

LIFEWAY FOODS INC  
Form 10-K  
March 31, 2009

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-K

R ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

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

For the transition period from: \_\_\_\_\_ to \_\_\_\_\_  
Commission file number: 0-17363

LIFEWAY FOODS, INC.  
(Name of registrant as specified in its charter)

Illinois  
(State or other jurisdiction of  
incorporation or organization)

36-3442829  
(IRS Employer  
Identification No.)

6431 West Oakton, Morton Grove, Illinois 60053  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number:  
(847) 967-1010

Securities registered under Section 12(b) of the Exchange Act:  
Common Stock, No Par Value

Securities registered under Section 12(g) of the Exchange Act:  
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions 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 Act). Yes  No

The issuer's revenues for its most recent fiscal year were: \$44,461,455.

The aggregate market value of the voting and non-voting common equity held by non-affiliates (approximately 4,822,576 shares) computed by reference to the price at which the stock was sold as of March 2, 2009 (\$7.65 per share as quoted on the National Market System of the Nasdaq Stock Market) was: \$36,892,706.

The number of shares outstanding of each of the issuer's classes of common equity, as of March 2, 2009 is 16,722,592 shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE:

No portions of the Notice of Annual Meeting and Proxy Statement, to be filed no later than April 30, 2009, for the Registrant's 2009 Annual Meeting of Shareholders, scheduled to be held June 19, 2009, are incorporated by reference in Part III.

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LIFEWAY FOODS, INC.

Table of Contents

|          |  |    |
|----------|--|----|
| PART I   |  |    |
| Item 1.  | Business   | 4  |
| Item 1A. | Risk Factors   | 13 |
| Item 1B. | Unresovled Staff Comments  | 13 |
| Item 2.  | Properties   | 13 |
| Item 3.  | Legal Proceedings  | 14 |
| Item 4.  | Submission of Matters to a Vote of Security Holders  | 14 |
| PART II  |  |    |
| Item 5.  | Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities | 14 |
| Item 6.  | Selected Financial Data  | 16 |
| Item 7.  | Management’s Discussion and Analysis of Financial Condition and Results of Operations                        | 16 |
| Item 7A. | Quantitative and Qualitative Disclosures About Market Risk   | 18 |
| Item 8.  | Financial Statements and Supplementary Data  | 18 |
| Item 9.  | Changes in and Disagreements With Accountants on Accounting and Financial Disclosure                         | 37 |
| Item 9A. | Controls and Procedures  | 37 |
| Item 9B. | Other Information  | 37 |
| PART III |  |    |
| Item 10. | Directors, Executive Officers and Corporate Governance   | 38 |
| Item 11. | Executive Compensation   | 41 |
| Item 12. | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters               | 43 |
| Item 13. | Certain Relationships and Related Transactions, and Director Independence                                    | 44 |
| Item 14. | Principal Accountant Fees and Services   | 44 |
| PART IV  |  |    |

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|          |  |    |
|----------|--|----|
| Item 15. | Exhibits, Financial Statement Schedules                  | 46 |
|          | Signatures   | 48 |
|          | Index of Exhibits  | 49 |
|          | List of Subsidiaries                                     |    |
|          | Consent of Independent Registered Public Accounting Firm |    |
|          | Rule 13a-14(a)/15d-14(a) Certifications                  |    |
|          | Section 1350 Certifications                              |    |
|          | Press Release  |    |

PART I

CAUTIONARY STATEMENT IDENTIFYING IMPORTANT FACTORS  
THAT COULD CAUSE THE COMPANY'S ACTUAL RESULTS TO  
DIFFER FROM THOSE PROJECTED IN FORWARD LOOKING STATEMENTS

In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, readers of this document and any document incorporated by reference herein, are advised that this document and documents incorporated by reference into this document contain both statements of historical facts and forward looking statements. Forward looking statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those indicated by the forward looking statements. Examples of forward looking statements include, but are not limited to (i) projections of revenues, income or loss, earnings or losses per share, capital expenditures, dividends, capital structure and other financial items, (ii) statements of Lifeway Foods, Inc.'s plans and objectives, including the introduction of new products, or estimates or predictions of actions by customers, suppliers, competitors or regulatory authorities, (iii) statements of future economic performance, and (iv) statements of assumptions underlying other statements and statements about Lifeway Foods, Inc. or its business.

This document and any documents incorporated by reference herein also identify important factors which could cause actual results to differ materially from those indicated by forward looking statements. These risks and uncertainties include price competition, the decisions of customers or consumers, the actions of competitors, changes in the pricing of commodities, the effects of government regulation, possible delays in the introduction of new products, customer acceptance of products and services, and other factors which are described herein and/or in documents incorporated by reference herein.

The cautionary statements made pursuant to the Private Litigation Securities Reform Act of 1995 above and elsewhere by Lifeway Foods, Inc. ("Lifeway" or the "Company") should not be construed as exhaustive or as any admission regarding the adequacy of disclosures made by Lifeway prior to the effective date of such act. Forward looking statements are beyond the ability of Lifeway to control and in many cases we cannot predict what factors would cause results to differ materially from those indicated by the forward looking statements.

ITEM 1. BUSINESS.

BUSINESS DEVELOPMENT

Lifeway Foods, Inc., an Illinois corporation, commenced operations in February 1986, and was incorporated under the laws of the State of Illinois on May 19, 1986. The Company's principal business activity is the manufacturing of probiotic, cultured, functional dairy and non-dairy health food products. Lifeway's primary products are kefir, a drinkable dairy beverage similar to but distinct from yogurt, in several flavors sold under the name "Lifeway Kefir" and "Helios Nutrition Organic Kefir"; a line of various drinkable yogurts sold under the "La Fruta", "Tuscan" and "Lassi" brands and "BasicsPlus," a dairy based immune-supporting dietary supplement beverage. The Company also produces several soy-based kefir beverages under the "SoyTreat" trademark. In addition to the drinkable products, Lifeway manufactures "Lifeway Farmer Cheese," a line of various farmer cheeses, a line of gourmet cream cheeses, and "Sweet Kiss," a fruit sugar-flavored spreadable cheese similar in consistency to cream cheese. The Company also manufactures and markets a vegetable-based seasoning under the "Golden Zesta" brand. In the Chicago metropolitan area, Lifeway distributes its products on its own trucks and via one distributor. The Company directly distributes its products in the Philadelphia metropolitan area using its own trucks. Lifeway manufactures all of its products at Company-owned facilities and distributes its products primarily throughout the United States.

SUBSIDIARY ENTITIES

On September 30, 1992, Lifeway formed a wholly-owned subsidiary, LFI Enterprises, Inc. ("LFIE"), incorporated in the State of Illinois. Until August 1, 2001, LFIE operated a "Russian" theme restaurant and supper club facility. On August 1, 2001, Lifeway ceased operations at the facility after condemnation proceedings were initiated by the Village of Niles, Illinois, which sought to control the property for municipal purposes. This property was sold in January 2003 for a capital gain of approximately \$1.2 million.

On March 19, 2004, LFIE formed Lifeway Foods Canada, LLC, an Illinois limited liability company ("LFC"), to serve as a holding company for prospective operations within Canada. LFIE is the manager and sole member of LFC.

On July 26, 2004, Lifeway, by its subsidiary, LFIE, acquired certain assets and inventory of Ilya's Farms, Inc., a twelve year old, privately-held gourmet cream cheese producer based in the Philadelphia metropolitan area. No prior relationship existed between Ilya's Farms, Inc. or its principal, Michael Kofman, and either the Company or LFIE.

The total cash purchase consideration of \$575,600 for the assets and inventory of Ilya's Farms, Inc. was paid by LFIE in cash from Company funds without financing. Additionally, there are certain royalty payments to be made in connection therewith. The Company provided a guaranty of payment for the transaction. The acquisition included approximately \$64,000 of tangible assets (including certain manufacturing equipment and a delivery truck) and inventory as well as the brand name "Ilya's Farms" and other trademarks and the recipes and manufacturing processes previously used by Ilya's Farms, Inc. The equipment acquired by LFIE from Ilya's Farms, Inc. was previously used to manufacture cream cheese products. The inventory which was purchased by LFIE consisted entirely of different varieties of cream cheese. The founder of Ilya's Farms, Inc., Michael Kofman, assisted LFIE over a one-month transition period and is available, if needed, on a consulting basis going forward. Additionally, LFIE has hired the 10 employees formerly employed by Ilya's Farms, Inc.

On August 3, 2006, the Company acquired all of the issued and outstanding stock of Helios Nutrition, Ltd. ("Helios") from the stockholders of Helios for a combination of 202,650 shares of the Company's common stock, \$2,500,000 in cash, and a promissory note issued by the Company in favor of Amani Holdings, LLC in the principal amount of \$4,200,000.

On February 6, 2009, the Company acquired all of the issued and outstanding stock (the "Shares") of Fresh Made, Inc., a Pennsylvania corporation ("Fresh") for a combination of \$8,050,000 (less certain offsets) in cash, and a promissory note

in the principal amount of \$2,735,000.00, due on February 6, 2011, 128,948 shares of common stock of Lifeway valued at a total of \$980,000.00, and cancellation of a \$265,000.00 loan. In connection with such acquisition, Lifeway also acquired 1.1355 acres of land in Philadelphia, PA (the "Property"). The consideration for the Property was \$2,000,000.00.

## BUSINESS OF ISSUER

### PRODUCTS

Lifeway's primary product is kefir, which, like the better-known product of yogurt, is a fermented dairy product. Kefir has a slightly effervescent quality, with a taste similar to yogurt and a consistency similar to buttermilk. It is a product distinct from yogurt because it incorporates the unique microorganisms of kefir as the cultures to ferment the milk. Lifeway's Kefir is a drinkable product intended for use as a breakfast meal or a snack, or as a base for lower-calorie dressings, dips, soups or sauces. Kefir is also used as the base of Lifeway's plain farmer's cheese, a cheese made without salt, sugar or animal rennet. In addition, kefir is the primary ingredient of Lifeway's "Sweet Kiss" product, a fruit sugar-flavored, cream cheese-like spread which is intended to be used as a dessert spread or frosting.

Kefir contains a unique mixture of several live microorganisms and nutrients such as proteins, minerals and vitamins. Kefir is highly digestible and, due to its acidity and enzymes, stimulates digestion of other foods. Kefir is considered to be the most favorable milk product for people suffering from genetically-based lactose intolerance. A study published in the May 2003 issue of the Journal of the American Dietetic Association suggests that kefir improves lactose digestion and tolerance in adults with lactose maldigestion. Studies also indicate that kefir may stimulate protein digestion and appetite, decrease the cholesterol content in blood, improve salivation and excretion of stomach and pancreatic enzymes and peristalsis. As compared to yogurt, many naturopathic practitioners consider kefir to be the best remedy for digestive troubles because it has a very low curd tension (the curd breaks up very easily into small particles). The curd of yogurt, on the other hand, holds together or breaks into lumps. The small size of the kefir curd facilitates digestion by presenting a large surface area on which digestive agents may work.

Kefir is a good source of calcium, protein, and Vitamin B-complex. In addition, because the fermentation process produces a less sour tasting product than yogurt, less sugar is required to make a desirable product, and the end product contains fewer calories than regular yogurt.

Lifeway currently sells some or all of the products listed below, except as specifically noted, to various retail establishments including supermarkets, grocery stores, gourmet shops, delicatessens and convenience stores.

**LIFEWAY'S KEFIR.** "Lifeway's Kefir" is a drinkable kefir product manufactured in ten regular and low-fat varieties, including plain, pomegranate, raspberry, blueberry, strawberry, cherry, peach, banana-strawberry, cappuccino and vanilla, and sold in 32 ounce containers and 8 ounce single serving containers featuring color-coded caps and labels describing nutritional information. In March 1996, Lifeway began marketing its non-fat, low cholesterol kefir in six flavors — plain, raspberry, strawberry, strawberry-banana, peach and blueberry. The kefir product is currently marketed under the name "Lifeway's Kefir," and is typically sold by retailers from their dairy sections.

**LIFEWAY'S ORGANIC SOYTREAT.** "SoyTreat" is a soy alternative to dairy kefir and is made from organic soy milk, which is derived from non-genetically modified soybeans. SoyTreat can be consumed by those who desire the benefits of kefir, but are lactose intolerant or interested in a soy-based alternative to milk. SoyTreat also provides 7.0g of soy protein per serving, and features the United States Food and Drug Administration-approved health claim, "25g of soy protein a day as part of a diet low in saturated fat can help lower cholesterol and reduce the risk of heart disease." At present SoyTreat is manufactured in two flavors: strawberry and peach.

**LIFEWAY'S ORGANIC KEFIR.** "Lifeway's Organic Kefir" meets the organic standards and specifications of the United States Department of Agriculture for organic products and is manufactured in five flavors: plain, wildberry, raspberry, strawberry and peach. Lifeway's Organic Kefir is sweetened with organic cane juice.

**LIFEWAY'S SLIM6.** "Lifeway's Slim6" is a line of low-fat kefir beverages with no added sugar designed for consumers who follow low-carbohydrate diets. Lifeway's Slim6 has only 8 grams of carbohydrates and 2.5 grams of fat per 8-ounce serving and is available in five flavors: strawberries n' cream, mixed berry, tropical fruit, strawberry-banana and an original, unsweetened version.

**LA FRUTA DRINKABLE YOGURT.** "La Fruta" is a yogurt like drink similar to a milkshake or smoothie that is specifically formulated to accommodate the Hispanic market, the fastest growing demographic in the United States. La Fruta is manufactured in six flavors: strawberry, mango, pina colada, banana-strawberry, horchata and tres leches.

**LA FRUTA CHEESE.** "La Fruta Cheese" is a cheese product similar to cream cheese that is specifically formulated to accommodate the Hispanic market, the fastest growing demographic in the United States. La Fruta Cheese is manufactured in a tres leches flavor.



TUSCAN BRAND DRINKABLE YOGURT. “Tuscan Brand Drinkable Yogurt” is a cultured dairy beverage mainly marketed on the East Coast and manufactured in a variety of flavors which vary depending upon distributor demand.

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**FARMER CHEESE.** “Farmer Cheese” is based on a cultured soft cheese and is intended to be used in a variety of recipes as a low fat, low-cholesterol, low-calorie substitute for cream cheese or ricotta, and is available in various styles.

**SWEET KISS.** “Sweet Kiss” is a sweet cheese probiotic spread available in five flavors: plain, plain with raisins, apple, peach and chocolate.

**ELITA; BAMBINO.** “Elita” and “Bambino” cheeses are low-fat, low-cholesterol kefir based cheese spreads which are marketed as an alternative to cream cheese.

**KRESTYANSKI TWOROG.** “Krestyanski Tworog” is a European-style kefir-based soft style cheese which can also be used in a variety of recipes, eaten with a spoon, used as a cheese spread, or substituted in recipes for cream cheese, ricotta cheese or cottage cheese and is marketed to consumers of various Eastern European ethnicities.

**BASICS PLUS.** “Basics Plus” is a patented kefir-based beverage product designed to improve gastrointestinal functions, enhancing the immune system. This product contains certain “passive immunity products” purchased from GalaGen, Inc. prior to its 2002 bankruptcy as described elsewhere in this report. Lifeway is currently engaged in discussion with several potential new suppliers of passive immunity products and is not currently manufacturing this beverage.

**KEFIR STARTER.** “Kefir Starter” is a powdered form of kefir that is sold in envelope packets and allows a consumer to make his or her own drinkable kefir at home by adding milk. Lifeway continues to develop sales of the product internationally and via the internet.

**LASSI.** “Lassi” is a cultured drink inspired by the traditions of India. Sold in 8 ounce containers in two flavors, strawberry and mango.

**GOLDEN ZESTA.** “Golden Zesta” is a vegetable-based seasoning, which, because of its low sodium content, may also be used as a salt substitute and is marketed to delicatessens, gourmet shops and ethnic grocers.

**IT’S PUDDING.** “It’s Pudding!” is the only organic pudding produced in the following flavors: rice, chocolate, vanilla, banana and tapioca.

**PROBUGS.** “ProBugs” is a kefir product that contains 10 live and active kefir cultures. Aimed at children ages 2-9, ProBugs comes in three flavors, “Sublime Slime Limetm,” “Orange Creamy Crawlertm” and “Goo-Berry Pietm” and is packaged in patented no spill spout pouches designed as cartoon bug characters Peter, Polly and Penelope ProBugtm.

**HELIOS NUTRITION ORGANIC KEFIR.** “Helios Nutrition Organic Kefir” is a kefir product made from organic milk and manufactured with a unique blend of active cultures. It is sold in 8 and 32 ounce bottles and made in five flavors: peach, plain, strawberry, vanilla and raspberry.

Lifeway intends to continue to develop new products based on kefir and Farmer Cheese. There is no assurance that such products or any other new products can be developed successfully or marketed profitably.

### DISTRIBUTION

With its twelve company-owned trucks, Lifeway distributes its products directly and extensively in the State of Illinois, primarily in the Chicago metropolitan area. Lifeway also directly distributes its products in the Philadelphia and Tri State metropolitan area.

In addition to the Chicago and Philadelphia and Tri State metropolitan areas, Lifeway's products are distributed to stores throughout the United States. Lifeway has verbal distribution arrangements with various distributors throughout the United States. These verbal distribution arrangements, in the opinion of Lifeway, allow management the necessary latitude to expand into new areas and markets and establish new relationships with distributors on an ongoing basis. Lifeway has not offered any exclusive territories to any distributors.

Distributors are provided Lifeway products at wholesale prices for distribution to their retail accounts. Lifeway believes that the price at which its products are sold to its distributors is competitive with the prices generally paid by distributors for similar products in the markets served. In all areas served, distributors currently deliver the products directly to the refrigerated cases of dairy sections of their retail customers. Each distributor carries a line of Lifeway's products on its trucks, checks the retail stores for space allocated to Lifeway's products, determines inventory requirements of the store and places Lifeway products directly into the retailers' dairy cases. Lifeway believes this method of distribution best serves the needs of each retail store, and is the best available means to ensure consistency and quality of product handling, quality control, flavor selection and favorable retail display. Under the distribution arrangements, each distributor must meet certain prescribed product handling, service and administrative requirements including, among others, frequency of delivery, replacement of damaged, old or substandard packages, and delivery of products directly to the refrigerated case.

Additionally, Lifeway has attempted international distribution of certain of its products by attempting to export to distributors operating in the Canadian provinces of Ontario and Quebec. Lifeway's products are subject to strict import quotas imposed by the Trade Control Policy Division of the Department of Foreign Affairs and International Trade of Canada. In an attempt to address this situation, management is exploring various alternatives to permit expansion of Lifeway's product line in Canada. Lifeway believes that it currently is in compliance with all applicable Canadian regulations.

## MARKETING

Lifeway continues to promote the verifiable nutritional characteristics, purity and good taste of its kefir and kefir-based products. Lifeway primarily advertises its products through local radio stations, which advertisements are directed to both users and non-users of cultured milk products of all kinds. In addition, through newspaper and magazine advertising, Lifeway provides educational information on its products and appeals to the common perception that the products may be of particular benefit for a wide range of ills, including intestinal disorders, and continues to educate the public on the possible health benefits which could be derived from the use of kefir and kefir-based products. Lifeway believes that the potential for healthful benefits as suggested by the educational information it has obtained properly serves as the basis for such an advertising strategy.

In addition to local radio stations, newspapers and magazines, Lifeway promotes further exposure of its products through the internet, catalog advertising and promotion, store demonstrations throughout the United States, and participation in various trade shows. Lifeway also sponsors several different sporting events in the Chicago metropolitan area as an additional marketing tool.

Lifeway does not promote products manufactured under the LaFruta and Tuscan brand names with any marketing or advertising.

## COMPETITION

Although Lifeway faces a small amount of direct competition in the United States and Canadian markets for kefir products, Lifeway's kefir-based products compete with all other yogurt and other dairy products. Many producers of yogurt and other dairy products are well-established and have significantly greater financial resources than Lifeway to promote their products.

In connection with the certain Stockholders' Agreement, as amended, between Lifeway, Danone Foods, Inc. and other parties, as well as certain other transactions between these two foregoing companies described elsewhere in this report, the parties agreed that they would not compete with each other during the term of the Stockholders' Agreement, as extended, with respect to certain yogurt, cheese and kefir products. Specifically, Lifeway agreed not to produce or sell in the United States or Western Europe any type of yogurt, fromage frais, Italian style cheese, chilled desserts or any soy-based products, other than those that are kefir-based or those that were already being produced and sold by

Lifeway as of December 24, 1999, and Danone agreed not to produce or sell any type of kefir-based products in the United States. On January 15, 2009, the term of the Stockholders' Agreement was extended to December 31, 2009.

#### SUPPLIERS

Lifeway purchases its raw materials, such as milk, sugar and fruit from unaffiliated suppliers, and is not limited or contractually bound to any supplier. Lifeway has ready access to multiple suppliers for all of its raw materials and packaging requirements. Prior to making any purchase, Lifeway determines which supplier can offer the lowest price for the highest quality of product. The raw and packaging materials purchased by Lifeway are considered commodity items and are widely available on the open market with the exception of the licensed ingredient in BasicsPlus. Lifeway owns and operates the means of production of all of its products.

## MAJOR CUSTOMERS

Lifeway distributes its products to numerous accounts throughout the United States. Concentrations of credit with regard to trade accounts receivable and sales are limited due to the fact that Lifeway's customers are spread across different geographic areas. The customers are concentrated in the retail food industry, for example, Trader's Joe's. In 2008, Lifeway's largest customer represented approximately 9% of sales and reflected sales in various regions of the United States outside the Chicago, Illinois metropolitan area.

## TRANSACTIONS WITH GROUPE DANONE SA

All share amounts and prices in this subsection are historical and have not been adjusted for the stock split which occurred in the first quarter of 2004 or in the second quarter of 2006. On October 1, 1999, Lifeway and certain members of the Smolyansky family sold shares of restricted common stock to Danone at \$10.00 per share. Later in 1999, Danone purchased additional shares of common stock from certain individuals, including shares purchased in transactions with certain Company affiliates, including Lifeway's founder Michael Smolyansky, Val Nikolenko, Vice President of Production and Pol Sikar, a director, and his affiliates. As a result of these transactions, Danone became the beneficial owner of 20% of the outstanding common stock of Lifeway. Pursuant to the terms and conditions of the transaction, Lifeway granted certain limited rights to Danone, which include a right to nominate one director, anti-dilutive rights relating to future offerings and limited registration rights. In addition, as described above, Lifeway and Danone are parties to a Stockholders' Agreement dated October 1, 1999, pursuant to which the parties agreed that they would not compete with each other through December 31, 2009 with respect to certain yogurt, cheese and kefir products. The Stockholders' Agreement also provides that Danone may not own more than 20% of the outstanding common stock of Lifeway as a result of direct or indirect acquisition of shares. Danone's interest as of December 31, 2008 was approximately 20.7% due to reductions in Lifeway's shares outstanding, primarily due to share repurchases by Lifeway. On January 15, 2009, the term of the Stockholders' Agreement was extended to December 31, 2009. The ability of Danone to sell such a large stake in Lifeway could have a negative effect on the Company's stock price.

## PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS

All trademark registrations have been granted by the United States Patent and Trademark Office ("USPTO"), unless otherwise noted below. Each trademark registration may be renewed upon expiration. Lifeway intends to make all timely filings as required for all trademarks listed.

| Mark       | Use   | Date of Registration | Expiration of Registration | Comments  |
|------------|---|----------------------|----------------------------|---|
| Lifeway    | Cheese and kefir  | December 12, 1989    | December 12, 2009          | Registration was timely renewed on December 12, 1999. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date. |
| Sweet Kiss | Cheese, cottage cheese and other milk products, excluding ice cream, ice milk and frozen yogurt | February 10, 1998    | February 10, 2018          | Registration was timely renewed on May 23, 2008. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.      |
| Kwashenka  |   | February 10, 1998    | February 10, 2018          |   |

Kefir, yogurt,  
cheeses, cottage  
cheeses and other  
milk products,  
excluding ice  
cream, ice milk and  
frozen yogurt

An Affidavit of Continued Use was timely filed between the 5th and 6th anniversaries of the registration date. Registration is renewable between the 9th and 10th anniversaries of the registration date or the six-month grace period following the registration expiration date.

Bambino

Cheeses, cottage  
cheeses and other  
milk products

October 7, 2003

October 7, 2013

An Affidavit of Continued Use was timely filed between the 5th and 6th anniversaries of the registration date. Registration is renewable between the 9th and 10th anniversaries of the registration date or the six-month grace period following the registration expiration date.

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| Mark   | Use  | Date of Registration | Expiration of Registration | Comments   |
|--|--|----------------------|----------------------------|--|
| KPECTBRHCKNN<br>(A stylized presentation of “Krestyanskiy” in Cyrillic characters-means “Peasant”) | Cheeses, cottage cheeses and other milk products excluding ice cream, ice milk and frozen yogurt     | September 8, 1998    | September 8, 2018          | Registration was timely renewed on August 23, 2008. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.  |
| BA3APHBIII (A stylized presentation of “Bazarny” in Cyrillic characters)                           | Pressed unripened cheese   | July 25, 2000        | July 25, 2010              | An Affidavit of Continued Use was timely filed between the 5th and 6th anniversaries of the registration date. Registration is renewable between the 9th and 10th anniversaries of the registration date or the six-month grace period following the registration expiration date. |
| BA3APHBIII (A stylized presentation of “Bazarny” in Cyrillic characters)                           | Cultured milk products, excluding ice cream, ice milk and frozen yogurt; cheeses and cottage cheese. |                      |                            | Application filed on July 31, 2008, based on actual use.   |
| BAZARNY  | Cultured milk products, excluding ice cream, ice milk and frozen yogurt; cheeses and cottage cheese. |                      |                            | Application filed on July 31, 2008, based on actual use.   |
| SoyTreat   | Soy-based food beverage intended for use as cultured milk substitute                                 | November 11, 2008    | November 11, 2014          | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date.                                       |
| Korovka  | Dairy-based spread   | November 6, 2001     | November 6, 2011           | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period   |



|          |   |                |                |   |
|----------|---|----------------|----------------|---|
| La Fruta | Cultured milk products, excluding ice cream, ice milk and frozen yogurt | March 29, 2005 | March 29, 2015 | following the sixth anniversary date.<br>Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date. |
|----------|---|----------------|----------------|---|

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| Mark  | Use  | Date of Registration | Expiration of Registration | Comments   |
|---|--|----------------------|----------------------------|--|
| PTICHYE MOLOKO (a stylized presentation of “Ptichye Moloko” in Cyrillic characters) | Kefir, yogurt, cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and frozen yogurt | October 18, 2005     | October 18, 2015           | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date.   |
| BIOKEFIR  | yogurt, cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and frozen yogurt        |                      |                            | Application filed April 8, 2008, on an intent-to-use basis. A Notice of Allowance was issued on November 18, 2008. A Statement of Use is due on May 18, 2009, or within the 3 year extension period following the Notice of Allowance date. After acceptance of the Statement of Use, registration will precede in due course. |
| SUBLIME SLIME LIME  | Dairy-based beverages; dairy-based food beverages; kefir; soy- based food beverage used as milk substitute       | July 10, 2007        | July 10, 2013              | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date.   |
| PROBUGS   | Dairy-based beverages; dairy-based food beverages; kefir; soy- based food beverage used as milk substitute       | July 10, 2007        | July 10, 2013              | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date.   |
| ORANGE CREAMY CRAWLER   | Dairy-based beverages; dairy-based food beverages; kefir; soy- based food beverage used as milk substitute       | July 10, 2007        | July 10, 2013              | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary   |

|          |  |               |               |   |
|----------|--|---------------|---------------|---|
| (DESIGN) | Dairy-based beverages;<br>dairy-based food beverages; kefir;<br>soy- based food beverage used as milk substitute | July 17, 2007 | July 17, 2013 | date.<br>Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date. |
| (DESIGN) | Dairy-based beverages;<br>dairy-based food beverages; kefir;<br>soy- based food beverage used as milk substitute | July 10, 2007 | July 10, 2013 | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date.          |

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| Mark                 | Use   | Date of Registration | Expiration of Registration | Comments   |
|----------------------|---|----------------------|----------------------------|--|
| (DESIGN)<br>Penelope | Dairy-based beverages;<br>dairy-based food beverages; kefir;<br>soy- based food beverage used as milk substitute                    | April 8, 2008        | April 8, 2014              | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date. |
| PRIDE OF MAIN STREET | Dairy Product   | November 9, 1987     | November 9, 2007           | Only for the State of MN, not in US  |
| HELIOS NUTRITION     | Dairy products and functional foods   | October 5, 1999      | October 5, 2009            | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date. |
| STARFRUIT            | Franchise services, namely, offering technical and business management assistance in the establishment and operation of restaurants | October 7, 2008      | October 7, 2014            | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date. |
| STARFRUIT            | Restaurant services   | June 24, 2008        | June 24, 2014              | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary date. |
| GOO-BERRY PIE        | Dairy-based beverages;<br>dairy-based food beverages; kefir;<br>soy-based food beverage used as a milk substitute                   | April 1, 2008        | April 1, 2014              | Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the 5th and 6th anniversaries of the registration date or the six-month grace period following the sixth anniversary       |

date.

## PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS

Lifeway also uses the following unregistered trademarks, and claims common law rights to: “Elita,” “Healthy Foods Today for a Better Life Tomorrow,” “Milkshake Smoothie,” “Toplenka,” “White Cheese,” “Drink It to Be Beautiful Inside and Out,” “Golden Zesta” and “Pride of Main Street.”

On December 27, 1990, Lifeway purchased the Tuscan brand-name liquid drinkable yogurt customer list along with a limited license of the trademark and use of the Tuscan liquid yogurt U.P.C. codes from a third party.

In October 1998, Lifeway entered into a sublicense agreement with GalaGen, Inc. and Metagenics, Inc. with an effective date of May 1, 1998 (“Lifeway sublicense”), wherein GalaGen sublicensed patent rights of Metagenics for kefir-based products containing natural immune components exclusively to Lifeway. Under the rights granted to it by the Lifeway sublicense, Lifeway manufactures and sells products using the Basics Plus trademark. GalaGen had acquired the primary license for such patent rights in an agreement executed with Metagenics in April 1998. The terms of the Lifeway sublicense provide that Metagenics will permit Lifeway to continue to have the exclusive patent rights to produce or sell kefir-based products containing natural immune components in the event the original license between GalaGen and Metagenics is terminated, and such termination was not caused by Lifeway. On February 25, 2002, GalaGen filed a petition for bankruptcy in the United States Bankruptcy Court, District of Minnesota, which terminated both its primary license with Metagenics and its participation in the Lifeway sublicense. The license and sublicense were excluded from the sale of assets of GalaGen pursuant to an order of the Bankruptcy Court. Lifeway has not received any indication that Metagenics will not permit Lifeway to continue to have the exclusive patent rights to produce or sell kefir-based products containing natural immune components. Thus, Lifeway believes that it continues to have the exclusive patent rights licensed directly from Metagenics. Either party may terminate the license agreement for cause. The term of the license agreement expires when the last valid claim of the patent rights expires, which currently is July 2, 2013, however, this term can be extended in accordance with the terms of the license agreement.

In connection with the purchase of Ilya’s Farm, Inc., the Company has undertaken a royalty obligation of 5% of all sales of Ilya’s Farm, Inc.’s products, which is paid quarterly, in arrears.

## REGULATION

Lifeway is subject to regulation by federal, state and local governmental authorities regarding the distribution and sale of food products. Although Lifeway believes that it currently has all material government permits, licenses, qualifications and approvals for its operations, there can be no assurance that Lifeway will be able to maintain its existing licenses and permits or to obtain any future licenses, permits, qualifications or approvals which may be required for the operation of Lifeway’s business.

Lifeway believes that it is currently in compliance with all applicable environmental laws and that the cost of such compliance was not material to the financial position of Lifeway.

In addition, any Lifeway products exported to Canada would be subject to strict quotas imposed by the Trade Control Policy Division of the Department of Foreign Affairs and International Trade of Canada. Lifeway believes that it currently is in compliance with all applicable Canadian regulations. The Company exported no products to Canada in 2008.

## RESEARCH AND DEVELOPMENT

Lifeway continues its program of new product development, centered around the nutritional and “low calorie” features of its proprietary kefir formulas.

Lifeway conducts primarily all of its research internally, but at times will employ the services of an outside testing facility. During 2007 and 2008, the amount Lifeway expended for research and new product development was not material to the financial position of Lifeway and no amount was customer supported.

## EMPLOYEES

Lifeway currently employs approximately 200 employees, all of whom are full-time employees. Substantially all of these employees are engaged in the manufacturing of the Company's products. None of Lifeway's employees are covered by collective bargaining agreements.

## ITEM 1A. RISK FACTORS.

Not applicable to smaller reporting company.

## ITEM 1B. UNRESOLVED STAFF COMMENTS.

Not applicable.

## ITEM 2. PROPERTIES.

On May 16, 1988, Lifeway purchased an approximately 26,000 square foot parcel of real property, including an approximately 8,500 square foot one-story brick building in good condition, located at 7625 N. Austin Avenue, Skokie, Illinois. Lifeway uses this facility for manufacturing and storage and has no plans to improve or renovate this property. The acquisition loan to Lifeway from 1st National Bank of Morton Grove, collateralized by the real estate, was refinanced in 1998 by Lifeway and paid off in full on February 21, 2002. Lifeway is the only occupant of this property and presently holds fee simple title free and clear of all encumbrances thereto. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

On October 16, 1996, Lifeway purchased a 110,000 square foot commercially-zoned parcel of real property, including a 46,000 square foot one-story brick building in good condition, located at 6431 Oakton Avenue, Morton Grove, Illinois. This property is used as Lifeway's corporate headquarters and main manufacturing facility. This property has been improved every year since the time of purchase by the addition of custom-built refrigerated storage space and the addition of various machinery and equipment used to manufacture, package and store Lifeway's products. Lifeway is the only occupant of this property and presently holds fee simple title subject to a mortgage which secures the property as collateral for the acquisition loan to Lifeway from MB Financial Bank of Morton Grove. The acquisition loan was refinanced in September 2006 at a rate of 7% and is payable in monthly principal and interest installments of \$3,273, with a balloon payment of \$416,825 due in September 2011. At December 31, 2008, the loan had a balance of \$438,926. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

In June 2005, the Company purchased a 100,000-square-foot distribution and warehousing facility that is equipped with 40,000 square feet of refrigeration. The facility, located at 6101 Gross Point Road in Niles, Illinois, will be used to store raw materials and finished goods in order to relieve space pressures at the Company's existing 50,000-square foot building, less than a mile away. The additional space at the Company's main plant will be used to expand production capacity for the Company's kefir and other probiotic products. Lifeway is the only occupant of this property and presently holds fee simple title subject to a mortgage which secures the property as collateral for the acquisition loan to Lifeway from Harris Bank at a rate of 5.6% and is payable in monthly principal and interest installments of \$19,513 with a balloon payment of \$2,652,142.70 due July 14, 2010. At December 31, 2008, the loan had a balance of \$2,760,288. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

Included in the purchase of Pride of Main Street Dairy on August 3, 2006, Lifeway acquired an approximately 35,000 square foot commercially zoned parcel of real estate located at 214 Main Street S. Sauk Centre, MN, including a 16,000 square foot two-story brick building used for production, and a 5,600 square foot storage facility. This



property is used as the main headquarters and main production facility for Pride of Main Street Dairy. The building was built in the 1920's with an addition in 1990. The facility is being used to produce all of the Pride of Main Street Dairy products, and approximately 70% of the Helios Nutrition Organic Kefir, with the remaining 30% being produced in Lifeway's main production facility in Morton Grove, Illinois. Pride of Main Street is the only occupier of this property and presently holds fee simple title free and clear of all encumbrances thereto. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

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On February 6, 2009, in connection with the Company's acquisition of Fresh Made, Inc., a Pennsylvania corporation, Lifeway also acquired 1.1355 acres of land in Philadelphia, PA (the "Property"). The consideration for the Property was \$2,000,000.00. Fresh Made is the only occupier of this property. The Company holds fee simple title free and clear of all encumbrances other than that certain mortgage securing indebtedness due to the seller's and incurred in connection with its acquisition.

For financial statement and tax purposes, Lifeway depreciates its buildings and improvements on a straight line basis over 31 and 39 years.

Management believes that Lifeway has adequate insurance coverage for all its properties.

### ITEM 3. LEGAL PROCEEDINGS.

Lifeway is from time to time engaged in litigation matters arising in the ordinary course of business none of which presently is expected to have a material adverse effect on its business results or operations.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matter was submitted during the fourth quarter of the fiscal year ended December 31, 2008, to a vote of security holders through the solicitation of proxies or otherwise.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

#### MARKET INFORMATION

Lifeway's Common Stock, no par value, the only class of common equity of Lifeway, is traded on The Nasdaq Stock Market National Market System under the symbol "LWAY." Trading commenced on March 29, 1988.

The range of high and low bid quotations for Lifeway's Common Stock for the quarterly periods within the two most recent fiscal years, as reported by The Nasdaq Stock Market National Market System, is set forth in the following table:

|                  | Low Bid | High Bid |
|------------------|---------|----------|
| First Qtr. 2007  | 8.51    | 10.24    |
| Second Qtr. 2007 | 8.55    | 11.59    |
| Third Qtr. 2007  | 11.09   | 17.75    |
| Fourth Qtr. 2007 | 9.62    | 20.75    |
| First Qtr. 2008  | 9.25    | 11.75    |
| Second Qtr. 2008 | 10.40   | 14.05    |
| Third Qtr. 2008  | 9.02    | 15.48    |
| Fourth Qtr. 2008 | 5.43    | 11.89    |

Note: The foregoing quotations have been adjusted for the August 14, 2006 two-for-one company stock split.

As of March 2, 2009, there were approximately 88 holders of record of Lifeway's Common Stock. The Company has no information regarding beneficial owners whose shares are held in street name.

#### DIVIDENDS

Lifeway has paid no cash dividends on its Common Stock since inception and management does not anticipate that such dividends will be paid in the foreseeable future.

14

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## SALES OF UNREGISTERED SECURITIES

There were no sales of unregistered securities in 2008.

## PURCHASES OF THE COMPANY'S SECURITIES

| Period                                     | (a) Total<br>Numbers of<br>Shares (or Units)<br>Purchased | (b) Average Price<br>Paid per Share (or<br>Unit) | (c) Total Number<br>of Shares (or<br>Units) Purchased<br>as Part of<br>Publicly<br>Announced Plans<br>or Programs | (d) Maximum<br>Number (or<br>Approximate<br>Dollar Value) of<br>Shares (or Units)<br>that May Yet Be<br>Purchased Under<br>the Plans or<br>Programs |
|--|---|--|---|---|
| January 1, 2008 to January 31,<br>2008*    | 3,000   | \$ 9.53  | 3,000   | 97,000  |
| February 1, 2008 to February 28,<br>2008 * | 15,800  | 10.12  | 15,800  | 81,200  |
| March 1, 2008 to March 31, 2008*           | 18,200  | 9.59   | 18,200  | 63,000  |
| April 1, 2008 to April 31, 2008*           | 21,745  | 12.80  | 21,745  | 41,255  |
| May 1, 2008 to May 31, 2008*               | 24,418  | 12.47  | 24,418  | 16,837  |
| June 1, 2008 to June 30, 2008*             | 7,656   | 12.12  | 7,656   | 9,181   |
| July 1, 2008 to July 30, 2008*             | 9,181   | 11.03  | 9,181   | 0   |
| *Total                                     | 100,000   | \$ 11.09   | 100,000   | 0   |
| December 1, 2008 to December 31,<br>2008** | 12,009  | \$ 8.22  | 12,009  | 87,991  |
| **Total                                    | 12,009  | \$ 8.22  | 12,009  | 87,991  |

\* Pursuant to the share repurchase program approved on December 17, 2007 for 100,000 split adjusted shares with a plan expiration date of one year.

\*\* Pursuant to the share repurchase program approved November 20, 2008 for 100,000 split adjusted shares with a plan expiration date of one year. As of the date of this filing, Lifeway has repurchased an additional 15,195 shares of the Company's securities in 2009 pursuant to this program at a total cost of \$101,628.31.

## EQUITY COMPENSATION PLAN INFORMATION

See Part III, Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, of this Annual Report on Form 10-K for information regarding securities authorized for issuance under our equity compensation plans.

ITEM 6. SELECTED FINANCIAL DATA.

Not applicable to smaller reporting company.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS .

RESULTS OF OPERATIONS

The following analysis should be read in conjunction with the audited financial statements of the Company and related notes included elsewhere in this annual report and the unaudited financial statements and Management's Discussion and Analysis contained in our Form 10-QSB, for the fiscal quarters ended March 31, 2008, June 30, 2008, and September 30, 2008.

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

Sales increased by \$401,371, (approximately 4%) to \$10,575,543 during the three month period ended December 31, 2008 from \$10,174,172 during the same three month period in 2007. This increase is primarily attributable to increased sales and awareness of Lifeway's flagship product, Kefir and Probugs, Lifeway's organic kids oriented Kefir. The company's flagship brand Lifeway, grew 8% in the fourth quarter 2008 when compared to the same quarter in 2007. The company's Helios Organic Kefir brand, which was acquired in August 2006, saw a decline in sales of \$153,000 from \$1,043,000 in the fourth quarter 2007 to \$890,000 in the same period in 2008 or a decrease of 14.6%. The decrease is primarily attributable to the decline in demand of higher cost, premium organic products as well as an overall slowdown in demand associated with retailers who primarily sell these products. We believe that this slowdown in this premium priced food segment is temporary as macro economic conditions improve.

Cost of goods sold as a percentage of sales was approximately 82% during the fourth quarter 2008, compared to about 77% during the same period in 2007. This increase is primarily attributable to the increase in labor costs as well as the costs of packaging supplies and transportation expenses. During the fourth quarter 2008, oil related production supplies and fuel surcharges on product deliveries remained at higher levels when compared to the same period 2007, but have subsequently begun to decrease as the price of oil has decreased since the record highs experienced in August and September 2008. Historically, there is a several month lag when material suppliers institute price decreases based on the declining costs of the underlying materials. Additionally, as part of Lifeway's growth strategy, the company increased its product sampling and demonstration activities, couponing, and other promotional initiatives in the fourth quarter 2008, when compared to the same period in 2007, which has an impact on cost of goods sold. During the fourth quarter 2008, the company also created a reserve account for these types of promotional expenses off invoice in the amount \$75,000 that did not exist in the fourth quarter 2007.

Even though the cost of conventional milk was lower in the fourth quarter 2008 compared to the same period a year ago, the cost of organic milk and other organic raw material ingredients increased approximately 10% during this same period. In the fourth quarter 2008, amount of organic products sold comprised approximately 30% of Lifeway's total sales. These products include Lifeway's Organic Kefir, Lifeway's Organic ProBugs kids Kefir, and Lifeway's Helios Organic Kefir lines.

Operating expenses as a percentage of sales was approximately 19% during the fourth quarter, 2008, compared to about 20% during the same period in 2007. This decrease is primarily attributable to a decrease in selling related expenses and operating synergies gained by the consolidation of the 2006 Helios Nutrition acquisition into our overall operations, as well as our continuing efforts to maximize efficiency through capital investments. Even though there were substantial professional fees and expenses paid in the fourth quarter, 2008 related to the February 6, 2009 acquisition of Fresh Made, Inc., we were able to lower the overall operating expenses as a percentage of sales during the fourth quarter, 2008, when compared to the same period a year ago.

Total other expenses for the fourth quarter 2008 were \$1,252,744, compared with total other expenses of \$91,373 during the same period in 2007. This increase is primarily attributable to a higher realized loss on the sale of marketable securities in 2008, when compared to the same period in 2007. During the fourth quarter 2008, the company realized losses in the amount of \$587,243 and recognized an impairment to marketable securities in the amount of \$687,971. During the fourth quarter 2007, the company realized losses in the amount of \$123,799. Marketable securities are discussed in Note 4 of the Notes to Consolidated Financial Statements.

Total net loss for the group was \$742,965, or \$.04 per split adjusted share for the fourth quarter, 2008, compared with \$153,109, or \$.01 per split adjusted share in the same period in 2007.

#### Comparison of Year Ended December 31, 2008 to Year Ended December 31, 2007

Sales increased by \$5,732,299 (approximately 15%) to \$44,461,455 during the twelve month period ended December 31, 2008 from \$38,729,156 during the same twelve month period in 2007. This increase is primarily attributable to increased sales and awareness of Lifeway's flagship product, Kefir and Probugs, Lifeway's organic kids oriented Kefir. The company's flagship brand, Lifeway Kefir grew approximately 17% in 2008 when compared to 2007. Included in that figure is Lifeway Probugs Organic Kefir, which increased sales 124% to \$1,760,254 in 2008 compared to sales of \$786,326 in 2007. In 2008, the Helios Kefir brand generated revenues of \$4,482,848, compared to 2007 revenues of \$4,563,026.

Cost of goods sold as a percentage of sales excluding depreciation expense was approximately 70% in 2008, compared to about 66% in 2007. This increase is primarily attributable to the increase in labor costs as well as the costs of packaging supplies and transportation expenses. During the 2008, oil related production supplies and fuel surcharges on product deliveries remained at higher levels when compared to 2007, but have subsequently begun to decrease as the price of oil has decreased since the record highs experienced in August and September 2008. Historically, there is a several month lag when material suppliers institute price decreases based on the declining costs of the underlying materials. Additionally, as part of Lifeway's growth strategy, the company increased its product sampling and demonstration activities, couponing, and other promotional initiatives in the fourth quarter 2008, when compared to the same period in 2007, which has an impact on cost of goods sold. During the fourth quarter 2008, the company also created a reserve account for these types of promotional expenses off invoice in the amount \$75,000 that did not exist in the fourth quarter 2007. Milk prices on average were similar as a whole in 2008 when compared to 2007.

Operating expenses as a percentage of sales was approximately 19% in 2008, compared to about 20% in 2007. This decrease is primarily attributable to an increase in sales, a decrease in selling related expenses and operating synergies gained by the consolidation of the 2006 Helios Nutrition acquisition into our overall operations, as well as our continuing efforts to maximize efficiency through capital investments. Even though there were substantial professional fees and expenses related to the February 6, 2009 acquisition of Fresh Made, Inc. paid in the fourth quarter 2008, we were able to lower the overall operating expenses as a percentage of sales during the fourth quarter 2008, when compared to the same period a year ago.

Total other expenses for 2008 were \$1,598,930, compared with total other income of \$528,150 during the same period in 2007. This increase in expenses is primarily attributable to a higher realized loss on the sale of marketable securities in 2008, when compared to the same period in 2007. During 2008, the company realized losses in the amount of \$733,647 and recognized an impairment to marketable securities in the amount of \$958,879. During 2007, the company realized gains in the amount of \$539,739. Marketable securities are discussed in Note 4 of the notes to the financial statements.

Provision for income taxes was \$679,789, or a 26% tax rate in 2008 compared with \$1,812,539 or a 37% tax rate in 2007. Income taxes are discussed in Note 9 of the Notes to Consolidated Financial Statements.

Total net income for the group was \$1,912,275, or \$.11 per split adjusted share for the twelve months ended December 31, 2008, compared with \$3,152,660, or \$.19 per split adjusted share in the same period in 2007.

#### SOURCES AND USES OF CASH IN 2008

Net cash provided by operating activities was \$4,733,660 during the twelve months ended December 31, 2008, which is an increase of \$2,386,523 compared to \$2,347,137 of net cash provided by operating activities the same period in 2007. This increase in cash provided by operating activities is primarily due to a \$1,393,370 swing in the impact inventories had on cash flows as of December 31, 2008, from the same period in 2007.

Net cash used in investing activities was \$2,616,344 during the twelve months ended December 31, 2008, which is an increase of \$1,715,014 compared to the same period in 2007. This increase is primarily due to the Company's sale of \$7,168,246 of marketable securities during 2007 compared to selling \$5,323,423 of marketable securities during 2008, therefore generating more cash by selling investments in 2007. The company also used \$2,157,315 to purchase machinery and equipment in 2008 compared with using \$1,824,879 to purchase machinery and equipment in 2007. The Company has no additional capital expenditures outside the ordinary course of business.

Net cash used in financing activities was \$2,435,953 during the twelve months ended December 31, 2008, which is an increase of \$38,219 compared to \$2,397,734 of net cash used in financing activities during the same period in

2007. This increase is primarily attributable to the Company's repurchase of \$1,239,488 of treasury shares during 2007, compared with the Company's repurchase of \$752,603 of treasury shares during 2007.

A significant portion of our assets are held in marketable securities. All 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. Other than the February 6, 2009 acquisition of Fresh Made, Inc., we know of no trend, demand or event which would negatively affect liquidity in 2009. 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 June 13, 2008, Lifeway's Board of Directors approved awards of an aggregate amount of 10,500 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain key employees and consultants for services rendered to the Company. The stock awards were made on June 13, 2008 and have vesting periods of one year. The expense for the awards is measured as of July 1, 2007 at \$11.87 per share for 10,500 shares, or a total stock award expense of \$124,635. This expense will be recognized as the stock awards vest in 12 equal portions of \$10,386, or 875 shares per month for one year.

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

As stated, the Company acquired Fresh Made, Inc. on February 6, 2009. This acquisition will affect the Company's sales and operating income as the Fresh Made operations are fully assimilated into the Company's operations.



### Off-Balance Sheet Arrangements

We have never entered into any off-balance sheet financing arrangements and have never established any special purpose entities. We have not guaranteed any debt or commitments of other entities or entered into any options on non-financial assets.

### 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.

### Subsequent Events

On February 6, 2009, Lifeway Foods, Inc., a Illinois corporation ("Lifeway") entered into and consummated a Stock Purchase Agreement (the "Stock Agreement") by and among Lifeway, Ilya Mandel, an individual and Michael Edelson, an individual (each a "Seller" and collectively "Sellers").

Upon the terms and subject to the conditions set forth in the Stock Agreement, Lifeway purchased from Sellers all of the issued and outstanding stock (the "Shares") of Fresh Made, Inc., a Pennsylvania corporation ("Fresh"). The consideration for the Shares was an aggregate of \$8,050,000, less certain offsets for any selling expenses in excess of certain limits set forth in the Stock Agreement and other payments and funded debt all as set forth in the Stock Agreement, a note in the principal amount of \$2,735,000, due on February 6, 2011, 128,948 shares of common stock of Lifeway valued at a total of \$980,000 ("Lifeway's Common Stock"), the cancellation of a loan in the principal amount of \$265,000 and not more than \$98,000 in funds held in Fresh's two accounts with Vist Financial Corp. The issuance of Lifeway's Common Stock was exempted from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended.

Also on February 6, 2009, Lifeway entered into and consummated a Real Property Purchase Agreement (the "Real Property Agreement") by and among Sellers and Lifeway. Pursuant to the Real Property Agreement, Lifeway acquired 1.1355 acres of land in Philadelphia, PA (the "Property") from Sellers. The consideration for the Property was \$2,000,000.

### Recent Accounting Pronouncements

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

statements issued for fiscal years beginning after December 15, 2008. The Company will apply the provisions of this standard to any acquisitions that it completes on or after December 15, 2008.

## Forward Looking Statements

In this report, in reports subsequently filed by Lifeway with the SEC on Form 10-QSB and filed or furnished on Form 8-K, and in related comments by management, our use of the words “believe,” “expect,” “anticipate,” “estimate,” “forecast,” “objective,” “plan,” “goal,” “project,” “explore,” “priorities/targets,” and similar expressions is intended to identify forward-looking statements. While these statements represent our current judgment on what the future may hold, and we believe these judgments are reasonable, actual results may differ materially due to numerous important factors that are described in this report and other factors that may be described in subsequent reports which Lifeway may file with the SEC on Form 10-QSB and filed or furnished on Form 8-K, including but not limited to:

- Changes in economic conditions, commodity prices;

Shortages of and price increase for fuel, labor strikes or work stoppages, market acceptance of the Company’s new products;

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

Management’s ability to achieve reductions in cost and employment levels, to realize production efficiencies and to implement capital expenditures, all at of the levels and times planned by management.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not applicable to smaller reporting company.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The annotated consolidated financial statements of the Company that constitute Item 8 of this report commence on the pages that follow this page.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of  
LIFEWAY FOODS, INC. AND SUBSIDIARIES

We have audited the accompanying consolidated balance sheets of LIFEWAY FOODS, INC. AND SUBSIDIARIES (the "Company") as of December 31, 2008 and 2007, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of LIFEWAY FOODS, INC. AND SUBSIDIARIES as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America.

Plante & Moran, PLLC  
Grand Rapids, MI  
March 31, 2009

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

|  | December 31,<br>2008 | December 31,<br>2007 |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| Current assets   |                      |                      |
| Cash and cash equivalents  | \$ 277,248           | \$ 595,885           |
| Marketable securities  | 5,262,168            | 6,989,474            |
| Inventories  | 3,097,542            | 3,506,554            |
| Accounts receivable, net of allowance for doubtful accounts of \$110,011 and \$39,460 at December 31, 2008 and 2007  | 4,765,865            | 4,209,662            |
| Prepaid expenses and other current assets  | 23,226               | 21,253               |
| Other receivables  | 40,314               | 43,111               |
| Deferred income taxes  | 919,649              | 311,960              |
| Refundable income taxes  | 356,416              | 240,880              |
| Total current assets   | 14,742,428           | 15,918,779           |
| Property and equipment, net  | 11,062,714           | 9,678,948            |
| Intangible assets  |                      |                      |
| Goodwill   | 5,414,858            | 5,414,858            |
| Other intangible assets, net of accumulated amortization of \$921,422 and \$601,976 at December 31, 2008 and 2007  | 2,936,216            | 3,255,662            |
| Total intangible assets  | 8,351,074            | 8,670,520            |
| Other assets   | 500,000              | 500,000              |
| Total assets   | \$ 34,656,216        | \$ 34,768,247        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                      |                      |
| Current liabilities  |                      |                      |
| Current maturities of notes payable  | \$ 928,444           | \$ 1,136,126         |
| Accounts payable   | 2,260,272            | 1,594,330            |
| Accrued expenses   | 458,282              | 414,039              |
| Total current liabilities  | 3,646,998            | 3,144,495            |
| Notes payable  | 3,108,014            | 4,096,797            |
| Deferred income taxes  | 1,607,155            | 1,712,795            |
| Stockholders' equity   |                      |                      |
| Common stock, no par value; 20,000,000 shares authorized; 17,273,776 shares issued; 16,724,467 shares outstanding at December 31, 2008; 17,273,776 shares issued; 16,827,726 shares outstanding at December 31, 2007 | 6,509,267            | 6,509,267            |
| Paid-in-capital  | 1,202,009            | 1,120,669            |

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|  |               |               |
|--|---------------|---------------|
| Treasury stock, at cost                            | ( 3,302,025)  | ( 2,078,165)  |
| Retained earnings                                  | 22,383,707    | 20,471,432    |
| Accumulated other comprehensive loss, net of taxes | ( 498,909)    | ( 209,043)    |
| Total stockholders' equity                         | 26,294,049    | 25,814,160    |
| Total liabilities and stockholders' equity         | \$ 34,656,216 | \$ 34,768,247 |

See accompanying notes to financial statements

21

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LIFEWAY FOODS, INC. AND SUBSIDIARIES  
 Consolidated Statements of Income and Comprehensive Income  
 For the Years Ended December 31, 2008 and 2007

|  | Year Ended<br>December 31,<br>2008 | Year Ended<br>December 31,<br>2007 |
|--|------------------------------------|------------------------------------|
| Sales  | 44,461,455                         | \$ 38,729,156                      |
| Cost of goods sold   | 30,926,114                         | 25,582,981                         |
| Depreciation expense   | 777,715                            | 726,647                            |
| Total cost of goods sold   | 31,703,829                         | 26,309,628                         |
| Gross profit   | 12,757,626                         | 12,419,528                         |
| Selling Expenses   | 4,098,176                          | 3,744,388                          |
| General and Administrative   | 4,149,010                          | 3,914,825                          |
| Amortization expense   | 319,446                            | 323,266                            |
| Total Operating Expenses   | 8,566,632                          | 7,982,479                          |
| Income from operations   | 4,190,994                          | 4,437,049                          |
| Other income (expense):  |                                    |                                    |
| Interest and dividend income   | 343,329                            | 350,286                            |
| Rental Income  | 48,886                             | 48,305                             |
| Interest expense   | ( 298,619)                         | ( 410,180)                         |
| Impairment of marketable securities                                      | ( 958,879)                         | —                                  |
| Gain (loss) on sale of marketable securities, net                        | ( 733,647)                         | 539,739                            |
| Total other income (Expense)   | ( 1,598,930)                       | 528,150                            |
| Income before provision for income taxes                                 | 2,592,064                          | 4,965,199                          |
| Provision for income taxes   | 679,789                            | 1,812,539                          |
| Net income   | \$ 1,912,275                       | \$ 3,152,660                       |
| Basic and diluted earnings per common share                              | 0.11                               | 0.19                               |
| Weighted average number of shares outstanding                            | 16,765,080                         | 16,855,611                         |
| <b>COMPREHENSIVE INCOME</b>  |                                    |                                    |
| Net income   | \$ 1,912,275                       | \$ 3,152,660                       |
| Other comprehensive income (loss), net of tax:                           |                                    |                                    |
| Unrealized gains (losses) on marketable securities (net of tax benefits) | ( 720,517)                         | ( 47,091)                          |
|  | 430,651                            | ( 315,721)                         |

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Less reclassification adjustment for (gains) losses included in net income (net of taxes)

|                      |    |           |    |           |
|----------------------|----|-----------|----|-----------|
| Comprehensive income | \$ | 1,622,409 | \$ | 2,789,848 |
|----------------------|----|-----------|----|-----------|

See accompanying notes to financial statements

22

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LIFEWAY FOODS, INC. AND SUBSIDIARIES  
 Consolidated Statements of Changes in Stockholders' Equity  
 For the Years Ended December 31, 2008 and 2007

|  | Common Stock, No Par Value   |                         | # of Shares of | Treasury Stock | Common Stock | Paid In Capital | Treasury Stock | Retained Earnings | Accumulated                                   | Total |
|--|------------------------------|-------------------------|----------------|----------------|--------------|-----------------|----------------|-------------------|---|-------|
|  | 20,000,000 Shares Authorized |                         |                |                |              |                 |                |                   | Other Comprehensive Income (Loss), Net of Tax |       |
|  | # of Shares Issued           | # of Shares Outstanding |                |                |              |                 |                |                   |   |       |
| Balances at December 31, 2006  | 17,273,776                   | 16,897,826              | 375,950        | 6,509,267      | 1,080,911    | (1,334,313)     | 17,318,772     | 153,770           | 23,728,400                                    |       |
| Redemption of stock  | —                            | (75,000)                | 75,000         | —              | —            | (752,603)       | —              | —                 | (752,603)                                     |       |
| Issuance of treasury stock for compensation  | —                            | 4,900                   | (4,900)        | —              | 39,758       | 8,751           | —              | —                 | 48,509  |       |
| Other comprehensive income (loss):<br>unrealized gains on securities, net of taxes and classification adjustment | —                            | —                       | —              | —              | —            | —               | —              | (362,813)         | (362,813)                                     |       |
| Net income for the year ended December 31, 2007  | —                            | —                       | —              | —              | —            | —               | 3,152,660      | —                 | 3,152,660                                     |       |
| Balances at December 31, 2007  | 17,273,776                   | 16,827,726              | 446,050        | 6,509,267      | 1,120,669    | (2,078,165)     | 20,471,432     | (209,043)         | 25,814,166                                    |       |
| Redemption of stock  | —                            | (112,009)               | 112,009        | —              | —            | (1,239,488)     | —              | —                 | (1,239,488)                                   |       |
|  | —                            | 8,750                   | (8,750)        | —              | 81,340       | 15,628          | —              | —                 | 96,968  |       |

|  |            |            |         |              |              |                |               |              |               |            |
|--|------------|------------|---------|--------------|--------------|----------------|---------------|--------------|---------------|------------|
| suance of<br>treasury stock<br>r<br>mpensation   |            |            |         |              |              |                |               |              |               |            |
| ther<br>mprehensive<br>come (loss):<br>nrealized<br>ins on<br>curities, net<br>taxes and<br>classification<br>justment | —          | —          | —       | —            | —            | —              | —             | —            | ( 289,866)    | ( 289,866) |
| et income for<br>e year ended<br>ecember 31,<br>008  | —          | —          | —       | —            | —            | —              | —             | 1,912,275    | —             | 1,912,275  |
| alances at<br>ecember 31,<br>008   | 17,273,776 | 16,724,467 | 549,309 | \$ 6,509,267 | \$ 1,202,009 | \$ (3,302,025) | \$ 22,383,707 | \$ (498,909) | \$ 26,294,040 |            |

See accompanying notes to financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
For the Years Ended December 31, 2008 and 2007

|  | Years Ended<br>December 31, |              |
|--|-----------------------------|--------------|
|  | 2008                        | 2007         |
| Cash flows from operating activities:  |                             |              |
| Net income   | \$ 1,912,275                | \$ 3,152,660 |
| Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition: |                             |              |
| Depreciation and amortization  | 1,092,995                   | 1,049,913    |
| (Gain)Loss on sale of marketable securities, net   | 733,647                     | ( 539,739)   |
| Impairment of marketable securities  | 958,879                     | —            |
| Deferred income taxes  | ( 509,386)                  | ( 223,717)   |
| Treasury stock issued for compensation   | 96,968                      | 48,509       |
| Increase (decrease) in allowance for doubtful accounts   | 70,551                      | ( 40,540)    |
| (Increase) decrease in operating assets:   |                             |              |
| Accounts receivable  | ( 626,754)                  | ( 226,405)   |
| Other receivables  | 2,797                       | 27,939       |
| Inventories  | 409,012                     | ( 984,358)   |
| Refundable income taxes  | ( 115,536)                  | 26,891       |
| Prepaid expenses and other current assets  | ( 1,973)                    | ( 9,270)     |
| Increase (decrease) in operating liabilities:  |                             |              |
| Accounts payable   | 665,942                     | 131,316      |
| Accrued expenses   | 44,243                      | ( 66,062)    |
| Net cash provided by operating activities  | 4,733,660                   | 2,347,137    |
| Cash flows from investing activities:  |                             |              |
| Investment in cost method securities   | —                           | ( 500,000)   |
| Purchases of marketable securities   | ( 5,782,452)                | ( 5,744,697) |
| Sale of marketable securities  | 5,323,423                   | 7,168,246    |
| Purchases of property and equipment  | ( 2,157,315)                | (1,824,879)  |
| Net cash used in investing activities  | ( 2,616,344)                | ( 901,330)   |
| Cash flows from financing activities:  |                             |              |
| Proceeds of note payable   | —                           | 300,000      |
| Purchases of treasury stock, net   | ( 1,239,488)                | ( 752,603)   |
| Repayment of notes payable   | ( 1,196,465)                | ( 1,945,131) |
| Net cash used in financing activities  | ( 2,435,953)                | ( 2,397,734) |
| Net decrease in cash and cash equivalents  | ( 318,637)                  | ( 951,927)   |
| Cash and cash equivalents at the beginning of the period   | 595,885                     | 1,547,812    |
| Cash and cash equivalents at the end of the period   | \$ 277,248                  | \$ 595,885   |

See accompanying notes to financial statements



LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

Note 1 – NATURE OF BUSINESS

Lifeway Foods, Inc. (The “Company”) commenced operations in February 1986 and incorporated under the laws of the state of Illinois on May 19, 1986. The Company’s principal business activity is the production of dairy products. Specifically, the Company produces Kefir, a drinkable product which is similar to but distinct from yogurt, in several flavors sold under the name “Lifeway’s Kefir;” a plain farmer’s cheese sold under the name “Lifeway’s Farmer’s Cheese;” a fruit sugar-flavored product similar in consistency to cream cheese sold under the name of “Sweet Kiss;” and a dairy beverage, similar to Kefir, with increased protein and calcium, sold under the name “Basics Plus.” The Company also produces several soy-based products under the name “Soy Treat” and a vegetable-based seasoning under the name “Golden Zesta.” The Company currently distributes its products throughout the Chicago Metropolitan area and various cities in the East Coast through local food stores. In addition, the products are sold throughout the United States and Ontario, Canada by distributors. The Company also distributes some of its products to Eastern Europe.

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of the significant accounting policies applied in the preparation of the accompanying financial statements follows:

Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, LFI Enterprises, Inc., Helios Nutrition, Ltd., Pride of Main Street, L.L.C. and Starfruit, L.L.C. All significant intercompany accounts and transactions have been eliminated.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made in preparing the consolidated financial statements include the allowance for doubtful accounts, the valuation of goodwill, intangible assets and deferred taxes.

Revenue Recognition

Sales represent sales of Company produced dairy products that are recorded at the time of shipment and the following four criteria have been met: (i) The product has been shipped and the Company has no significant remaining obligations; (ii) Persuasive evidence of an agreement exists; (iii) The price to the buyer is fixed or determinable and (iv) Collection is probable. In addition, shipping costs invoiced to the customers are included in net sales and the related cost in cost of sales.

Cash and cash equivalents

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

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



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

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Gross bank balances, not including outstanding checks, of amounts reported by financial institutions are categorized as follows:

|  | December 31, |    |           |
|--|--------------|----|-----------|
|  | 2008         |    | 2007      |
| Amounts insured                        | \$ 847,711   | \$ | 576,563   |
| Uninsured and uncollateralized amounts | —            |    | 523,295   |
| Total bank balances                    | \$ 847,711   | \$ | 1,099,858 |

Marketable securities

All investment securities are classified as available-for-sale, and are carried at fair value or quoted market prices. Unrealized gains and losses on available-for-sale securities are reported as a separate component of stockholders' equity, net of tax. 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 size and duration of the decline; the financial condition of the investee; and the intent and ability to retain the investment for a sufficient period of time to allow for possible recovery in the market value of the investment.

Accounts receivable

Credit terms are extended to customers in the normal course of business. The Company performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral.

Accounts receivable are recorded at invoice amounts, and reduced to their estimated net realizable value by recognition of an allowance for doubtful accounts. The Company's estimate of the allowance for doubtful accounts is based upon historical experience, its evaluation of the current status of specific receivables, and unusual circumstances, if any. Accounts are considered past due if payment is not made on a timely basis in accordance with the Company's credit terms. Accounts considered uncollectible are charged against the allowance.

Inventories

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

Property and equipment

Property and equipment are stated at depreciated cost or fair value where depreciated cost is not recoverable. Depreciation is computed using the straight-line method. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to income as incurred; significant renewals and betterments are capitalized.





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

## Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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

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

## Intangible assets

The Company accounts for intangible assets at historical cost. Intangible assets acquired in a business combination are recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. Goodwill represents the excess purchase price over the fair value of the net tangible and other intangible assets acquired. Goodwill is not amortized and is reviewed for impairment at least annually. The Company amortizes other intangible assets over their estimated useful lives, as disclosed in the table below.

The Company reviews intangible assets and their related useful lives at least once a year to determine if any adverse conditions exist that would indicate the carrying value of these assets may not be recoverable. The Company conducts more frequent impairment assessments if certain conditions exist, including: a change in the competitive landscape, any internal decisions to pursue new or different strategies, a loss of a significant customer, or a significant change in the market place including changes in the prices paid for the Company's products or changes in the size of the market for the Company's products.

If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset is amortized prospectively over the revised remaining useful life.

Intangible assets are being amortized over the following useful lives:

| Category  | Years |
|---|-------|
| Recipes   | 4     |
| Customer lists and other customer related intangibles | 7     |
| Lease agreement                                       | 7     |
| Trade names   | 15    |
| Formula   | 10    |
| C u s t o m e r relationships                         | 12    |



LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

Income taxes

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

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

As of January 1, 2007, the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109" (FIN 48), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. Pursuant to FIN 48, the Company has analyzed filing positions in all of the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The only periods subject to examination for the Company's federal return are the 2004 through 2007 tax years. The Company believes that its income tax filing positions and deductions would be sustained on audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

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

Treasury stock

Treasury stock is recorded using the cost method.

Advertising costs

The Company expenses advertising costs as incurred. During the year ended December 31, 2008 and 2007, approximately \$1,530,207 and \$1,642,114 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 year ended December 31, 2008 and 2007, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

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

## Note 3 – INTANGIBLE ASSETS

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

|  | December 31, 2008 |                             | December 31, 2007 |                             |
|--|-------------------|-----------------------------|-------------------|-----------------------------|
|  | Cost              | Accumulated<br>Amortization | Cost              | Accumulated<br>Amortization |
| Recipes  | \$ 43,600         | \$ 43,600                   | \$ 43,600         | \$ 37,242                   |
| Customer lists and other<br>customer related intangibles | 305,200           | 182,938                     | 305,200           | 141,518                     |
| Lease acquisition  | 87,200            | 55,019                      | 87,200            | 42,562                      |
| Other  | 6,638             | 4,647                       | 6,638             | 3,319                       |
| Customer relationship                                    | 985,000           | 198,368                     | 985,000           | 116,285                     |
| Contractual backlog                                      | 12,000            | 12,000                      | 12,000            | 12,000                      |
| Trade names  | 1,980,000         | 319,000                     | 1,980,000         | 187,000                     |
| Formula  | 438,000           | 105,850                     | 438,000           | 62,050                      |
|  | \$ 3,857,638      | \$ 921,422                  | \$ 3,857,638      | \$ 601,976                  |

Amortization expense is expected to be as follows for the years ending December 31:

|            |              |
|------------|--------------|
| 2009       | \$ 313,225   |
| 2010       | 312,756      |
| 2011       | 300,964      |
| 2012       | 257,883      |
| 2013       | 257,883      |
| Thereafter | 1,493,505    |
|            | \$ 2,936,216 |

Amortization expense during the years ended December 31, 2008 and 2007 was \$319,446 and \$323,266, respectively.

## Note 4 – MARKETABLE SECURITIES

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

| December 31, 2008             | Cost         | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|-------------------------------|--------------|---------------------|----------------------|---------------|
| Equities                      | \$ 2,116,004 | \$ 75,333           | \$ ( 279,487)        | \$ 1,911,850  |
| Mutual Funds                  | 888,182      | 202                 | ( 339,970)           | 548,414       |
| Preferred Securities          | 1,541,423    | 13,075              | ( 308,963)           | 1,245,535     |
| Corporate Bonds               | 783,761      | 1,559               | ( 19,289)            | 766,031       |
| Municipal Bonds               | 4,586        | 414                 | —                    | 5,000         |
| Government agency Obligations | 778,140      | 8,668               | ( 1,470)             | 785,338       |
| Total                         | \$ 6,112,096 | \$ 99,251           | \$ ( 949,179)        | \$ 5,262,168  |



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

## Note 4 – MARKETABLE SECURITIES - Continued

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

Proceeds from the sale of marketable securities were \$5,323,423 and \$7,168,246 during the years ended December 31, 2008 and 2007, respectively.

Gross gains of \$384,574 and \$876,527 and gross losses of \$1,118,221 and \$336,788 were realized on these sales during the years ended December 31, 2008 and 2007, respectively.

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

| Description of<br>Securities     | Less Than 12 Months |                      | 12 Months or Greater |                      | Total        |                      |
|----------------------------------|---------------------|----------------------|----------------------|----------------------|--------------|----------------------|
|                                  | Fair Value          | Unrealized<br>Losses | Fair Value           | Unrealized<br>Losses | Fair Value   | Unrealized<br>Losses |
| Equities                         | \$ 733,161          | \$ ( 242,055)        | \$ 65,931            | \$ ( 37,432)         | \$ 799,092   | \$ ( 279,487)        |
| Mutual Funds                     | 363,006             | ( 179,941)           | 86,086               | ( 160,029)           | 449,092      | ( 339,970)           |
| Preferred Securities             | 150,722             | ( 28,643)            | 435,043              | ( 280,320)           | 585,765      | ( 308,963)           |
| Corporate Bonds                  | 345,302             | ( 18,789)            | 125,348              | ( 500)               | 470,650      | ( 19,289)            |
| Government<br>Agency Obligations | 168,319             | ( 1,470)             | —                    | —                    | 168,319      | ( 1,470)             |
|                                  | \$ 1,760,510        | \$ ( 470,898)        | \$ 712,408           | \$ ( 478,281)        | \$ 2,472,918 | \$ ( 949,179)        |

We recorded other than temporary impairments related to investments in marketable securities in certain investments of \$958,879 related to securities with a cost basis of \$2,267,834 and a fair value of \$1,308,955. The impairments recognized relate to securities that were in an unrealized loss position at December 31, 2008 that were subsequently sold and equity holdings that we consider other than temporarily impaired due to the recent performance of the issuers of those securities.

## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## Note 4 – MARKETABLE SECURITIES - Continued

Equities, Mutual Funds, 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. 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 December 31, 2008.

Preferred Securities - The Company's investments in preferred securities consist of investments in preferred stock of companies in various industries. The Company evaluated the continuing performance of the securities, the credit worthiness of the issuers as well as 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 December 31, 2008.

## Note 5 – INVENTORIES

Inventories consist of the following:

|                     | December 31, |              |
|---------------------|--------------|--------------|
|                     | 2008         | 2007         |
| Finished goods      | \$ 1,343,811 | \$ 1,296,985 |
| Production supplies | 1,291,484    | 1,383,384    |
| Raw materials       | 462,247      | 826,185      |
| Total inventories   | \$ 3,097,542 | \$ 3,506,554 |

## Note 6 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

|                               | December 31, |            |
|-------------------------------|--------------|------------|
|                               | 2008         | 2007       |
| Land                          | \$ 969,232   | \$ 969,232 |
| Buildings and improvements    | 7,138,042    | 6,743,647  |
| Machinery and equipment       | 8,229,202    | 8,159,199  |
| Vehicles                      | 610,558      | 581,458    |
| Office equipment              | 180,351      | 101,583    |
| Construction in process       | 2,309,045    | 719,830    |
|                               | 19,436,430   | 17,274,949 |
| Less accumulated depreciation | 8,373,716    | 7,596,001  |

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|                              |    |            |    |           |
|------------------------------|----|------------|----|-----------|
| Total property and equipment | \$ | 11,062,714 | \$ | 9,678,948 |
|------------------------------|----|------------|----|-----------|

Depreciation expense during the years ended December 31, 2008 and 2007 was \$777,715 and \$726,647, respectively.



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

## Note 7 – ACCRUED EXPENSES

Accrued expenses consist of the following:

|                                   | December 31, |            |
|-----------------------------------|--------------|------------|
|                                   | 2008         | 2007       |
| Accrued payroll and payroll taxes | \$ 98,089    | \$ 58,395  |
| Accrued property tax              | 291,819      | 285,279    |
| Other                             | 68,374       | 70,365     |
|                                   | \$ 458,282   | \$ 414,039 |

## Note 8 – NOTES PAYABLE

Notes payable consist of the following:

|   | December 31, |              |
|---|--------------|--------------|
|   | 2008         | 2007         |
| Mortgage note payable to a bank, payable in monthly installments of \$3,273 including interest at 7%, with a balloon payment of \$416,825 due September 25, 2011. Collateralized by real estate.                    | \$ 438,926   | \$ 446,450   |
| Mortgage note payable to a bank, payable in monthly installments of \$19,513 including interest at 5.6%, with a balloon payment of \$2,652,143 due July 14, 2010. Collateralized by real estate.                    | 2,760,288    | 2,834,970    |
| Note payable to Amani Holding LLC, payable in quarterly installments of \$262,500 plus interest at the floating prime rate per annum (3.25% at December 31, 2008) due September 1, 2010 secured by letter of credit | 837,244      | 1,951,503    |
| Total notes payable   | 4,036,458    | 5,232,923    |
| Less current maturities   | 928,444      | 1,136,126    |
| Total long-term portion   | \$ 3,108,014 | \$ 4,096,797 |

Maturities of notes payables are as follows:

|                                 |    |           |
|---------------------------------|----|-----------|
| For the Year Ended December 31, |    |           |
| 2009                            | \$ | 928,444   |
| 2010                            |    | 2,687,827 |
| 2011                            |    | 420,187   |
| Total                           | \$ | 4,036,458 |



## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## Note 9 – PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

|                            | For the Years Ended<br>December, |              |
|----------------------------|----------------------------------|--------------|
|                            | 2008                             | 2007         |
| Current:                   |                                  |              |
| Federal                    | \$ 1,005,159                     | \$ 1,699,408 |
| State and local            | 184,016                          | 336,848      |
| Total current              | 1,189,175                        | 2,036,256    |
| Deferred                   | ( 509,386)                       | ( 223,717)   |
| Provision for income taxes | \$ 679,789                       | \$ 1,812,539 |

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

|   | For the Years Ended<br>December 31, |              |
|---|-------------------------------------|--------------|
|   | 2008                                | 2007         |
| Federal income tax expense computed at the statutory rate | \$ 881,302                          | \$ 1,688,168 |
| State and local tax expense, net                          | 124,419                             | 238,330      |
| Permanent differences                                     | ( 150,772)                          | ( 113,959)   |
| Correction of prior year estimate                         | ( 175,160)                          | —            |
| Provision for income taxes                                | \$ 679,789                          | \$ 1,812,539 |

Amounts for deferred tax assets and liabilities are as follows:

|  | December 31,    |                 |
|--|-----------------|-----------------|
|  | 2008            | 2007            |
| Non-current deferred tax liabilities arising from: |                 |                 |
| Temporary differences -                            |                 |                 |
| accumulated depreciation and amortization          | \$ ( 1,607,155) | \$ ( 1,712,795) |
| Current deferred tax assets arising from:          |                 |                 |
| Unrealized losses on marketable securities         | 351,020         | 147,077         |
| Impairment of marketable securities                | 396,017         | —               |
| Inventory  | 127,177         | 148,586         |
| Allowance for doubtful accounts                    | 14,460          | 16,297          |
| Allowance for promotions                           | 30,975          | —               |
| Total current deferred tax assets (liabilities)    | 919,649         | 311,960         |
| Net deferred tax liability                         | \$ ( 687,506)   | \$ ( 1,400,835) |



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

## Note 10 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

|              | For the Years Ended |              |
|--------------|---------------------|--------------|
|              | December 31,        |              |
|              | 2008                | 2007         |
| Interest     | \$ 307,620          | \$ 430,098   |
| Income taxes | \$ 1,288,428        | \$ 2,026,031 |

## Note 11 – STOCK AWARD AND STOCK OPTION PLANS

The Company has a registration statement filed with the Securities and Exchange Commission in connection with a Consulting Service Compensation Plan covering up to 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, 2008 there were no stock options outstanding or exercisable. There were approximately 940,000 shares available for issuance under the Plan at December 31, 2008.

On June 13, 2008, Lifeway's Board of Directors approved awards of an aggregate amount of 10,500 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain key employees and consultants for services rendered to the Company. The stock awards were made on June 13, 2008 and have vesting periods of one year. The expense for the awards is measured as of July 1, 2008 at \$11.87 per share for 10,500 shares, or a total stock award expense of \$124,635. This expense will be recognized as the stock awards vest in 12 equal portions of \$10,386, or 875 shares per month for one year.

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

## Note 12 – FAIR VALUE MEASUREMENTS

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



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

Note 12 – FAIR VALUE MEASUREMENTS - Continued

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.

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

|   | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets (Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) | Balance at<br>December 31,<br>2008 |
|---|---|--|---|------------------------------------|
| Assets  |   |  |   |                                    |
| Investment securities- available - for - sale | \$ 5,262,168  | —  | —   | 5,262,168                          |

Note 13 – RECENT ACCOUNTING PRONOUNCEMENTS

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

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

Note 13 – RECENT ACCOUNTING PRONOUNCEMENTS - Continued

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

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

Note 14 – SUBSEQUENT EVENTS

On February 6, 2009, Lifeway Foods, Inc., a Illinois corporation (“Lifeway”) entered into and consummated a Stock Purchase Agreement (the “Stock Agreement”) by and among Lifeway, Ilya Mandel, an individual and Michael Edelson, an individual (each a “Seller” and collectively “Sellers”).

Upon the terms and subject to the conditions set forth in the Stock Agreement, Lifeway purchased from Sellers all of the issued and outstanding stock (the “Shares”) of Fresh Made, Inc., a Pennsylvania corporation (“Fresh”). The consideration for the Shares was an aggregate of \$8,050,000, less certain offsets for any selling expenses in excess of certain limits set forth in the Stock Agreement and other payments and funded debt all as set forth in the Stock Agreement, a note in the principal amount of \$2,735,000, due on February 6, 2011, 128,948 shares of common stock of Lifeway valued at a total of \$980,000 (“Lifeway’s Common Stock”), the cancellation of a loan in the principal amount of \$265,000 and not more than \$98,000 in funds held in Fresh’s two accounts with Vist Financial Corp. The issuance of Lifeway’s Common Stock was exempted from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended.

Also on February 6, 2009, Lifeway entered into and consummated a Real Property Purchase Agreement (the “Real Property Agreement”) by and among Sellers and Lifeway. Pursuant to the Real Property Agreement, Lifeway acquired 1.1355 acres of land in Philadelphia, PA (the “Property”) from Sellers. The consideration for the Property was \$2,000,000.





ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure material information required to be disclosed in our reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required financial disclosure. In designing and evaluating the disclosure controls and procedures, we recognized that a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

As of December 31, 2008, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial 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 Officer concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of December 31, 2008 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 below. 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-K fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented.

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Exchange Act Rule 13a-15(f). The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, management assessed the effectiveness of our internal control over financial reporting as of December 31, 2008. In making its assessment of internal control over financial reporting, management used the criteria described in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. In conjunction with our auditors, management identified three material weaknesses in the Company's internal control over financial reporting. A material weakness is a significant deficiency, or a combination of significant deficiencies which when aggregated, results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by employees in the normal course of their assigned functions. As a result of these material weaknesses, we concluded that the Company's internal control over financial reporting was not effective as of December 31, 2008 based on the criteria in Internal Control — Integrated Framework. We are taking steps to address these material weaknesses which could possibly have led to a material misstatement in our financial statements if not detected and corrected.

We have identified material weaknesses in our internal control for financial reporting due to an incomplete and undocumented financial reporting process, including an overview of the financial statement disclosure principles; that there is no documented accounting procedures manual available for employee use; and in valuing other than temporary impairment of marketable securities. Our independent registered accounting firm identified the need for an impairment of marketable securities that led to a material adjustment at December 31, 2008. Additionally, there was no requirement to post monthly activity to the Company's general ledger. We plan to take corrective action to improve our review procedures for posting and updating the monthly financial activity and have begun creating an accounting manual for our accounting personnel during 2009. In addition, we plan on implementing additional controls involving our analysis of other than temporary impairment in 2009.

This Annual Report on Form 10-K does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this Annual Report on Form 10-K.

ITEM 9B. OTHER INFORMATION.

None.

37

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

DIRECTORS AND EXECUTIVE OFFICERS.

LUDMILA SMOLYANSKY, 58, was appointed as a Director by the Board to fill a vacancy created by an increase of the maximum number of Directors up to seven and unanimously elected as the Chairperson of the Board in November 2002. For more than 20 years, Mrs. Smolyansky has been the operator of several independent delicatessen, gourmet food distributorship businesses and imported food distributorships. In 2002, prior to the commencement of her tenure as a Director, she was hired by the Company as its General Manager. Mrs. Smolyansky devotes as much time as necessary to the business of the Company and currently holds no other directorships in any other reporting company. Mrs. Smolyansky is the mother of Julie Smolyansky (the President, Chief Executive Officer (CEO), and a Director of the Company) and Edward P. Smolyansky (the Company Treasurer and Chief Financial and Accounting Officer).

JULIE SMOLYANSKY, 33, was appointed as a Director, and elected President, CEO, CFO and Treasurer of the Company by the Board of Directors to fill the vacancies in those positions created by the death of her father, Michael Smolyansky, in June 2002. She is a graduate with a Bachelor's degree from the University of Illinois at Chicago. Prior to her appointment, Ms. Smolyansky spent six years as the Company's Director of Sales and Marketing. She devotes as much time as necessary to the business of the Company and currently holds no other directorships in any other reporting company. Ms. Smolyansky is the daughter of Ludmila Smolyansky, the Chairperson of the Board. In 2004, Ms. Smolyansky resigned as CFO and Treasurer and Edward Smolyansky, Ms. Smolyansky's brother, was appointed to such positions.

POL SIKAR, 60, has been a Director of the Company since its inception in February 1986. He is a graduate with a Master's degree from the Odessa State Institute of Civil Engineering in Russia. For more than 12 years, he has been President and a major shareholder of Montrose Glass & Mirror Co., a company providing glass and mirror products to the wholesale and retail trade in the greater Chicago area. Mr. Sikar devotes as much time as necessary to the business of the Company. Mr. Sikar holds no other directorships in any other reporting company.

RENZO BERNARDI, 56, has been a Director of the Company since 1994. Mr. Bernardi is the president and founder of Renzo & Sons, Inc., a Dairy and Food Service Company which has been in business since 1969 (formerly, Renzo-Milk Distribution Systems). He has over 30 years of experience in the dairy distribution industry. Mr. Bernardi is a graduate of Istituto Tecnico E Commerciale of Macomer, Sardinia. Mr. Bernardi devotes as much time as necessary to the business of the Company. Mr. Bernardi holds no other directorships in any other reporting company.

JUAN CARLOS DALTO, 45, has served as a director of the Company since July 2004. Juan Carlos Dalto is President and CEO of The Dannon Company. He has extensive international background in the packaged goods industry and has strategic and direct responsibilities for Dannon's dairy products in the United States and Canada. Mr. Dalto joined Dannon's parent company, Groupe Danone, as Marketing VP for Danone Argentina, his native country, in December 1997 after which he served as CEO for Danone Portugal in 2000. Mr. Dalto holds a Masters in Strategic Marketing from Adam Smith Open University, Buenos Aires, Argentina and a Diploma for Business Executives in Strategic Marketing Planning from University of Michigan. He also holds a degree in Industrial Engineering from the Buenos Aires Institute of Technology. Mr. Dalto was initially appointed to the Board in connection with that certain Stockholders Agreement, as amended with Groupe Danone.

JULIE OBERWEIS, 34, has served as a director of the Company since June 2006. She is the co-founder and CFO of Stratigent, LLC, a web analytics consulting company. Prior to Stratigent, she worked in investment consulting at Cambridge Associates as well as at Ritchie Capital Management, L.L.C., a global alternative asset management firm. She currently sits on the board of Oberweis Group, Inc., the holding company of Oberweis Dairy, and the DuPage Childrens Museum. Julie holds a degree in finance from the University of Illinois and is a Chartered Financial Analyst (CFA) charterholder.

EDWARD P. SMOLYANSKY, 29, was appointed as Chief Financial and Accounting Officer and Treasurer of Lifeway Foods in November 2004. He had served as the Controller of the Company June 2002 until such time. He received his baccalaureate degree in finance from Loyola University of Chicago in December 2001. Edward P. Smolyansky is the brother of Company President and Chief Executive Officer Julie Smolyansky and the son of Lifeway's Chairperson of the Board of Directors, Ludmila Smolyansky.

#### KEY EMPLOYEES.

VALERIY NIKOLENKO, 63, Vice President of Operations, has been VP of Operations for 13 years with Lifeway Foods.

#### SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities and Exchange Act of 1934 requires the Company's officers and Directors, and persons who own more than 10% of a registered class of the Company's equity securities, to file reports of ownership and changes in ownership with the Securities and Exchange Commission ("SEC"). Officers, directors, and greater than 10% shareholders are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file. Based solely on its review of copies of such reports received or representations from certain reporting persons, the Company believes that, during the year ended December 31, 2008, other than the filings listed below, all other Section 16(a) filing requirements applicable to its officers, Directors and 10% shareholders were timely met. Those filings were: (1) Edward Smolyansky reported one transaction on each of two Form 4s late; and (2) Ludmila Smolyansky reported on transaction on one Form 4 late.

#### FAMILY RELATIONSHIPS

Julie Smolyansky, the President, CEO and director of Lifeway is the daughter of Ludmila Smolyansky, Chairperson of the Board of Directors of Lifeway and the sister of Edward P. Smolyansky. Edward P. Smolyansky, the Chief Financial and Accounting Officer and Treasurer of Lifeway is the son of Ludmila Smolyansky and the brother of Julie Smolyansky.

## CODE OF ETHICS

The Company has adopted a Code of Ethics applicable to all officers which is included in this report as an exhibit hereto. The Company has posted such Code of Ethics on its website, which can be found at [www.lifeway.net](http://www.lifeway.net). Any person may, without charge, request a copy of such Code of Ethics by contacting the Company at 847-967-1010 or by email at [info@lifeway.net](mailto:info@lifeway.net).

## CORPORATE GOVERNANCE

The Board does not have any formal policy regarding the consideration of director candidates recommended by shareholders; any recommendation would be considered on an individual basis. The Board believes this is appropriate due to the lack of such recommendations made in the past, and its ability to consider the establishment of such a policy in the event of an increase of such recommendations. Accordingly, there have been no material changes to the procedure by which any security holder may recommend nominees to the Board.

The Company's Audit Committee consists of Mr. Sikar and Ms. Oberweis, each of whom has an understanding of finance and accounting and is able to read and understand fundamental financial statements. Audit Committee members are appointed by the full Board. The functions of the Audit Committee are to review the Company's internal controls, accounting policies and financial reporting practices; to review the financial statements, the arrangements for and scope of the independent audit, as well as the results of the audit engagement; to review the services and fees of the independent auditors, including pre-approval of non-audit services, the auditors' independence; and recommend to the Board of Directors for its approval and for ratification by the shareholders the engagement of the independent auditors to serve the following year in examining the accounts of the Company. No member of the Audit Committee is a "financial expert," as defined in Item 407(d)(5)(ii) of Regulation S-K promulgated by the SEC. The Board examined the qualifications of its Audit Committee members and determined that the present members of the Audit Committee, based on their prior education and professional experience, were sufficiently capable of performing the duties of the Audit Committee in 2008 without being "financial experts" within such definition.

## ITEM 11. EXECUTIVE COMPENSATION.

Summary Compensation Table as of December 31, 2007 and December 31, 2008

| Name   | Year | Salary    | Bonus    | Stock Awards | All other Comp. (5) | Total     |
|--|------|-----------|----------|--------------|---------------------|-----------|
| Julie Smolyansky, CEO and President(1)                                   | 2008 | \$247,038 | \$20,000 | \$42,050     | \$20,288            | \$329,376 |
|  | 2007 | 166,153   | 22,500   | 17,325       | 23,334              | 229,312   |
| Edward P. Smolyansky,<br>CFO Chief Accounting Officer and Controller (2) | 2008 | \$276,884 | \$40,000 | \$42,050     | \$11,900            | \$370,831 |
|  | 2007 | 178,461   | 22,500   | 17,325       | 11,838              | 230,124   |
| Ludmila Smolyansky, Chairman (3)   | 2008 | \$190,076 | \$50,000 | \$ —         | \$8,400             | \$248,476 |
|  | 2007 | 162,807   | 55,000   | —            | 5,600               | 233,407   |
| Val Nikolenko, Vice President of Operations and<br>Secretary (4)         | 2008 | \$114,035 | \$12,000 | \$5,030      | \$14,021            | \$145,086 |
|  | 2007 | 110,832   | 10,000   | 2,887        | 13,813              | 137,532   |

## NOTES TO SUMMARY COMPENSATION TABLE

- (1) The Board appointed Julie Smolyansky as the CEO, CFO, President and Treasurer of the Company on June 10, 2002. Until that date and since September 21, 1998 she had been Director of Sales and Marketing of the Company. Since November 2004, Ms. Smolyansky has served solely as CEO and President.
- (2) The Board appointed Edward Smolyansky as the CFO, Chief Accounting Officer and Controller of the Company in November 2004.
- (3) The Company approves, on an annual basis, the payment to Ludmila Smolyansky of salary and bonus as other compensation for continuing advisory services to the Company and in light of her extensive experience. Ludmila Smolyansky devotes as much time as necessary to the business of the Company.
- (4) The Board appointed Val Nikolenko as the Vice President of Operations and Secretary of the Company in December 1993.
- (5) Represents (i) the Company's portion of the matching contributions to the Company's 401(k) plan on behalf of the Named Executive Officer, Julie Smolyansky (\$4,500 for 2008 and \$7,546 for 2007); Edward Smolyansky (\$8,100 for 2008 and \$8,038 for 2007); Val Nikolenko (\$5,041 for 2005 and \$4,833 for 2007) and (ii) the following amounts related to personal useage of automobiles leased by the Company, and related insurance and fuel, for 2007 and 2008, (x) for Julie Smolyansky, \$11,988 of lease payments, \$2,000 of insurance premiums and \$1,800 of fuel, (y) for Edward Smolyansky, \$2,000 of insurance premiums and \$1,800 of fuel, and (z) for Val Nikolenko, \$7,080 of lease payments, \$1,000 of insurance premiums and \$1,800 of fuel.

The Company does not maintain any formal bonus or cash incentive plans or arrangements. However, the Board determines bonus awards, if any, on an annual basis for other persons.

Julie Smolyansky has an employment agreement (the "Employment Agreement") with the Company pursuant to which she serves as Chief Executive Officer. Pursuant to the Employment Agreement, Ms. Smolyansky is entitled to an annual base salary and an annual bonus subject to such incentive bonus targets and plans which the Company may adopt from time to time. The Company has not currently set any such targets in advance or adopted any such plans. In lieu thereof, the Board of Directors determines Ms. Smolyansky's salary and bonus on an annual basis concurrently with determining amounts for other executive officers. In the event that (a) Ms. Smolyansky is terminated other than for Cause (as defined therein) or (b) Ms. Smolyansky terminates her employment for Good Reason (as defined therein) or death, then Ms. Smolyansky is entitled to a lump sum payment consisting of (y) twice her then-current base salary and (z) the aggregate of the annual bonus for which she is then eligible under the Employment Agreement and any such plans.

There are no employment agreements with other executive officers (written or unwritten).

Outstanding Equity Awards At December 31, 2008

| Name               | Stock Awards  |   |
|--------------------|---|---|
|                    | Number of Shares or Units of Stock That Have Not Vested | Market Value of Shares or Units of Stock That Have Not Vested |
| Julie Smolyansky   | 2,500   | \$22,450  |
| Edward Smolyansky  | 2,500   | \$22,450  |
| Ludmila Smolyansky | --  | --  |
| Val Nikolenko      | 250   | \$ 2,245  |

On June 9, 1995, the Company filed a registration statement on Form S-8 with the Securities and Exchange Commission in connection with the "Lifeway Foods, Inc. Consulting and Services Compensation Plan" (the "Plan") covering 1,200,000, as adjusted, shares of its Common Stock. The Plan was adopted by the Company on June 5, 1995. 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 a total of approximately 936,000 shares eligible for issuance under the Plan at December 31, 2008. 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, 2008, there were no stock options outstanding or exercisable.

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

On June 13, 2008, Lifeway's Board of Directors approved awards of an aggregate amount of 10,500 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain key employees and consultants for services rendered to the Company. The stock awards were made on June 13, 2008 and vest ratably over a one year period. The expense for the awards is measured as of July 1, 2008 at \$11.87 per share for 10,500 shares, or a total stock award expense of \$124,635. This expense will be recognized as the stock awards vest in 12 equal portions of \$10,386, or 875 shares per month for one year.





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Director Compensation as of December 31, 2008

| Name           | Fees Earned or Paid |         |
|----------------|---------------------|---------|
|                | in Cash             | Total   |
| Pol Sikar      | \$2,000             | \$2,000 |
| Renzo Bernardi | \$2,000             | \$2,000 |
| Julie Oberweis | \$2,000             | \$2,000 |

During 2008, each outside (non-employee) director was compensated at the rate of \$500 per non-annual meeting attended. Neither any employee director (Ludmila Smolyansky and Julie Smolyansky) nor any Director serving as the nominee of Danone (Juan Carlos Dalto) was compensated as a Director during 2008.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

Equity Compensation Plan Information

| Plan category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|--|---|---|---|
|  | (a)   | (b)   | (c)   |
| Equity compensation plans approved by security holders     | 0   | \$0.00  | 936,000   |
| Equity compensation plans not approved by security holders | 0   | \$0.00  | 0   |
| Total  | 0   | \$0.00  | 936,000   |

\*All of Lifeway's equity compensation plans have been approved by its shareholders.

The following table sets forth certain information known to the Company regarding the beneficial ownership of the Company's Common Stock, the Company's only outstanding class of securities, as of March 2, 2009 by (a) each shareholder known by the Company to be the beneficial owner of more than five percent of the Company's Common Stock, (b) each of the Company's directors, (c) each of the Company's executive officers named in the Summary Compensation Table above and (d) all executive officers and directors of the Company as a group. The shareholders listed below have sole voting and investment power except as noted.

| Name and Address of Beneficial Owner | Amount and Nature of Beneficial Ownership | Percent of Class |   |
|--------------------------------------|---|------------------|---|
|                                      |   |                  |   |
| Ludmila Smolyansky(3,4)              | 7,540,354(3)                              | 45.1             | % |
| Julie Smolyansky(4)                  | 541,060                                   | 3.24             | % |
| Edward Smolyansky(4)                 | 340,946                                   | 2.04             | % |
| Pol Sikar(4)                         | 3,000                                     | *                |   |
| Renzo Bernardi(4)                    | 14,900                                    | *                |   |

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|  |           |      |   |
|--|-----------|------|---|
| Juan Carlos Dalto(4,5)   | 0         | *    |   |
| Julie Oberweis(4)  | 0         | *    |   |
| Val Nikolenko  | 5,000     | *    |   |
| All Directors and Officers of the Company as a Group<br>(Eight persons in total) | 8,445,260 | 50.5 | % |
| DS Waters, LP  | 3,454,756 | 20.7 | % |

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\*Less than .01%.

43

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## NOTES TO BENEFICIAL OWNERSHIP TABLE

- (1) With the exception of Juan Carlos Dalto and DS Waters, LP, the address for all Directors and shareholders listed in this table is 6431 Oakton St., Morton Grove, IL 60053. The address for Juan Carlos Dalto and DS Waters, LP is 100 Hillside Avenue, White Plains, NY 10603-2861.
- (2) Based upon 16,722,592 shares of Common Stock outstanding as of March 2, 2009.
- (3) On March 2, 2009, Mrs. Smolyansky directly owned 7,535,354 shares of Common Stock. Additionally, Mrs. Smolyansky is deemed to be the indirect beneficial owner of 5,000 shares of Common Stock held in the Smolyansky Family Foundation, of which Mrs. Smolyansky is the Trustee.
- (4) A director or officer of the Company.
- (5) Mr. Dalto is also an officer of The Dannon Company, Inc., which is an affiliate of DS Waters, LP.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE.

### Related Transactions

Based on a review of the questionnaires that our directors and employees subject to Section 16 of the Exchange Act of 1934 completed and a review of our internal records on any related person that were identified in such questionnaires, we have determined that there are no related party transactions in excess of \$120,000 or 1% of the average of the Company's total assets, since the beginning of 2008 or currently proposed, involving the Company.

### Director Independence

In evaluating director independence, the Company has adopted the definition set forth in Rule 4200 of the NASDAQ Marketplace Rules. The Company's board of directors, taking into consideration the relationships described in the Certain Relationships and Related Transactions section above, has determined that of the Company's current directors, Pol Sikar, Renzo Bernardi, and Julie Oberweis were independent of management. The Company's board of directors has also determined that of the individuals who served as directors during 2008, Pol Sikar, Renzo Bernardi, and Julie Oberweis were independent of management.

The Board of Directors does not have a standing nominating committee, compensation committee or any committees performing similar functions. As there are only six Directors serving on the Board, it is the view of the Board that all Directors should participate in the process for the nomination and review of potential Director candidates and for the review of the Company's executive pay practices. Accordingly, Julie Smolyansky, Ludmila Smolyansky and Juan Carlos Dalto, who are not considered independent, participate in the nominating process, in the review of executive employment contracts and in review of the Company's executive compensation practices, together with the independent directors.

## ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

### AUDIT FEES

In 2008 and 2007, Plante & Moran, PLLC, billed Lifeway approximately \$153,550 and \$151,000, respectively, for professional services rendered for the audit of Lifeway's annual financial statements and review of financial statements included in Lifeway's Forms 10-QSB or services that are normally provided in connection with statutory and

regulatory filings or engagements in 2007 and 2008.

AUDIT-RELATED FEES

None.

44

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## TAX FEES

No professional services were rendered by Plante & Moran, PLLC to Lifeway regarding tax advice, tax compliance and tax planning during 2007 and 2008.

## ALL OTHER FEES

No other fees were billed to Lifeway by Plante during 2007 and 2008 other than those described in this report.

No hours expended by Plante & Moran, PLLC in its engagement to audit Lifeway's financial statements for the most recent fiscal year were attributable to work performed by persons other than Plante's full-time permanent employees. The Audit Committee has approved 100% of all services performed by Plante for Lifeway and disclosed above.

## AUDIT COMMITTEE PRE-APPROVAL POLICIES AND PROCEDURES

The Lifeway Audit Committee (the "Committee"), comprised of Messrs. Julie Oberweis, Pol Sikar and Renzo Bernardi, pre-approved Plante & Moran, PLLC as the Company's independent auditor for the year-ended December 31, 2008 and has adopted the following guidelines regarding the engagement of the Company's independent auditor to perform services for the Company:

For audit services (including statutory audit engagements as required under local country laws), the independent auditor will provide the Committee with an engagement letter during the January-March quarter of each year outlining the scope of the audit services proposed to be performed during the fiscal year. If agreed to by the Committee, this engagement letter will be formally accepted by the Committee at its first or second quarter meeting.

The independent auditor will submit to the Committee for approval an audit services fee proposal after acceptance of the engagement letter.

For non-audit services, the Company's management will submit to the Committee for approval (during the second or third quarter of each fiscal year) the list of non-audit services that it recommends the Committee engage the independent auditor to provide for the fiscal year. Company management and the independent auditor will each confirm to the Committee that each non-audit service on the list is permissible under all applicable legal requirements. In addition to the list of planned non-audit services, a budget estimating non-audit service spending for the fiscal year will be provided. The Committee will approve both the list of permissible non-audit services and the budget for such services. The Committee will be informed routinely as to the non-audit services actually provided by the independent auditor pursuant to this pre-approval process.

To ensure prompt handling of unexpected matters, the Committee delegates to either member thereof the authority to amend or modify the list of approved permissible non-audit services and fees. Either member will report action taken to the Committee at the next Committee meeting.

The independent auditor must ensure that all audit and non-audit services provided to the Company have been approved by the Committee. The Chief Financial Officer will be responsible for tracking all independent auditor fees against the budget for such services and report at least annually to the Committee.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.

A list of the Financial Statements and Financial Statement Schedules filed as part of this Report is set forth in Item 8, which list is incorporated herein by reference.

EXHIBITS

- 2.1 Stock Purchase Agreement dated February 6, 2009 by and among Lifeway Foods, Inc., Iyla Mandel and Michael Edelson (incorporated by reference to Exhibit 2.1 of Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed February 13, 2009). (File No. 000-17363)
- 2.2 Real Property Agreement dated February 6, 2009 by and among Lifeway Foods, Inc., Ilya Mandel and Michael Edelson (incorporated by reference to Exhibit 2.2 of Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009). (File No. 000-17363)
- 3.1 Amended and Restated By-laws (incorporated by reference to Exhibit No. 3.5 of Lifeway's Current Report on Form 8-K dated and filed on December 10, 2002). (File No. 000-17363)
- 3.2 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)
- 4.1 Form of Promissory Note, dated August 3, 2006 in favor of Amani Holdings, LLC (incorporated by reference to Exhibit 4.1 of Lifeway's Current Report on Form 8-K dated August 9, 2006 and filed on August 9, 2006). (File No. 000-17363)
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- 4.3 Term Note dated February 6, 2009 (incorporated by reference to Exhibit 10.3 on Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009). (File No. 000-17363).
- 10.1 Lifeway Foods, Inc. Consulting and Services Compensation Plan, dated June 5, 1995 (incorporated by reference to Lifeway's Registration Statement on Form S-8, File No. 33-93306). (File No. 000-17363)
- 10.2 Stock Purchase Agreement with Danone Foods, Inc., dated October 1, 1999 (incorporated by reference to Exhibit 10.10 of Lifeway's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999). (File No. 000-17363)
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- 10.5

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Fourth Extension to Stockholders' Agreement, dated May 3, 2006, between Lifeway Foods, Inc. and DS Waters, L.P. (incorporated by reference to Exhibit 99.1 of Lifeway's Current Report on Form 8-K dated April 28, 2006 and filed on May 5, 2006). (File No. 0-17363)

- 10.6 Fifth Extension to Stockholders' Agreement, dated December 26, 2006, between Lifeway Foods, Inc. and DS Waters, L.P. (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated January 3, 2007 and filed on January 3, 2007). (File No. 000-17363)
- 10.7 Sixth Extension to Stockholders' Agreement, dated December 31, 2007, between Lifeway Foods, Inc. and DS Waters, L.P. (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated December 31, 2007 and filed on January 3, 2008). (File No. 000-17363)
- 10.8 Seventh Extension to Stockholders' Agreement, dated January 15, 2009, between Lifeway Foods, Inc. and DS Waters, L.P. (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated January 15, 2009 and filed on January 16, 2009). (File No. 000-17363)
- 10.9 Loan and Security Agreement dated February 6, 2009 by and among Lifeway Foods, Inc., Fresh Made, Inc., LFI Enterprises, Inc., Helios Nutrition Limited, Pride Main Street Dairy, LLC and Starfruit, LLC and The Private Bank and Trust Company (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009). (File No. 000-17363)



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- 11 Statement re: computation of per share earnings. (Incorporated by reference to Note 2 of the Consolidated Financial Statements).
- 14 Code of Ethics (incorporated by reference to Exhibit 14 on Lifeway's Annual Report on Form 10-KSB for the year ended December 31, 2007 and filed on March 31, 2008). (File No. 000-17363).
- 21 List of Subsidiaries of the Registrant
- 23.1 Consent of Independent Registered Public Accounting Firm
- 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
- 99.1 Press Release dated March 31, 2009 – "Lifeway Foods Reports 4th Quarter and Twelve Months Ended December 31, 2008 Results."

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

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

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

Date: March 31, 2009

KNOW ALL MEN BY THESE PRESENTS, that each individual whose signature appears below hereby constitutes and appoints Julie Smolyansky and Edward P. Smolyansky, and each of them individually, his or her true and lawful agent, proxy and attorney-in-fact, with full power of substitution and resubstitution, for him or her and in his or her name, place and stead, in any and all capacities, to (i) act on, sign and file with the Securities and Exchange Commission any and all amendments to this Report together with all schedules and exhibits thereto, (ii) act on, sign and file with the Securities and Exchange Commission any and all exhibits to this Report and any and all exhibits and schedules thereto, (iii) act on, sign and file any and all such certificates, notices, communications, reports, instruments, agreements and other documents as may be necessary or appropriate in connection therewith and (iv) take any and all such actions which may be necessary or appropriate in connection therewith, granting unto such agents, proxies and attorneys-in-fact, and each of them individually, full power and authority to do and perform each and every act and thing necessary or appropriate to be done, as fully for all intents and purposes as he or she might or could do in person, and hereby approving, ratifying and confirming all that such agents, proxies and attorneys-in-fact, any of them or any of his, her or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: March 31, 2009

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

Date: March 31, 2009

/s/ Ludmila Smolyansky  
Ludmila Smolyansky  
Chairperson of the Board of  
Directors

Date: March 31, 2009  
/s/ Pol Sikar  
Pol Sikar  
Director

Date: March 31, 2009  
Juan Carlos Dalto  
Director

Date: March 31, 2009  
/s/ Renzo Bernardi  
Renzo Bernardi  
Director

Date:  
Julie Oberweis  
Director

INDEX OF EXHIBITS

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