of temporary differences that arise 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 investments, capitalization of indirect costs for tax purposes, purchase price adjustments, and the recognition of an allowance for doubtful accounts for financial statement purposes.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2011 and 2010
and December 31, 2010

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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 2009 and 2010 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.

During the year ended December 31, 2010, the IRS completed a review of the Company's 2007 and 2008 federal tax return filings, resulting in a liability of approximately \$220,000 being recognized and paid during 2010. 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 and promotional costs

The Company expenses advertising costs as incurred. For the year ended December 31, 2010 and for the three months ended March 31, 2011 and 2010 total advertising costs and promotional discounts and allowances were \$4,545,043, \$1,445,997 and \$1,361,694, respectively. For the year ended 2010 and for the three months ended March 31, 2011 and 2010, \$2,390,002, \$829,345, and \$829,068 were classified as advertising expense, respectively, and \$2,155,041, \$616,652, and \$532,626 were considered to be promotional discounts and allowances and were classified as reductions of sales, respectively.

Earnings 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, 2011 and 2010 and for the year ended December 31, 2010, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

Reclassification

Certain 2010 balance sheet amounts have been reclassified to conform to the 2011 presentation.

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

March 31, 2011 and 2010

and December 31, 2010

Note 3 – ACQUISITIONS

On October 20, 2010, Lifeway purchased certain assets of First Juice, Inc., a producer of organic fruit and vegetable juice beverages designed for children (“First”). The consideration for substantially all of the assets was an aggregate of \$770,000, consisting of a \$500,000 previous investment in preferred stock and an additional \$270,000 cash paid in 2010. Production was moved to Lifeway facilities upon closing of the acquisition. The acquisition was consummated to expand the Company’s presence in the children’s market, increase distribution channels for existing Lifeway products, and increase diversification of the Company’s products. There were no significant liabilities assumed. Acquisition costs for legal and professional fees have been included in General and Administrative costs and were not significant. The entire amount of goodwill resulting from the acquisition is tax deductible.

The estimated fair value of assets acquired, including the real property, and liabilities assumed consisted of the following:

| | | |
|---|----|---------|
| Trade names | \$ | 268,000 |
| Other current assets | | 6,000 |
| Customer lists | | 199,000 |
| Fixed assets | | 35,000 |
| Non-compete agreement | | -0- |
| Non amortizable goodwill and brand asset | | 262,000 |
| Total fair value of assets acquired and liabilities assumed | \$ | 770,000 |

Had the acquisition occurred on January 1, 2010, the impact on the gross revenue and net income of the Company would not have been significant and would have had no impact on earnings per share for the full year ended December 31, 2010.

Note 4 – INTANGIBLE ASSETS

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

| | March 31, 2011 | | March 31, 2010 | | December 31, 2010 | |
|---|----------------|--------------------------|----------------|--------------------------|-------------------|--------------------------|
| | Cost | Accumulated Amortization | Cost | Accumulated Amortization | Cost | Accumulated Amortization |
| Recipes | \$ 43,600 | \$ 43,600 | \$ 43,600 | \$ 43,600 | \$ 43,600 | \$ 43,600 |
| Customer lists and other customer related intangibles | 4,504,200 | 1,166,160 | 4,305,200 | 695,568 | 4,504,200 | 1,039,323 |
| Lease acquisition | 87,200 | 81,750 | 87,200 | 70,590 | 87,200 | 79,941 |
| Customer relationship | 985,000 | 383,056 | 985,000 | 300,972 | 985,000 | 362,526 |
| Trade names | 2,248,000 | 621,100 | 1,980,000 | 484,000 | 2,248,000 | 585,267 |
| Formula | 438,000 | 204,400 | 438,000 | 160,600 | 438,000 | 193,450 |
| | \$ 8,306,000 | \$ 2,500,066 | \$ 7,857,638 | \$ 1,773,968 | \$ 8,306,000 | \$ 2,304,107 |

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
March 31, 2011 and 2010
and December 31, 2010

Note 4 – INTANGIBLE ASSETS - Continued

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

| | | |
|------------|----|-----------|
| 2012 | \$ | 780,200 |
| 2013 | | 760,317 |
| 2014 | | 714,192 |
| 2015 | | 711,367 |
| 2016 | | 711,367 |
| Thereafter | | 2,128,491 |
| | \$ | 5,805,934 |

Amortization expense during the three months ended March 31, 2011 and 2010 and the year ended December 31, 2010 was \$195,959, \$175,760 and \$724,537, respectively.

Note 5 – INVESTMENTS

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

| March 31, 2011 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|-------------------------------|-------------|---------------------|----------------------|---------------|
| Equities | \$261,472 | \$6,227 | \$(37,440) | \$230,259 |
| Mutual Funds | 103,346 | 1,902 | (798) | 104,450 |
| Preferred Securities | 203,514 | --- | (12,984) | 190,530 |
| Corporate Bonds | 792,379 | 3,941 | (7,177) | 789,143 |
| Total | \$1,360,711 | \$12,070 | \$(58,399) | \$1,314,382 |
| March 31, 2010 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Equities | \$1,278,619 | \$190,688 | \$(120,631) | \$1,348,676 |
| Mutual Funds | 228,746 | 6,781 | (4,326) | 231,201 |
| Preferred Securities | 388,705 | 7,450 | (63,703) | 332,452 |
| Corporate Bonds | 1,595,713 | 84,119 | (6,877) | 1,672,955 |
| Government Agency Obligations | 815,778 | 3,433 | (6,714) | 812,497 |
| Total | \$4,307,561 | \$292,471 | \$(202,251) | \$4,397,781 |
| December 31, 2010 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Equities | \$ 225,573 | \$ 16,173 | \$ (68,974) | \$ 172,772 |
| Mutual Funds | 202,108 | 4,661 | (2,017) | 204,752 |
| Preferred Securities | 228,514 | — | (18,329) | 210,185 |

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| | | | | |
|-----------------|--------------|-----------|--------------|--------------|
| Corporate Bonds | 496,451 | 843 | (5,771) | 491,523 |
| Total | \$ 1,152,646 | \$ 21,677 | \$ (95,091) | \$ 1,079,232 |

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

March 31, 2011 and 2010

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Note 5 – INVESTMENTS - Continued

Proceeds from the sale of investments were \$5,669,158, \$234,388 and \$531,455 during the year ended December 31, 2010 and for the three months ended March 31, 2011 and 2010, respectively.

Gross gains of \$451,420, \$15,652 and \$23,737 and gross losses of \$200,940, \$18,249 and \$52,996 were realized on these sales during the year ended December 31, 2010 and for the three months ended March 31, 2011 and 2010, respectively.

The following table shows the gross unrealized losses and fair value of the 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, 2011 and 2010 and at December 31, 2010:

| March 31, 2011 | Less Than 12 Months | | 12 Months or Greater | | Total | |
|----------------------|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Equities | \$ 163,063 | \$ (7,801) | \$ 25,270 | \$ (29,639) | \$ 188,333 | \$ (37,440) |
| Mutual Funds | 20,124 | (680) | 5,824 | (118) | 25,948 | (798) |
| Preferred Securities | --- | --- | 190,530 | (12,984) | 190,530 | (12,984) |
| Corporate Bonds | 409,750 | (7,177) | --- | --- | 409,750 | (7,177) |
| | \$ 592,937 | \$ (15,658) | \$ 221,624 | \$ (42,741) | \$ 814,561 | \$ (58,399) |

| March 31, 2010 | Less Than 12 Months | | 12 Months or Greater | | Total | |
|-------------------------------|---------------------|-------------------|----------------------|-------------------|--------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Equities | \$ 79,393 | \$ (29,937) | \$ 205,060 | \$ (90,694) | \$ 284,453 | \$ (120,631) |
| Mutual Funds | 414 | (4) | 26,034 | (4,322) | 26,448 | (4,326) |
| Preferred Securities | --- | --- | 310,252 | (63,703) | 310,252 | (63,703) |
| Corporate Bonds | 164,144 | (5,510) | 103,645 | (1,367) | 267,789 | (6,877) |
| Government Agency Obligations | 479,469 | (5,563) | 85,376 | (1,151) | 564,845 | (6,714) |
| | \$ 723,420 | \$ (41,014) | \$ 730,367 | \$ (161,237) | \$ 1,453,787 | \$ (202,251) |

| December 31, 2010 | Less Than 12 Months | | 12 Months or Greater | | Total | |
|----------------------|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Equities | \$ 48,202 | \$ (11,675) | \$ 101,467 | \$ (57,299) | \$ 149,669 | \$ (68,974) |
| Mutual Funds | — | — | 85,061 | (2,017) | 85,061 | (2,017) |
| Preferred Securities | — | — | 210,185 | (18,329) | 210,185 | (18,329) |

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| | | | | | | |
|-----------------|------------|--------------|------------|--------------|------------|---------------|
| Corporate Bonds | 146,710 | (2,296) | 122,532 | (3,475) | 269,242 | (5,771)) |
| | \$ 194,912 | \$ (13,971) | \$ 519,245 | \$ (81,120) | \$ 714,157 | \$ (95,091)) |

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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Note 5 – INVESTMENTS - Continued

Equities, Mutual Funds, Preferred Securities, Corporate Bonds and Government Agency Obligations - The Company's investments in equity securities, mutual funds, corporate bonds and government agency obligations consist of investments in common stock, preferred stock and debt securities of companies in various industries. As of March 31, 2011, there were nine equity securities, fourteen mutual fund securities, two preferred securities, and five corporate bond securities that had unrealized losses. 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, 2011.

Note 6 – INVENTORIES

Inventories consist of the following:

| | March 31, | | December 31, | |
|---------------------|--------------|--------------|--------------|------|
| | 2011 | 2010 | 2010 | 2010 |
| Finished goods | \$ 1,959,323 | \$ 1,287,500 | \$ 1,636,988 | |
| Production supplies | 1,637,602 | 1,571,096 | 1,527,064 | |
| Raw materials | 1,155,129 | 1,011,229 | 821,322 | |
| Total inventories | \$ 4,752,054 | \$ 3,869,825 | \$ 3,985,374 | |

Note 7 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

| | March 31, | | December 31, | |
|-------------------------------|---------------|---------------|---------------|------|
| | 2011 | 2010 | 2010 | 2010 |
| Land | \$ 1,178,160 | \$ 1,178,160 | \$ 1,178,160 | |
| Buildings and improvements | 11,367,274 | 10,684,220 | 11,328,860 | |
| Machinery and equipment | 14,006,251 | 12,677,396 | 13,713,649 | |
| Vehicles | 1,073,745 | 961,245 | 976,745 | |
| Office equipment | 374,564 | 276,427 | 352,135 | |
| Construction in process | --- | 207,830 | 96,990 | |
| | 27,999,994 | 25,985,278 | 27,646,539 | |
| Less accumulated depreciation | 12,870,339 | 11,503,456 | 12,493,826 | |
| Total property and equipment | \$ 15,129,655 | \$ 14,481,822 | \$ 15,152,713 | |

Depreciation expense during the three months ended March 31, 2011 and 2010 and for the year ended December 31, 2010 was \$376,513, \$403,375 and \$1,393,745, respectively.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
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Note 8 – ACCRUED EXPENSES

Accrued expenses consist of the following:

| | 2011 | March 31, 2011 | 2010 | December 31, 2010 |
|-----------------------------------|------|-------------------|------|-------------------------|
| Accrued payroll and payroll taxes | \$ | 320,531 | \$ | 298,246 |
| Accrued property tax | | 203,933 | | 222,537 |
| Other | | 71,377 | | 116,480 |
| | \$ | 595,841 | \$ | 637,263 |
| | | | | 181,274 |
| | | | | 273,876 |
| | | | | 54,309 |
| | | | | 509,459 |

Note 9 – NOTES PAYABLE

Notes payable consist of the following:

| | 2011 | March 31, 2011 | 2010 | December 31, 2010 |
|--|------|-------------------|-----------|-------------------------|
| Note payable to Private Bank in monthly installments of \$42,222, plus variable interest rate, currently at 2.761%, with a balloon payment of \$5,066,667 due February 6, 2014. Collateralized by substantially all assets of the Company. | \$ | 6,502,222 | \$ | 7,008,889 |
| Line of credit with Private Bank at variable interest rate, currently at 2.761%. The agreement has been extended with terms allowing borrowings up to \$2.0 million, maturing on May 31, 2011. The Company is in the process of negotiating a renewal of this facility at maturity. Collateralized by substantially all assets of the Company. | | --- | 500,000 | --- |
| Line of credit with Morgan Stanley for borrowings up to \$2.8 million at variable interest rate, currently at 3.01% due on demand. Collateralized by investments with a fair value of \$1,077,323, cash and CD's totaling \$1,711,934 at March 31, 2011. | | 1,858,110 | 2,484,522 | 2,344,946 |
| Notes payable to Ilya Mandel & Michael Edelson, subordinated to Private Bank, payable in quarterly installments of \$341,875, plus interest at the floating rate per annum (3.25% at March 31, 2010). This | | --- | 1,242,165 | --- |

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balance was paid in full during August, 2010.

| | | | | |
|-------------------------|--------------|----|------------|-----------|
| Total notes payable | 8,360,332 | | 11,235,576 | 8,973,835 |
| Less current maturities | 2,364,774 | | 4,733,354 | 2,851,610 |
| Total long-term portion | \$ 5,995,558 | \$ | 6,502,222 | 6,122,225 |

In accordance with the Private Bank agreements referenced above, the Company is subject to minimum fixed charged ratio and tangible net worth thresholds. At March 31, 2011, the Company was in compliance with these covenants.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
 Notes to Consolidated Financial Statements
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 and December 31, 2010

Note 9 – NOTES PAYABLE - Continued

Maturities of notes payables are as follows:

For the Period Ended March 31,

| | | | |
|-------|--|----|-----------|
| 2012 | | \$ | 2,364,774 |
| 2013 | | | 506,664 |
| 2014 | | | 5,488,894 |
| Total | | \$ | 8,360,332 |

Note 10 – PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

| | For the Three Months Ended | | For the Year |
|----------------------------|----------------------------|------------|--------------|
| | March 31, | | Ended |
| | 2011 | 2010 | December |
| | | | 31, |
| | | | 2010 |
| Current: | | | |
| Federal | \$ 1,005,605 | \$ 916,582 | 2,269,819 |
| State and local | 406,241 | 216,581 | 651,085 |
| Total current | 1,411,846 | 1,133,163 | 2,920,904 |
| Deferred | (119,129) | (222,915) | (96,918) |
| Provision for income taxes | \$ 1,292,717 | \$ 910,248 | 2,823,986 |

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 | | For the Year |
|---|----------------------------|------------|--------------|
| | March 31, | | Ended |
| | 2011 | 2010 | December 31, |
| | | | 2010 |
| Federal income tax expense computed at the statutory rate | \$ 1,094,286 | \$ 910,838 | \$ 2,180,228 |
| State and local tax expense, net | 305,756 | 128,589 | 651,085 |
| Permanent differences | (58,415) | (129,179) | (117,247) |
| Tax credits and other | (48,910) | --- | 109,920 |
| Provision for income taxes | \$ 1,292,717 | \$ 910,248 | \$ 2,823,986 |

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
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Note 10 – PROVISION FOR INCOME TAXES - Continued

Amounts for deferred tax assets and liabilities are as follows:

| | 2011 | March 31, 2010 | December 31, 2010 |
|--|----------------|-------------------|----------------------|
| Non-current deferred tax assets (liabilities) arising from: | | | |
| Temporary differences - | | | |
| Accumulated depreciation and amortization from purchase accounting adjustments | \$ (3,604,041) | \$ (3,655,289) | \$ (3,673,296) |
| Capital loss carry-forwards | 271,568 | 337,016 | 271,568 |
| Total non-current net deferred tax liabilities | (3,332,473) | (3,318,273) | (3,401,728) |
| Current deferred tax assets arising from: | | | |
| Unrealized losses on investments | 24,384 | (37,261) | 30,320 |
| Impairment of investments | --- | 59,003 | 4,232 |
| Inventory | 212,089 | 163,979 | 168,875 |
| Allowance for doubtful accounts and discounts | 131,703 | 117,710 | 125,043 |
| Total current deferred tax assets | 368,176 | 303,431 | 328,470 |
| Net deferred tax liability | \$ (2,964,297) | \$ (3,014,842) | \$ (3,073,258) |

Note 11 – SUPPLEMENTAL CASH FLOW INFORMATION

The Company applied a previous investment in First Juice of \$500,000 toward the acquisition. The impact on the acquisition and intangible assets has been omitted from the investing section of the cash flow statement.

Cash paid for interest and income taxes are as follows:

| | For the Three Months Ended March 31, | | For the Year Ended December 31, |
|--------------|---|------------|---------------------------------------|
| | 2011 | 2010 | 2010 |
| Interest | \$ 58,624 | \$ 106,643 | \$ 375,347 |
| Income taxes | \$ 200,000 | \$ 301,100 | \$ 2,824,824 |

Note 12 – 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 1,200,000 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. 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, 2010 and at March 31, 2011 and 2010, there were no stock options outstanding or exercisable. There were approximately 940,000 shares available for issuance under the Plan at March 31, 2011.

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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Note 12 – STOCK AWARD AND STOCK OPTION PLANS

On May 28, 2009, Lifeway's Board of Directors approved awards of an aggregate amount of 18,000 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 May 28, 2009 and have vesting periods of one year. The expense for the awards is measured as of July 14, 2009 at \$14.69 per share for 18,000 shares, or a total stock award expense of \$264,420. This expense was recognized as the stock awards vested in 12 equal portions of \$22,035, or 1,500 shares per month for one year.

Note 13 – FAIR VALUE MEASUREMENTS

Generally accepted accounting principles define fair value as the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The standards emphasize that fair value is a market-based measurement, not an entity-specific measurement and establish the following fair value hierarchy used in fair value measurements:

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.

The Company has available for sale investment securities measured at fair value on a recurring basis. All categories of investment securities noted in Note 5 were valued using Level 1 inputs as described above, in 2011 and 2010. There were no other assets or liabilities measured at fair value on a recurring or non-recurring basis as of March 31, 2011, March 31, 2010 or December 31, 2010.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
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Note 14 – RECENT ACCOUNTING PRONOUNCEMENTS

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures. FASB ASU 2010-06 amends the fair value disclosure guidance to include new disclosures and changes to clarify existing disclosure requirements. ASU 2010-06 was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements of Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The impact of ASU 2010-06 on the Company's disclosures was not significant to the consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Comparison of Quarter Ended March 31, 2011 to Quarter Ended March 31, 2010

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-K, for the fiscal year ended December 31, 2010.

Results of Operations

Total consolidated gross sales increased by \$3,083,107 (approximately 19%) to \$19,047,266 during the three month period ended March 31, 2011 from \$15,964,159 during the same three month period in 2010. This increase is primarily attributable to increased sales and awareness of flagship line, Kefir, as well as ProBugs® Organic Kefir for kids.

Cost of goods sold as a percentage of net sales, excluding depreciation expense, was approximately 55.8% during the first quarter of 2011, compared to approximately 54.2% during the same period in 2010. The slight increase was primarily attributable to the cost of transportation and other petroleum based production supplies partially offset by the decreased cost of conventional milk, our largest raw material. The cost of milk was approximately 10% lower during the first quarter 2011 when compared to the same period in 2010. Gross profit increased approximately 14% during the first quarter of 2011 compared with the same period in 2010.

Operating expenses as a percentage of net sales were approximately 23.2% during the first quarter of 2011 compared to approximately 24.6% during the same period in 2010. This decrease was primarily attributable to decreased promotional allowances as compared to the same period in 2010.

Total operating income increased by \$517,227 (approximately 19%) to \$3,265,622 during the first quarter of 2011, from \$2,748,395 during the same period in 2010.

Total other expenses for the first quarter of 2011 were \$47,134 compared with total expenses of \$69,458 during the same period in 2010. This decrease in total other expenses is primarily attributable to a higher realized loss on the sale of investments during the first quarter 2010 compared to the same period in 2011. Additionally, interest expense decreased by \$33,812 to \$62,130 during the first quarter of 2011 from \$95,942 during the same period in 2010. Investments are discussed in Note 5 of the Notes to Consolidated Financial Statements.

Total net income was \$1,925,771 or \$0.12 per share for the three month period ended March 31, 2011 compared to \$1,768,689 or \$0.11 per share in the same period in 2010. This represents a 9% increase in net income for the first quarter of 2011 compared to the same period in 2010.

Liquidity and Capital Resources

Sources and Uses of Cash

Net cash provided by operating activities was \$1,143,898 during the three months ended March 31, 2011 which is an increase of \$47,494 when compared to the same period in 2010. This increase is primarily attributable to a decrease in deferred income taxes and accounts receivable.

Net cash used in investing activities was \$564,116 during the three months ended March 31, 2011 which is an increase of \$136,058 compared to the same period in 2010. This increase is primarily due to an increase in purchases of

investments.

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The Company had a net increase in cash and cash equivalents of \$1,423,614 during the first quarter of 2011 compared to the same period in 2010. The Company had cash and cash equivalents of \$2,075,791 as of March 31, 2011 compared with cash and cash equivalents of \$652,177 as of March 31, 2010.

Assets and Liabilities

Total assets were \$52,312,441 as of March 31, 2011, which is an increase of \$253,710 when compared to December 31, 2010, and a decrease of \$623,147 when compared to March 31, 2010. This is primarily due to the other assets balance of \$500,000 related to the Company's previous investment in preferred stock of First Juice, Inc. as of March 31, 2010.

Total current liabilities were \$8,238,993 as of March 31, 2011, which is a decrease of \$646,767 when compared to December 31, 2010. Total current liabilities decreased by \$781,709 when compared to March 31, 2010. This is primarily due to the Company's repayment of notes payable during 2010.

Long term notes payables decreased by \$126,667 as of March 31, 2011, when compared to December 31, 2010 and decreased by \$506,664 when compared to March 31, 2010. The balance of the long term notes payable as of March 31, 2011 was \$5,995,558.

Total stockholder's equity was \$34,745,417 as of March 31, 2011, which is an increase of \$1,096,399 when compared to December 31, 2010. This is primarily due to the increase in retained earnings of \$1,925,771 when compared to December 31, 2010 resulting from net income for the three month period ended March 31, 2011. Total stockholder's equity increased by \$651,026 when compared to March 31, 2010. This is primarily due to the increase in retained earnings of \$3,779,548, which was offset by an increase in treasury stock of \$3,089,646 as of March 31, 2011, when compared to March 31, 2010.

We previously held significant portions of our assets in investments. During the fourth quarter of 2010, we converted certain securities to cash and cash equivalents in order to ensure we had easy access to capital to capitalize on the opportunities we see ahead for our business. All of our marketable securities are classified as available-for-sale on our balance sheet. 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 August 24, 2010 the USDA ruled to exempt Kefir beverages from the Class I milk classification, which provides exemptions from the Class I definition for Kefir and other drinkable yogurt products containing at least 20% yogurt (by weight) as well as products intended to be meal replacements. The final rule went into effect January 1, 2011.

This change from Class I to Class II costing should have a positive impact on what Lifeway pays for its key milk ingredient, which is about 80% of the products' cost of goods sold. The Company reported that in September 2010, it purchased approximately 4.3 million pounds of Class I conventional milk at an average price of \$0.18 per pound. Under the new pricing structure, the Company would have paid about \$0.16 per pound and saved approximately \$85,000. Historically, the price of Class II milk is typically 10 to 20% lower than the price of Class I milk.

In addition to having a positive effect on gross margins, the improved input costs will allow all of Lifeway's Kefir-based products to be more competitive with other non-Class I milk products, such as yogurts in the marketplace.

This expected increase in cash flow will provide greater financial flexibility, enabling the Company to expand marketing efforts or retain cash for future initiatives. Lifeway expects to see this improvement throughout 2011.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

As of March 31, 2011, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial and Accounting Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial and Accounting Officer concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of March 31, 2011 in ensuring that information required to be disclosed by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified under the Exchange Act rules and forms due to the material weaknesses described in our Form 10-K filed on March 31, 2011. As a result, we performed additional analysis and other post-closing procedures to ensure our consolidated financial statements were prepared in accordance with generally accepted accounting principles. Accordingly, management believes the consolidated financial statements included in this Form 10-Q fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented.

Changes in Internal Control Over Financial Reporting

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 control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

ITEM 1A. RISK FACTORS.

Not applicable.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

(c) PURCHASES OF THE COMPANY'S SECURITIES

| Period | (a) Total Numbers of Shares (or Units) Purchased | (b) Average Price Paid per Share (or Unit) | (c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs* | (d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs* |
|------------------------------------|--|---|---|--|
| Jan. 1, 2011 to Jan. 31, 2011 | 32,007 | 9.19 | 32,007 | 265,595 |
| Feb. 1, 2011 to Feb. 28, 2011 | 23,341 | 9.21 | 23,341 | 242,254 |
| March 1, 2011 to March 31, 2011 | 37,500 | 8.79 | 37,500 | 204,754 |
| Total | 92,848 | 9.06 | 92,848 | 204,754 |

*The Company established a share repurchase program approved May 7, 2010 for up to 200,000 shares with a plan expiration date of one year from the date of the first purchase, and on January 1, 2011, the Company approved a new share repurchase program for up to 250,000 shares with a plan expiration date of one year from the date of the first purchase.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. REMOVED AND RESERVED.

ITEM 5. OTHER INFORMATION.

On May 12, 2011, the Company announced its financial results for the fiscal quarter ended March 31, 2011 and certain other information. A copy of the Company's press release announcing these financial results and certain other information is attached as Exhibit 99.1 hereto. The information contained in Exhibit 99.1 hereto is being furnished, and should not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities imposed by that Section. The information contained in Exhibit 99.1 shall not be incorporated by reference into any registration statement or other document or filing under the Securities Act of 1933, as amended, except as may be expressly set forth in a specific filing. The press release filed as an exhibit to this report includes "safe harbor" language pursuant to the Private Securities Litigation Reform Act of 1995, as amended, indicating that certain statements about the Company's business and other matters contained in the press release are "forward-looking." The press release also cautions investors that "forward-looking" statements may be different from actual operating results. Finally, the press release states that a more thorough discussion of risks and uncertainties which may affect the Company's operating results is included in the Company's reports on file with the Securities and Exchange Commission.

ITEM 6. EXHIBITS.

| Exhibit Number | Description of Document |
|----------------|--|
| 31.1 | Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 99.1 | Press Release dated May 12, 2011. |

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LIFEWAY FOODS, INC.
(Registrant)

Date: May 16, 2011

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

Date: May 16, 2011

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

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