LIFEWAY FOODS INC
Form 10QSB
November 20, 2006

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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 September 30, 2006

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 such shorter period that the issuer was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 o

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 September 30, 2006, the issuer had 16,855,889 shares of common stock, no par value, outstanding.

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

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIFEWAY FOODS, INC. AND SUBSIDIARY
CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006 and 2005
AND DECEMBER 31, 2005

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Financial Condition
September 30, 2006 and 2005 (Unaudited) and December 31, 2005

	(Unaudited) September 30, 2006	(Unaudited) September 30, 2005	December, 31 2005
ASSETS			
Current assets			
Cash and cash equivalents	$ 1,242,306	$ 4,191,755	$ 4,354,081
Marketable securities	8,042,189	7,580,531	7,478,697
Inventories	2,628,508	1,301,066	1,716,999
Accounts receivable, net of allowance for doubtful accounts of $45,000 and $15,000 at September 30, 2006 and 2005 and $35,000 at December 31, 2005	3,984,991	2,637,528	2,517,615
Prepaid expenses and other current assets	46,547	82,293	9,144
Other receivables	59,810	109,093	56,435
Deferred income taxes	108,154	46,881	142,772
Refundable income taxes	68,346	58,037	11,562
Total current assets	**16,180,851**	**16,007,184**	**16,287,305**
Property and equipment, net	**8,574,181**	**7,755,352**	**7,751,446**
Intangible assets			
Goodwill	7,321,114	75,800	75,800
Other intangible assets, net of accumulated amortization of $142,010 and $59,379 at September 30, 2006 and 2005 and $92,432 at December 31, 2005	300,628	366,567	350,206
Total intangible assets	**7,621,742**	**442,367**	**426,006**
Total assets	**$ 32,376,774**	**$ 24,204,903**	**$ 24,464,757**
LIABILITIES AND STOCKHOLDERS EQUITY			
Current liabilities			
Current maturities of notes payable	$ 1,124,284	$ 534,938	$ 532,454
Accounts payable	1,251,720	648,881	426,253
Accrued expenses	270,990	453,895	355,011

Total current liabilities	**2,646,994**	**1,637,714**	**1,313,718**
Notes payable	**6,191,521**	**2,919,656**	**2,903,349**
Deferred income taxes	**346,217**	**362,314**	**348,923**
Stockholders equity			
Common stock	6,509,267	6,509,267	6,509,267
Paid-in-capital	1,080,911	82,738	90,725
Treasury stock, at cost	(1,235,542)	(1,034,172)	(1,024,659)
Retained earnings	16,807,609	13,715,660	14,422,948
Accumulated other comprehensive income (loss), net of taxes	29,797	11,726	(99,514)
Total stockholders equity	**23,192,042**	**19,285,219**	**19,898,767**
Total liabilities and stockholders equity	**$ 32,376,774**	**$ 24,204,903**	**$ 24,464,757**

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Income and Comprehensive Income
For the Three and Nine Months Ended September 30, 2006 and 2005 (Unaudited)
and The Year Ended December 31, 2005

	(Unaudited) Three Months Ended September 30		(Unaudited) Nine Months Ended September 30		Year Ended December 31,
	2006	**2005**	**2006**	**2005**	**2005**
Sales	$ 7,456,649	$ 5,194,648	$ 19,827,069	$ 14,924,076	$ 20,131,654
Cost of goods sold	4,599,428	3,073,314	11,550,612	$ 8,607,538	11,664,065
Gross profit	**2,857,221**	**2,121,334**	**8,276,457**	**6,316,538**	**8,467,589**
Operating expenses	1,737,901	1,359,171	4,820,613	$ 3,793,394	5,066,227
Income from operations	**1,119,320**	**762,163**	**3,455,844**	**2,523,144**	**3,401,362**
Other income (expense):					
Interest and dividend income	86,318	72,363	294,583	212,927	323,365
Interest expense	(96,557)	(36,877)	(209,983)	(51,195)	(100,762)
Gain (loss) on sale of marketable securities, net	89,260	162,446	277,674	324,433	445,327
Gain on marketable securities classified as trading	(2,370)	(681)	691	14,355	13,773
Total other income	76,651	197,251	362,965	500,520	681,703
Income before provision for income taxes	**1,195,971**	**959,414**	**3,818,809**	**3,023,664**	**4,083,065**
Provision for income taxes	456,012	400,464	1,434,148	1,182,479	1,534,592
Net income	**$ 739,959**	**$ 558,950**	**$ 2,384,661**	**$ 1,841,185**	**$ 2,548,473**
Basic and diluted earnings per common share	0.04	0.03	0.14	0.11	0.15
Weighted average number of shares outstanding	**16,860,139**	**16,786,768**	**16,855,889**	**16,815,536**	**16,808,992**

COMPREHENSIVE INCOME					
Net income	**$ 739,959**	**$ 558,950**	**$ 2,384,661**	**$ 1,841,185**	**$ 2,548,473**
Other comprehensive income (loss), net of tax:					
Unrealized gains (losses) on marketable securities (net of tax benefits)	102,436	103,458	312,717	82,988	42,708
Less reclassification adjustment for gains (losses) included in net income (net of taxes)	(73,184)	(96,369)	(183,406)	(190,442)	(261,402)
Comprehensive income	**$ 769,211**	**$ 566,039**	**$ 2,513,972**	**$ 1,733,731**	**$ 2,329,779**

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Stockholder s Equity
For the Nine Months Ended September 30, 2006 (Unaudited)
and the Year Ended December 31, 2005

	Common Stock, No Par Value 20,000,000 Shares Authorized							Accumulated Other Comprehensive Income (Loss), Net of Tax	
	# of Shares Issued	# of Shares Outstanding	# of Shares of Treasury Stock	Common Stock	Paid In Capital	Treasury Stock	Retained Earnings		Total
alances at ecember 31, 004	**17,273,776**	**16,882,876**	**390,900**	**$ 6,509,267**	**$ 64,314**	**$ (649,039)**	**$ 11,874,475**	**$ 119,180**	**$ 17,918,19**
suance of easury stock		7,634	(7,634)		26,411	25,934			52,34
edemption of ock		(100,000)	100,000			(401,554)			(401,55
ther omprehensive come (loss): nrealized sses on curities, net f taxes and classification djustment								(218,694)	(218,69
et income for e year ended ecember 31, 005							2,548,473		2,548,47
alances at ecember 31, 005	**17,273,776**	**16,790,510**	**483,266**	**$ 6,509,267**	**$ 90,725**	**$ (1,024,659)**	**$ 14,422,948**	**$ (99,514)**	**$ 19,898,76**
suance of easury stock or ompensation		4,666	(4,666)		13,311	15,855			29,16

suance of easury stock or acquisition f Helios		202,650			976,875	323,125			1,300,00
edemption of ock		(89,682)	89,682			(549,863)			(549,86
ther omprehensive come (loss): nrealized ains on ecurities, net f taxes and classification djustment								129,311	129,31
et income for e nine months nded eptember 30, 006							2,384,661		2,384,66
alances at eptember 30, 006	**17,273,776**	**16,908,144**	**568,282**	**$ 6,509,267**	**$ 1,080,911**	**$ (1,235,542)**	**$ 16,807,609**	**$ 29,797**	**$ 23,192,04**

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the Nine Months Ended September 30, 2006 and 2005 (Unaudited)
and the Year Ended December 31, 2005

	Nine Months Ended September 30,		Year Ended December 31,
	2006	**2005**	**2005**
Cash flows from operating activities:			
Net income	**$ 2,384,661**	**$ 1,841,185**	**$ 2,548,473**
Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition:			
Depreciation and amortization	457,844	486,050	650,945
(Gain)Loss on sale of marketable securities, net	(277,674)	(324,433)	(445,327)
Gain on marketable securities classified as trading	(691)	(14,355)	(13,773)
Deferred income taxes	(58,932)	(69,220)	(100,236)
Treasury stock issued for services	29,166	34,845	52,345
Increase in allowance for doubtful accounts	10,000		
(Increase) decrease in operating assets:			
Accounts receivable	(1,197,722)	(613,492)	(493,579)
Other receivables	(3,375)	(36,956)	15,702
Inventories	(691,875)	(395,369)	(811,302)
Refundable income taxes	(56,784)	200,580	247,055
Prepaid expenses and other current assets	468	(75,033)	(1,884)
Increase (decrease) in operating liabilities:			
Accounts payable	427,705	7,230	(215,398)
Accrued expenses	(84,021)	258,354	159,470
Net cash provided by operating activities	**938,770**	**1,299,386**	**1,592,491**
Cash flows from investing activities:			
Purchases of marketable securities	(5,258,207)	(5,149,008)	(6,460,561)
Sale of marketable securities	5,193,235	4,466,196	5,810,391
Purchases of property and equipment	(500,118)	(4,772,181)	(4,916,811)
Acquisition of Helios, net of cash acquired	(2,514,679)		
Net cash used in investing activities	**(3,079,769)**	**(5,454,993)**	**(5,566,981)**
Cash flows from financing activities:			
Proceeds from note payable		3,000,000	3,000,000
Purchases of treasury stock	(549,863)	(401,554)	(401,554)
Repayment of notes payable	(420,913)	(17,731)	(36,522)
Loan costs		(6,638)	(6,638)
Net cash provided by (used in) financing activities	**(970,776)**	**2,574,077**	**2,555,286**
Net decrease in cash and cash equivalents	**(3,111,775)**	**(1,581,530)**	**(1,419,204)**

Cash and cash equivalents at the beginning of the period	4,354,081	5,773,285	5,773,285
Cash and cash equivalents at the end of the period	**$ 1,242,306**	**$ 4,191,755**	**$ 4,354,081**

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
September 30, 2006 and 2005
and December 31, 2005

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; 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.

On August 3, 2006 the Company executed a Stock Purchase Agreement with George Economy, Amani Holdings, LLC and other shareholders (the stockholders) of the capital stock of Helios Nutrition, Ltd. (Helios) and Pride Main Street Dairy, L.L.C. pursuant to which the Company purchased all of the issued and outstanding stock of Helios from the Stockholders for a combination of an aggregate amount of 202,650 in shares of the Company s common stock, no par value, $2,526,000 in cash, and a promissory note issued by the Company in favor of Amani Stockholders in the principal amount of $4,200,000. The Stock Payment, the Cash Payment and Promissory Note are subject to adjustment under certain circumstances in accordance with the terms of the Stock Purchase Agreement.

The final net purchase price for the assets was $8,026,000 including professional fees related to the acquisition. The following table summarizes the tentative estimated fair values of the assets acquired and the liabilities assumed at the date of acquisition. The company is in the process of calculating a valuation of the identifiable intangible assets acquired; thus, the final purchase price allocation is subject to change:

Cash	$ 11,321
Accounts Receivable Assumed	279,654
Inventories	219,634
Equipment, Building and Land	730,883
Prepaid Items	37,871
Goodwill and Amortizable Intangibles	7,245,314
Total Assets Acquired	8,524,677
Note Payable and Accounts Payable Assumed	(498,677)
Net Assets Acquired	$ 8,026,000

At closing, $2,526,000 was paid of the total purchase, $1,300,000 was paid in stock, with the balance due as a $4,200,000 note to be paid in sixteen equal installments over the next sixteen quarters.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
September 30, 2006 and 2005
and December 31, 2005

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. and Pride of Main Street Dairy, 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.

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.

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

	September 30,		December 31
	2006	2005	2005
Amounts insured	$ 392,445	$ 500,000	$ 462,571
Uninsured and uncollateralized amounts	1,101,926	3,959,945	4,331,179
Total bank balances	$ 1,494,371	$ 4,459,945	$ 4,793,750

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
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Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Continued

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 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*, and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) 59, *Accounting for Noncurrent Marketable Equity Securities*, 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.

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

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
September 30, 2006 and 2005
and December 31, 2005

Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Continued

Intangible assets

The Company accounts for intangible assets at historical cost. Intangible assets acquired in a business combination are recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. Goodwill represents the excess purchase price over the fair value of the net tangible and other intangible assets acquired. Goodwill related to the acquisition of Helios is subject to change based on the fair value calculated in the final purchase price allocation. 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	8
Lease agreement	7

Income taxes

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

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

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
September 30, 2006 and 2005
and December 31, 2005

Note 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Continued

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, 2005 and for the nine months ended September 30, 2006 and 2005, approximately $1,176,440, $1,092,560 and $914,598 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 nine months ended September 30, 2006 and 2005 and the year ended December 31, 2005, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

Note 3 INTANGIBLE ASSETS

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

	September 30, 2006		September 30, 2005		December 31, 2005	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Recipes	$ 43,600	$ 23,617	$ 43,600	$ 12,717	$ 43,600	$ 15,442
Customer lists and other customer related intangibles	305,200	89,743	305,200	48,323	305,200	58,678
Lease acquisition	87,200	26,990	87,200	14,533	87,200	17,648
Goodwill	7,321,114		75,800		75,800	
Loan acquisition costs	6,638	1,660	6,638	498	6,638	664
	$ 7,763,752	$ 142,010	$ 518,438	$ 76,071	$ 518,438	$ 92,432

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

2007	$ 66,105
2008	66,105
2009	56,113
2010	47,211
2011	45,157
Thereafter	19,937
	$ 300,628

Amortization expense during the nine months ended September, 2006 and 2005 and the year ended December 31, 2005 was $49,579, $49,081 and $65,442, respectively.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
September 30, 2006 and 2005
And December 31, 2005

Note 4 MARKETABLE SECURITIES

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

September 30, 2006	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading	Fair Value
Equities	$ 2,918,943	$ 249,781	$ (150,197)		$ 3,018,527
Mutual Funds	288,630	2,447	(3,666)		287,411
Preferred Securities	1,491,741	5,214	(28,560)		1,468,395
Private Investment LP	600,000	42,660			642,660
Certificates of Deposit	225,000	1,305	(2,393)		223,912
Corporate Bonds	2,153,896	3,238	(70,694)		2,086,440
Municipal Bonds	160,757	1,828	(203)		162,382
Government agency	154,483			(2,021)	152,462
Total	$ 7,993,450	$ 306,473	$ (255,713)	(2,021)	$ 8,042,189

September 30, 2005	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading	Fair Value
Equities and Mutual Funds	$ 4,136,818	$ 221,349	$ (121,835)		$ 4,236,332
Preferred Securities	955,233		(19,849)		935,384
Certificates of Deposit	150,000		(3,630)		146,370
Corporate Bonds	2,159,363		(55,732)		2,103,631
Municipal bonds	61,275	1,012	(1,341)		60,946
Government agency	100,000			(2,132)	97,868
Total	$ 7,562,689	$ 222,361	$ (202,387)	$ (2,132)	$ 7,580,531

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
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Note 4 MARKETABLE SECURITIES Continued

December 31, 2005	Cost	Unrealized Gains	Unrealized Losses	Loss on Marketable Securities Classified as Trading	Fair Value
Equities	$ 2,432,964	$ 212,336	(198,478)		$ 2,446,822
Mutual Funds	699,921	3,770	(74,148)		629,543
Preferred Securities	1,002,738	1,468	(30,892)		973,314
Private Investment LP	600,000		(5,146)		594,854
Certificates of Deposit	240,000		(1,125)		238,875
Corporate Bonds	2,514,044	809	(77,888)		2,436,965
Municipal Bonds, maturing within five years	61,275	957	(1,195)		61,037
Government agency obligations, maturing after five years	100,000			(2,713)	97,287
Total	$ 7,650,942	$ 219,340	$ (388,872)	$ (2,713)	$ 7,478,697

Proceeds from the sale of marketable securities were $5,810,391, $5,196,300 and $4,466,196 during the year ended December 31, 2005 and for the nine months ended September 30, 2006 and 2005, respectively.

Gross gains of $445,327, $277,674 and $324,433 were realized on these sales during the year ended December 31, 2005 and for the nine months ended September 30, 2006 and 2005, 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 September 30, 2006:

	Less Than 12 Months		12 Months or Greater		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Equities	$ 903,773	$ (107,132)	$ 205,404	$ (43,065)	$ 1,109,177	$ (150,197)
Mutual Funds	10,710	(566)	96,900	(3,100)	107,610	(3,666)
Preferred Securities	330,360	(3,115)	682,405	(25,445)	1,012,765	(28,560)
Certificates of Deposit	72,607	(2,393)			72,607	(2,393)
Corporate Bonds	711,128	(24,186)	861,227	(46,508)	1,572,355	(70,694)
Municipal Bonds			19,802	(203)	19,802	(203)
	$ 2,028,578	$ (137,392)	$ 1,865,738	$ (118,321)	$ 3,894,316	(255,713)

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
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Note 4 MARKETABLE SECURITIES Continued

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 September 30, 2006.

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 September 30, 2006.

Private Investment Limited Partnership The Company s investments in private limited partnerships consist of one limited partnership interest. The Company evaluated the near-term prospects of the investment 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 it s investment to be other-than-temporarily impaired at September 30, 2006.

Certificates of Deposit The unrealized losses on the Company s investments in certificates of deposit were caused by interest rate increases since the date of purchase. The contractual terms of these investments do not permit the issuers to settle the securities at a price less than the face value of the investment. 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 September 30, 2006.

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 September 30, 2006.

Note 5 INVENTORIES

Inventories consist of the following:

	September 30,		December 31,
	2006	2005	2005
Finished goods	$ 988,212	$ 537,514	$ 658,522
Production supplies	905,615	460,664	662,310
Raw materials	734,681	302,888	396,167
Total inventories	$ 2,628,508	$ 1,301,066	$ 1,716,999

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
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Note 6 PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	September 30, 2006	September 30, 2005	December 31, 2005
Land	$ 969,232	$ 909,232	$ 909,232
Buildings and improvements	6,715,371	6,441,412	6,443,043
Machinery and equipment	6,961,853	5,667,016	5,806,853
Vehicles	534,365	510,510	513,670
Office equipment	89,192	78,763	78,763
	15,270,013	13,606,938	13,751,561
Less accumulated depreciation	6,695,832	5,851,581	6,000,115
Total property and equipment	$ 8,574,181	$ 7,755,352	$ 7,751,446

Depreciation expense during the year ended December 31, 2005 and for the nine months ended September 30, 2006 and 2005 was $585,503, $408,266 and $436,969, respectively.

Note 7 ACCRUED EXPENSES

Accrued expenses consist of the following:

	September 30, 2006	September 30, 2005	December 31, 2005
Accrued payroll and payroll taxes	$ 34,979	$ 135,090	$ 104,873
Accrued property tax	202,080	312,112	244,916
Other	33,931	6,693	5,222
	$ 270,990	$ 453,895	$ 355,011

Note 8 NOTES PAYABLE

Notes payable consist of the following:

	September 30, 2006	September 30, 2005	December 31, 2005
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.	$ 455,079	$ 465,179	$ 462,695
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.	2,923,226	2,989,415	2,973,108

Note payable to Amani Holding LLC, payable in quarterly installments of $262,500 plus interest at the floating prime rate per annum due September 1, 2010 secured by letter of credit	3,937,500		
Total notes payable	7,315,805	3,454,594	3,435,803
Less current maturities	1,124,284	534,938	532,454
Total long-term portion	$ 6,191,521	$ 2,919,656	$ 2,903,349

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
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Note 8 NOTES PAYABLE Continued

Maturities of notes payables are as follows:

For the year ended September 30,	
2007	$ 1,124,284
2008	1,125,226
2009	1,126,597
2010	3,522,873
2011	416,825
Total	$ 7,315,805

Note 9 PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

	For the Nine Months Ended September 30, 2006	2005	For the Year Ended December 31, 2005
Current:			
Federal	$ 1,203,942	$ 1,050,319	$ 1,364,033
State and local	289,274	201,380	270,795
Total current	1,493,216	1,251,699	1,634,828
Deferred	(59,068)	(69,220)	(100,236)
Provision for income taxes	$ 1,434,148	$ 1,182,479	$ 1,534,592

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

	For The Nine Months Ended September 30, 2006	2005	For The Year Ended December 31, 2005
Federal income tax expense computed at the statutory rate	$ 1,298,395	$ 1,028,045	$ 1,388,242
State and local tax expense, net	183,268	145,136	195,987
Permanent differences	(47,515)	9,298	(49,637)
Provision for income taxes	$ 1,434,148	$ 1,182,479	$ 1,534,592

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Note 9 PROVISION FOR INCOME TAXES Continued

Amounts for deferred tax assets and liabilities are as follows:

	September 30,		December 31
	2006	2005	2005
Non-current deferred tax liabilities arising from:			
Temporary differences accumulated depreciation	$ (346,217)	$ (362,314)	$ (348,923)
Current deferred tax assets (liabilities) arising from:			
Unrealized losses (gains) on marketable securities	(20,965)	(8,250)	70,016
Inventory	110,533	55,131	72,756
Allowance for doubtful accounts	18,585		
Total current deferred tax assets (liabilities)	108,153	46,881	142,772
Net deferred tax liability	$ (238,064)	$ (315,433)	$ (206,151)

Note 10 SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

	For the Nine Months Ended September 30,		For Year Ended December 31,
	2006	2005	2005
Interest	$ 209,983	$ 51,195	$ 100,762
Income taxes	$1,555,444	$1,053,064	$1,425,600

The Company had the following non-cash investing and financing activities during the period. As described in Note 1, the Company issued 202,650 shares of common stock with a fair value of $1,300,000 and a promissory note in the principal amount of $4,200,000 as partial consideration for the acquisition of Helios.

Note 11 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, 2005 and at September 30, 2006 and 2005. 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, 2005 and at September 30, 2006 and 2005, there were no stock options outstanding or exercisable.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
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Note 11 STOCK OPTION PLANS Continued

On February 12, 2004, Lifeway s Board of Directors approved awards of an aggregate amount of 10,200 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain employees and consultants for services rendered to the Company. The stock awards were made on April 1, 2004 and have vesting periods that vary from six months to one year, depending upon the individual grantee. During 2005, 550 shares vested for a total expense of $11,512.

On May 23, 2005, Lifeway s Board of Directors approved awards of an aggregate amount of 11,200 common shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain employees and consultants for services rendered to the Company. The stock awards were made on June 1, 2005 and have vesting periods of one year. The expense for the awards is measured as of June 1, 2005 at $6.25 per share for 11,200 shares, or a total stock award expense of $70,000. This expense will be recognized as the stock awards vest in 12 equal portions of $5,833, or 932 shares per month for one year. During 2005, 7,534 shares vested and the Company recognized a related expense of $40,833. During the nine months ended September 30, 2006, 4,666 shares vested for an expense of $29,166.

Note 12 FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value of the Company s financial instruments is as follows at:

	September 30, 2006		September 30, 2005		December 31, 2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	$1,242,306	$1,242,306	$4,191,755	$4,191,755	$4,354,081	$4,354,081
Marketable securities	$8,042,189	$8,042,189	$7,580,531	$7,580,531	$7,478,697	$7,478,697
Notes payable	$7,315,805	$7,275,702	$3,454,594	$3,437,469	$3,435,803	$3,416,969

Note 13 LITIGATION SETTLEMENT

During 2005, the Company agreed to pay $95,000 in the settlement of a lawsuit regarding the alleged non payment of overtime wages.

Note 14 RECENT ACCOUNTING PRONOUNCEMENTS

In November 2005, FASB issued FSP FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP FAS 115-1 also includes accounting considerations subsequent to the recognition of an other-than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP FAS 115-1 is required to be applied to reporting periods beginning after December 15, 2005. The Company has adopted FSP FAS 115-1 in 2006.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
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Note 15 STOCK SPLIT

On June 8, 2006, the Board of Directors approved a two-for-one split of the Company s common stock and an amendment to its charter to increase the number of common shares authorized from 10 million to 20 million. As a result of the stock split, each shareholder of record at the close of business on July 19, 2006 received one additional share of common stock for every one share held on such date. Upon completion of the split, the total number of shares of common stock outstanding increased from approximately 8,391,000 to approximately 16,782,000.

The earnings per share calculations as presented on the Consolidated Statements of Income and Comprehensive Income, the number of shares issued and outstanding per the Statement of Changes in Stockholders Equity and share amounts referenced throughout the Notes to the Consolidated Financial Statements have been adjusted to reflect split adjusted share amounts.

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

Comparison of Quarter Ended September 30, 2006 to Quarter Ended September 30, 2005

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, 2005, and in the Management s Discussion and Analysis contained in our Form 10-QSB, for the fiscal quarters ended March 31, 2006, and June 30, 2006.

Results of Operations

Total sales for the third quarter ended September 30, 2006 were $7,456,649. This represents the existing Lifeway Foods business line, as well as the Helios Nutrition subsidiary that was acquired July 27, 2006. Helios Nutrition and its subsidiary, Pride of Main Street Dairy accounted for a total of $897,614 in sales, with the Helios kefir brand accounting for $763,953 in sales, and the Pride of Main Street line accounting for $133,661 in sales.

Sales for the existing Lifeway Foods line increased by $1,364,386 (approximately 27%) to $6,559,034 during the three-month period ended September 30, 2006 from $5,194,648 during the same three-month period in 2005. This increase is primarily attributable to increased sales and awareness of Lifeway s existing drinkable dairy products including La Fruta, its flagship line, Kefir, as well as Lifeway s new kids kefir drink, Probugsä.

Cost of goods sold as a percentage of sales for the Lifeway Foods line was approximately 60% during the third quarter 2005, compared to about 59% during the same period in 2005. The increase was primarily attributable to the cost of freight, Lifeway s second largest cost of goods sold component, which was 85% higher in the third quarter 2006 compared to the same period in 2005. We expect to see the cost of freight decrease during the fourth quarter 2006.

Operating expenses as a percentage of sales for the Lifeway Foods line was approximately 25% during the third quarter 2006, compared to about 26% during the same period in 2005. Even though Lifeway incurred numerous one time legal and regulatory expenses related to the third quarter 2006 stock split, and the Helios acquisition, Lifeway was still able to decrease its operating expenses.

This decrease is primarily attributable to our continuing efforts to improve our production automation, through capital investments, thereby improving our overall operating income.

Total other income for the third quarter ended September 30, 2006 was $76,651, compared with $197,251 during the same period in 2005. This decrease is attributable to a $59,680 increase in interest expense, which includes approximately $56,000 in interest related to a $4.2 million note payable issued in connection with the Helios acquisition in July 2006, which was absent in 2005. The $4.2 million note payable is discussed in Note 8 of the Notes to Consolidated Financial Statements. The decrease is also attributable to gains on the sale of marketable securities, which was $89,260 in the third quarter ended September 2006, compared with $162,446 in the same period in 2005.

Provision for income taxes was $456,012, or a 38% tax rate during the third quarter 2006 compared with $400,464, or a 42% tax rate during the same period in 2005. Income taxes are discussed in Note 9 of the Notes to Consolidated Financial Statements.

Total net income for the group was $739,959, or $.04 per split adjusted share for the third quarter ended September 30, 2006, compared with $558,950 or $.03 per split adjusted share in the same period in 2005. This represents a 32% year over year increase.

Comparison of Nine Month Period Ended September 30, 2006 to Nine Month Period Ended September 30, 2005

Results of Operations

Total sales for the nine months ended September 30, 2006 were $19,827,069. This represents the existing Lifeway Foods business line, as well as the Helios Nutrition subsidiary that was acquired July 27, 2006. Helios Nutrition and its subsidiary, Pride of Main

Street Dairy accounted for a total of $897,615 in sales, with the Helios kefir brand accounting for $763,953 in sales, and the Pride of Main Street line accounting for $133,661 in sales.

Sales for the existing Lifeway Foods line increased by $4,005,377 (approximately 27%) to $18,929,453 during the nine month period ended September 30, 2006 from $14,924,076 during the same nine month period in 2005. This increase is primarily attributable to increased sales and awareness of Lifeway s existing drinkable dairy products including La Fruta, its flagship line, Kefir, as well as Lifeway s new kids kefir drink, Probugsä.

Cost of goods sold, as a percentage of sales for the Lifeway Foods line was approximately 58% during the nine month period ended September 30, 2006, compared to about 58% during the same period in 2005. Even though Lifeway s second largest cost of goods sold component, freight, increased 66% during the nine month period in 2006 compared to the same period in 2005, Lifeway was able to maintain a similar cost of goods level as in 2005 by maximizing its production efficiency. We expect to see the cost of freight to decrease during the fourth quarter 2006.

Total other income for the nine months ended September 30, 2006 was $362,965, compared with $500,520 during the same period in 2005. This decrease is primarily attributable to a $158,788 increase in interest expense, which includes approximately $56,000 in interest related to a $4.2 million note payable issued in connection with the Helios acquisition in July 2006, which was absent in 2005. The $4.2 million note payable is discussed in Note 8 of the Notes to Consolidated Financial Statements.

Total net income for the group was $2,384,661, or $.14 per split adjusted share for the nine months ended September 30, 2006, compared with $1,841,185 or $.11 per split adjusted share in the same period in 2005. This represents a 30% year over year increase.

Sources and Uses of Cash

Net cash used in investing activities was $3,079,769 during the nine months ended September 30, 2006, which is a decrease of $2,375,224 compared to the same period in 2005. This decrease is primarily due to the Company s purchase of a storage and distribution facility in 2005 of approximately $4.2 million. The company also used $2,514,679 net of cash acquired to purchase Helios Nutrition. The acquisition is discussed in Note 1 of the Notes to Consolidated Financial Statements.

Net cash used by financing activities was $970,776 during the nine months ended September 30, 2006, which is an increase of $3,554,853 compared to $2,574,077 of net cash provided by financing activities during the same period in 2005. This decrease is primarily attributable to the Company financing the purchase of the above mentioned facility in 2005. The Company took out a $3 million dollar note that has a maturity of 5 years, at an interest rate of 5.6%. The Company also purchased 89,682 shares of its treasury stock at a cost of $549,863 in the first nine months of 2006. In the first nine months of 2005, the Company purchased 100,000 shares of its treasury stock at a cost of $401,554 in the first nine months of 2005.

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 23, 2005, Lifeway s Board of Directors approved awards of an aggregate amount of 5,600 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain employees and consultants for services rendered to the Company. The stock awards were made on June 1, 2005 and have vesting periods of one year. The expense for the awards is measured as of June 1, 2005 at $12.50 per share for 5,600 shares, or a total stock award expense of $70,000. This expense will be recognized as the stock awards vest in 12 equal portions of $5,833, or 466 shares per month for one year.

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Lifeway closed the acquisition of Helios Nutrition, Ltd. (Helios) on August 3, 2006 by acquiring all of the issued and outstanding shares of Helios held by the Helios shareholders. Lifeway acquired all of the issued and outstanding stock of Helios from the stockholders for a combination of shares of common stock of Lifeway, cash and a promissory note issued by the Company in favor of the Helios stockholders in the principal amount of $4,200,000. As a condition of this transaction, Lifeway filed a Form S-3 on September 14, 2006 to register the shares issued to the stockholders. The review by the U.S. Securities Exchange Commission is still pending.

On June 8, 2006, Lifeway s Board of Directors voted to ratify, approve and accept a subdivision of the issued and outstanding common stock of the Company (a forward split) at a ratio of two shares (2) shares for each share of common stock issued and outstanding. This forward split became effective on August 16, 2006 for shareholders of record as of the close of business on July 19, 2006.

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 increases 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.

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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 6. EXHIBITS AND REPORTS ON FORM 8-K

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-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.

Reports on Form 8-K

1. Incorporated herein by reference to the Form 8-K filed with the Commission on July 10, 2006 (File No. 000-17363).

2. Incorporated herein by reference to the Form 8-K filed with the Commission on August 9, 2006 (File No. 000-17363).

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SIGNATURE

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

Date: November 20, 2006

LIFEWAY FOODS, INC.

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

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

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EXHIBIT INDEX

Exhibit Number	Description
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