

LIFEWAY FOODS INC  
Form 10-Q  
November 16, 2009

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

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(Mark  
One)

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

For the quarterly period ended: September 30, 2009

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-17363

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

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Illinois  
(State or Other Jurisdiction of Incorporation  
or Organization)

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

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

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by  
Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for

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

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

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

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

As of September 30, 2009, the issuer had 16,775,930 shares of common stock, no par value, outstanding.

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LIFEWAY FOODS, INC.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2009 and 2008

AND DECEMBER 31, 2008

## ITEM 1. FINANCIAL STATEMENTS.

## LIFEWAY FOODS, INC. AND SUBSIDIARIES

## Consolidated Statements of Financial Condition

September 30, 2009 and 2008 (Unaudited) and December 31, 2008

|   | (Unaudited)<br>September 30 |               | December 31,  |
|---|-----------------------------|---------------|---------------|
|   | 2009                        | 2008          | 2008          |
| <b>ASSETS</b>   |                             |               |               |
| Current assets  |                             |               |               |
| Cash and cash equivalents   | \$ 804,387                  | \$ 530,866    | \$ 277,248    |
| Marketable securities   | 4,950,457                   | 5,668,940     | 5,262,168     |
| Inventories   | 4,106,631                   | 4,207,094     | 3,097,542     |
| Accounts receivable, net of allowance for doubtful<br>accounts of \$35,011 at September 30, 2009 and 2008 and<br>\$110,011 at December 31, 2008               | 7,311,856                   | 5,161,414     | 4,765,865     |
| Prepaid expenses and other current assets   | 45,565                      | 20,864        | 23,226        |
| Other receivables   | 37,715                      | 28,918        | 40,314        |
| Deferred income taxes   | 338,070                     | 909,479       | 919,649       |
| Refundable income taxes   | 26,276                      | ---           | 356,416       |
| Total current assets  | 17,620,957                  | 16,527,575    | 14,742,428    |
| Property and equipment, net   | 13,812,039                  | 10,989,500    | 11,062,714    |
| Intangible assets   |                             |               |               |
| Goodwill and other non amortizable brand asset  | 12,154,091                  | 5,414,858     | 5,414,858     |
| Other intangible assets, net of accumulated amortization<br>of \$1,429,509 and \$841,561 at September 30, 2009 and<br>2008 and \$921,422 at December 31, 2008 | 6,428,129                   | 3,016,077     | 2,936,216     |
| Total intangible assets   | 18,582,220                  | 8,430,935     | 8,351,074     |
| Other assets  | 500,000                     | 500,000       | 500,000       |
| Total assets  | \$ 50,515,216               | \$ 36,448,010 | \$ 34,656,216 |

## LIABILITIES AND STOCKHOLDERS' EQUITY

## Current liabilities

|                                     |              |              |            |
|-------------------------------------|--------------|--------------|------------|
| Current maturities of notes payable | \$ 6,231,204 | \$ 1,125,608 | \$ 928,444 |
| Accounts payable                    | 2,180,297    | 2,361,318    | 2,260,272  |
| Accrued expenses                    | 683,685      | 532,662      | 458,282    |
| Margin payable                      | —            | 428,951      | —          |
| Accrued income taxes                | —            | 308,260      | —          |
| Total current liabilities           | 9,095,186    | 4,756,799    | 3,646,998  |
| Notes payable                       | 7,400,573    | 3,219,338    | 3,108,014  |

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|  |               |               |               |
|--|---------------|---------------|---------------|
| Deferred income taxes  | 2,010,273     | 1,615,421     | 1,607,155     |
| Stockholders' equity   |               |               |               |
| Common stock, no par value; 20,000,000 shares authorized; 17,273,776 shares issued; 16,775,930 shares outstanding at September 30, 2009; 17,273,776 shares issued; 16,730,226 shares outstanding at September 30, 2008; and 17,273,776 shares issues; 16,724,467 shares outstanding at December 31, 2008 | 6,509,267     | 6,509,267     | 6,509,267     |
| Paid-in-capital  | 1,939,316     | 1,175,539     | 1,202,009     |
| Treasury stock, at cost  | ( 3,851,462)  | ( 3,207,213)  | ( 3,302,025)  |
| Retained earnings  | 27,833,816    | 23,126,672    | 22,383,707    |
| Accumulated other comprehensive loss, net of taxes   | ( 421,753)    | ( 747,813)    | ( 498,909)    |
| Total stockholders' equity   | 32,009,184    | 26,856,452    | 26,294,049    |
| Total liabilities and stockholders' equity   | \$ 50,515,216 | \$ 36,448,010 | \$ 34,656,216 |

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Consolidated Statements of Income and Comprehensive Income

For the Three and Nine Months Ended September 30, 2009 and 2008 (Unaudited)

and the Year Ended December 31, 2008

|   | (Unaudited)                         |               | (Unaudited)                        |               | Year Ended<br>December 31,<br>2008 |
|---|-------------------------------------|---------------|------------------------------------|---------------|------------------------------------|
|   | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |                                    |
|   | 2009                                | 2008          | 2009                               | 2008          |                                    |
| Sales   | 15,433,876                          | \$ 11,240,282 | \$ 43,649,383                      | \$ 33,885,912 | 44,461,455                         |
| Cost of goods sold                                      | 8,892,088                           | 7,505,794     | 24,994,778                         | 22,403,574    | 30,926,114                         |
| Depreciation expense                                    | 288,613                             | 197,366       | 859,044                            | 581,920       | 777,715                            |
| Total cost of goods sold                                | 9,180,701                           | 7,703,160     | 25,853,822                         | 22,985,494    | 31,703,829                         |
| Gross profit  | 6,253,175                           | 3,537,122     | 17,795,561                         | 10,900,418    | 12,757,626                         |
| Selling Expenses  | 1,231,216                           | 957,978       | 3,176,162                          | 3,171,269     | 4,098,176                          |
| General and<br>Administrative                           | 1,613,828                           | 1,032,043     | 5,173,724                          | 3,109,506     | 4,149,010                          |
| Amortization expense                                    | 168,699                             | 79,862        | 508,086                            | 239,585       | 319,446                            |
| Total Operating Expenses                                | 3,013,743                           | 2,069,883     | 8,857,972                          | 6,520,360     | 8,566,632                          |
| Income from operations                                  | 3,239,432                           | 1,467,239     | 8,937,589                          | 4,380,058     | 4,190,994                          |
| Other income (expense):                                 |                                     |               |                                    |               |                                    |
| Interest and dividend<br>income                         | 34,180                              | 95,042        | 144,899                            | 261,037       | 343,329                            |
| Rental Income   | 12,047                              | 13,647        | 33,340                             | 36,940        | 48,886                             |
| Interest expense  | ( 99,864)                           | ( 71,928)     | ( 364,337)                         | ( 226,851)    | ( 298,619)                         |
| Impairment of marketable<br>securities                  | —                                   | ( 270,908)    | —                                  | ( 270,908)    | ( 958,879)                         |
| Loss on Disposition of<br>Equipment                     | —                                   | —             | ( 2,825)                           | —             | —                                  |
| Gain (loss) on sale of<br>marketable<br>securities, net | ( 178,143)                          | ( 110,259)    | ( 274,296)                         | ( 146,404)    | ( 733,647)                         |
| Total other income<br>(Expense)                         | ( 231,780)                          | ( 344,406)    | ( 463,219)                         | ( 346,186)    | ( 1,598,930)                       |
| Income before provision<br>for<br>income taxes          | 3,007,652                           | 1,122,833     | 8,474,370                          | 4,033,872     | 2,592,064                          |
| Provision for income<br>taxes                           | 1,636,911                           | 267,917       | 3,024,261                          | 1,378,632     | 679,789                            |

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|   |              |            |              |              |              |
|---|--------------|------------|--------------|--------------|--------------|
| Net income  | \$ 1,370,741 | \$ 854,916 | \$ 5,450,109 | \$ 2,655,240 | \$ 1,912,275 |
| Basic and diluted earnings per common share   | 0.08         | 0.05       | 0.32         | 0.16         | 0.11         |
| Weighted average number of shares outstanding   | 16,798,623   | 16,730,650 | 16,799,134   | 16,867,890   | 16,765,080   |
| <b>COMPREHENSIVE INCOME</b>   |              |            |              |              |              |
| Net income  | \$ 1,370,741 | \$ 854,916 | \$ 5,450,109 | \$ 2,655,240 | \$ 1,912,275 |
| Other comprehensive income (loss), net of tax:  |              |            |              |              |              |
| Unrealized gains (losses) on marketable securities (net of tax benefits)                  | 114,628      | ( 480,045) | 326,060      | ( 895,641)   | ( 720,517)   |
| Less reclassification adjustment for (gains) losses included in net income (net of taxes) | 104,609      | 64,746     | 161,071      | 85,963       | 430,651      |
| Comprehensive income  | \$ 1,589,978 | \$ 439,617 | \$ 5,937,240 | \$ 1,845,562 | \$ 1,622,409 |

See accompanying notes to financial statements



LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Changes in Stockholders' Equity  
For the Nine Months Ended September 30, 2009 (Unaudited)  
and the Year Ended December 31, 2008

|   | Common Stock,<br>No Par Value<br>20,000,000 Shares<br>Authorized |                            | # of<br>Shares<br>of | Treasury<br>Stock | Common<br>Stock | Paid In<br>Capital | Treasury<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss),<br>Net of Tax | Total |
|---|--|----------------------------|----------------------|-------------------|-----------------|--------------------|-------------------|----------------------|--|-------|
|   | # of Shares<br>Issued  | # of Shares<br>Outstanding |                      |                   |                 |                    |                   |                      |  |       |
| Balances at<br>December 31,<br>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<br>stock  | —  | ( 112,009)                 | 112,009              | —                 | —               | ( 1,239,488)       | —                 | —                    | ( 1,239,488)   |       |
| Issuance of<br>treasury stock   | —  | —                          | —                    | —                 | —               | —                  | —                 | —                    | —  |       |
| Compensation  | —  | 8,750                      | ( 8,750)             | —                 | 81,340          | 15,628             | —                 | —                    | 96,968   |       |
| Other<br>comprehensive<br>income (loss):  |  |                            |                      |                   |                 |                    |                   |                      |  |       |
| Unrealized<br>gains on<br>securities, net<br>of taxes and<br>classification<br>adjustment | —  | —                          | —                    | —                 | —               | —                  | —                 | ( 289,866)           | ( 289,866)   |       |
| Net income for<br>the year ended<br>December 31,<br>2008                                  | —  | —                          | —                    | —                 | —               | —                  | 1,912,275         | —                    | 1,912,275  |       |
| Balances at<br>December 31,<br>2008   | 17,273,776   | 16,724,467                 | 549,309              | 6,509,267         | 1,202,009       | (3,302,025)        | 22,383,707        | ( 498,909)           | 26,294,049   |       |
| Redemption of<br>stock  | —  | ( 87,991)                  | 87,991               | —                 | —               | ( 905,607)         | —                 | —                    | ( 905,607)   |       |
|   | —  | 10,507                     | ( 10,507)            | —                 | 92,569          | 20,908             | —                 | —                    | 113,479  |       |

|   |            |            |           |              |              |                |               |              |               |
|---|------------|------------|-----------|--------------|--------------|----------------|---------------|--------------|---------------|
| Balance of<br>treasury stock  |            |            |           |              |              |                |               |              |               |
| Compensation  |            |            |           |              |              |                |               |              |               |
| Balance of<br>treasury stock<br>Fresh Made<br>acquisition   | —          | 128,947    | (128,947) | —            | 644,738      | 335,262        | —             | —            | 980,000       |
| Other<br>comprehensive<br>income (loss):<br>Unrealized<br>gains on<br>securities, net<br>of taxes and<br>classification<br>adjustment | —          | —          | —         | —            | —            | —              | —             | 77,156       | 77,156        |
| Net income for<br>the nine months<br>ended<br>September 30,<br>2009   | —          | —          | —         | —            | —            | —              | 5,450,109     | —            | 5,450,109     |
| Balances at<br>September 30,<br>2009  | 17,273,776 | 16,775,930 | 497,846   | \$ 6,509,267 | \$ 1,939,316 | \$ (3,851,462) | \$ 27,833,816 | \$ (421,753) | \$ 32,009,180 |

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

For the Nine Months Ended September 30, 2009 and 2008 (Unaudited)

and the Year Ended December 31, 2008

|  | (Unaudited)           |                       |                      |
|--|-----------------------|-----------------------|----------------------|
|  | Nine Months Ended     |                       |                      |
|  | September 30,<br>2009 | September 30,<br>2008 | December 31,<br>2008 |
| Cash flows from operating activities:  |                       |                       |                      |
| Net income   | \$ 5,450,109          | \$ 2,655,240          | \$ 1,912,275         |
| Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition: |                       |                       |                      |
| Depreciation and amortization  | 1,367,130             | 821,505               | 1,092,995            |
| (Gain)Loss on sale of marketable securities, net   | 274,296               | 146,404               | 733,647              |
| Loss on disposition of assets  | 2,825                 | —                     | —                    |
| Impairment of marketable securities  | —                     | 270,908               | 958,879              |
| Deferred income taxes  | 236,063               | ( 125,221)            | ( 509,386)           |
| Treasury stock issued for compensation   | 113,476               | 65,809                | 96,968               |
| Increase (decrease) in allowance for doubtful accounts   | —                     | ( 4,449)              | 70,551               |
| (Increase) decrease in operating assets:   |                       |                       |                      |
| Accounts receivable  | ( 2,000,033)          | ( 947,303)            | ( 626,754)           |
| Other receivables  | 2,599                 | 14,193                | 2,797                |
| Inventories  | ( 636,236)            | ( 700,540)            | 409,012              |
| Refundable income taxes  | 807,067               | 240,880               | ( 115,536)           |
| Prepaid expenses and other current assets  | 4,661                 | 665                   | ( 1,973)             |
| Increase (decrease) in operating liabilities:  |                       |                       |                      |
| Accounts payable   | ( 284,927)            | 766,988               | 665,942              |
| Accrued expenses   | 167,114               | 118,650               | 44,243               |
| Accrued income taxes   | —                     | 308,260               | —                    |
| Net cash provided by operating activities  | 5,504,144             | 3,631,989             | 4,733,660            |
| Cash flows from investing activities:  |                       |                       |                      |
| Purchases of marketable securities   | ( 6,050,202)          | ( 4,864,873)          | ( 5,782,452)         |
| Sale of marketable securities  | 6,792,962             | 4,659,350             | 5,323,423            |
| Increase in margin   | —                     | 428,951               | —                    |
| Purchases of property and equipment  | ( 1,020,776)          | ( 1,892,472)          | ( 2,157,315)         |
| Acquisition of Fresh Made, net of cash acquired  | ( 3,442,546)          | —                     | —                    |
| Net cash used in investing activities  | ( 3,720,562)          | ( 1,669,044)          | ( 2,616,344)         |
| Cash flows from financing activities:  |                       |                       |                      |
| Proceeds of note payable   | 1,753,504             | —                     | —                    |
| Purchases of treasury stock, net   | ( 905,607)            | ( 1,139,987)          | ( 1,239,488)         |
| Repayment of notes payable   | ( 2,104,340)          | ( 887,977)            | ( 1,196,465)         |
| Net cash provided (used) in financing activities   | ( 1,256,443)          | ( 2,027,964)          | ( 2,435,953)         |
| Net increase (decrease) in cash and cash equivalents   | 527,139               | ( 65,019)             | ( 318,637)           |

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|  |            |            |            |
|--|------------|------------|------------|
| Cash and cash equivalents at the beginning of the period | 277,248    | 595,885    | 595,885    |
| Cash and cash equivalents at the end of the period       | \$ 804,387 | \$ 530,866 | \$ 277,248 |

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements  
September 30, 2009 and 2008  
and December 31, 2008

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., Starfruit, L.L.C., Fresh Made, Inc and Starfruit Franchise, 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 investment securities, 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.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements  
September 30, 2009 and 2008  
and December 31, 2008

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

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

|  | September 30, |            | December 31, |  |
|--|---------------|------------|--------------|--|
|  | 2009          | 2008       | 2008         |  |
| Amounts insured                        | \$ 1,787,108  | \$ 138,913 | \$ 847,711   |  |
| Uninsured and uncollateralized amounts | —             | 846,239    | —            |  |
| Total bank balances                    | \$ 1,787,108  | \$ 985,152 | \$ 847,711   |  |

## Marketable securities

All investment securities are classified as available-for-sale, 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. Amortization, accretion, interest and dividends, realized gains and losses, and declines in value judged to be other-than-temporary on available-for-sale securities are recorded in other income. All of the Company's securities are subject to a periodic impairment evaluation. This evaluation depends on the specific facts and circumstances. Factors that we consider in determining whether an other-than-temporary decline in value has occurred include: the market value of the security in relation to its cost basis; the financial condition of the investee; and the intent and ability to retain the investment for a sufficient period of time to allow for possible recovery in the market value of the investment.

## Accounts receivable

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

Accounts receivable are recorded at invoice amounts, and reduced to their estimated net realizable value by recognition of an allowance for doubtful accounts. 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  
September 30, 2009 and 2008  
and December 31, 2008

## 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. Brand assets represent the fair value of brands acquired. Brand assets have an indefinite life, therefore are not amortized, rather are reviewed periodically for impairment. The Company amortizes other intangible assets over their estimated useful lives, as disclosed in the table below.

The Company reviews intangible assets and their related useful lives at least once 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 | 7-10  |
| Lease agreement                                       | 7     |

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|                                  |    |
|----------------------------------|----|
| Trade names                      | 15 |
| Formula                          | 10 |
| C u s t o m e r<br>relationships | 12 |

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

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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 “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109,” which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. Pursuant to the adoption 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 the adoption. In addition, the Company did not record a cumulative effect adjustment related to the adoption of the standard.

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 for the nine months ended September 30, 2009 and 2008, approximately \$1,530,207, \$1,288,844 and \$1,241,442 of such costs respectively, were expensed.

Earning per common share

Earnings per common share were computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. For the nine months ended September 30, 2009 and 2008 and the year ended December 31, 2008, 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

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## Note 3 – ACQUISITION

On February 6, 2009, Lifeway Foods, Inc., a Illinois corporation (“Lifeway”) completed 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”).

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 \$8,048,000, 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 approximately \$2,089,000.

The acquisition was accounted for using the purchase accounting method of accounting, and accordingly, the purchase price was allocated to assets acquired and the liabilities assumed based on the fair value as of the merger date. Acquisition costs for legal and professional fees have been included in General and Administrative costs.

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

|  |               |
|--|---------------|
| Cash and cash equivalents                                    | \$ 226,000    |
| Accounts receivable (contractual amounts totaling \$545,958) | 546,000       |
| Other current assets   | 361,000       |
| Building and other fixed assets                              | 2,617,000     |
| Customer list  | 4,000,000     |
| Non amortizable goodwill and brand asset                     | 6,739,000     |
| Current liabilities  | ( 461,000)    |
| Total fair value of assets acquired and liabilities assumed  | \$ 14,028,000 |

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Note 4 – INTANGIBLE ASSETS

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

|   | September 30, 2009 |                          | September 30, 2008 |                          | December 31, 2008 |                          |
|---|--------------------|--------------------------|--------------------|--------------------------|-------------------|--------------------------|
|   | Cost               | Accumulated Amortization | Cost               | Accumulated Amortization | Cost              | Accumulated Amortization |
| Recipes   | \$ 43,600          | \$ 43,600                | \$ 43,600          | \$ 42,009                | \$ 43,600         | \$ 43,600                |
| Customer lists and other customer related intangibles | 4,305,200          | 486,280                  | 305,200            | 172,583                  | 305,200           | 182,938                  |
| Lease acquisition                                     | 87,200             | 64,359                   | 87,200             | 51,904                   | 87,200            | 55,019                   |
| Other   | 6,638              | 6,638                    | 6,638              | 4,317                    | 6,638             | 4,647                    |
| C u s t o m e r relationship                          | 985,000            | 259,932                  | 985,000            | 177,848                  | 985,000           | 198,368                  |
| Contractual backlog                                   | 12,000             | 12,000                   | 12,000             | 12,000                   | 12,000            | 12,000                   |
| Trade names   | 1,980,000          | 418,000                  | 1,980,000          | 286,000                  | 1,980,000         | 319,000                  |
| Formula   | 438,000            | 138,700                  | 438,000            | 94,900                   | 438,000           | 105,850                  |
|   | \$ 7,857,638       | \$ 1,429,509             | \$ 3,857,638       | \$ 841,561               | \$ 3,857,638      | \$ 921,422               |

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

|            |              |
|------------|--------------|
| 2010       | \$ 667,716   |
| 2011       | 667,631      |
| 2012       | 651,800      |
| 2013       | 624,550      |
| 2014       | 624,550      |
| Thereafter | 3,191,882    |
|            | \$ 6,428,129 |

Amortization expense during the nine months ended September 30, 2009 and 2008 and for the year ended December 31, 2008 was \$508,086, \$239,585 and \$319,446, respectively.

Goodwill and brand assets increased during the period ending September 30, 2009 due to the acquisition of Fresh Made (See Note 3).

Note 5 – MARKETABLE SECURITIES

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

| September 30, 2009 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|--------------------|------|------------------|-------------------|------------|
|--------------------|------|------------------|-------------------|------------|

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|                               |              |            |               |              |
|-------------------------------|--------------|------------|---------------|--------------|
| Equities                      | \$ 1,383,083 | \$ 127,024 | ( 137,790)    | \$ 1,372,317 |
| Mutual Funds                  | 178,166      | 2,018      | ( 25,885)     | 154,299      |
| Preferred Securities          | 388,705      | 7,080      | ( 135,301)    | 260,484      |
| Corporate Bonds               | 1,559,094    | 48,181     | ( 9,246)      | 1,598,029    |
| Government Agency Obligations | 933,760      | 9,212      | ( 6,764)      | 936,208      |
| Certificate of Deposits       | 652,005      | —          | ( 22,885)     | 629,120      |
| Total                         | \$ 5,094,813 | \$ 193,515 | \$ ( 337,871) | \$ 4,950,457 |

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LIFEWAY FOODS, INC. AND SUBSIDIARIES  
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## Note 5 – MARKETABLE SECURITIES - Continued

| September 30, 2008            | Cost         | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|-------------------------------|--------------|---------------------|----------------------|---------------|
| Equities                      | \$ 3,077,340 | \$ 55,002           | \$ ( 639,374)        | \$ 2,492,968  |
| Mutual Funds                  | 940,322      | —                   | ( 287,919)           | 652,403       |
| Preferred Securities          | 1,714,758    | —                   | ( 509,150)           | 1,205,608     |
| Corporate Bonds               | 917,990      | —                   | ( 75,144)            | 842,846       |
| Municipal Bonds               | 4,586        | 374                 | —                    | 4,960         |
| Government agency Obligations | 478,507      | —                   | ( 8,352)             | 470,155       |
| Total                         | \$ 7,133,503 | \$ 55,376           | \$ ( 1,519,939)      | \$ 5,668,940  |

  

| 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  |

Proceeds from the sale of marketable securities were \$5,323,423, \$6,792,962 and \$4,659,350 during the year ended December 31, 2008 and for the nine months ended September 30, 2009 and 2008 respectively.

Gross gains of \$384,574, \$346,407 and \$376,751 and gross losses of \$1,118,221, \$620,702 and \$523,155 were realized on these sales during the year ended December 31, 2008 and for the nine months ended September 30, 2009 and 2008, respectively.

The following table shows the gross unrealized losses and fair value of Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2009:

## LIFEWAY FOODS, INC. AND SUBSIDIARIES

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## Note 5 – MARKETABLE SECURITIES - Continued

| Description of Securities     | Less Than 12 Months |                   | 12 Months or Greater |                   | Total        |                   |
|-------------------------------|---------------------|-------------------|----------------------|-------------------|--------------|-------------------|
|                               | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value   | Unrealized Losses |
| Equities                      | \$ 304,784          | \$ ( 82,750)      | \$ 87,596            | \$ ( 55,040)      | \$ 392,380   | \$ ( 137,790)     |
| Mutual Funds                  | 86,194              | ( 17,854)         | 39,061               | ( 8,031)          | 125,255      | ( 25,885)         |
| Preferred Securities          | 3,264               | ( 1,101)          | 235,390              | ( 134,200)        | 238,654      | ( 135,301)        |
| Corporate Bonds               | 409,307             | ( 6,405)          | 101,403              | ( 2,841)          | 510,710      | ( 9,246)          |
| Government Agency Obligations | 259,936             | ( 5,085)          | 76,297               | ( 1,679)          | 336,233      | ( 6,764)          |
| Certificates of Deposit       | 379,120             | ( 22,885)         | —                    | —                 | 379,120      | ( 22,885)         |
|                               | \$ 1,442,605        | \$ ( 136,080)     | \$ 539,747           | \$ ( 201,791)     | \$ 1,982,352 | \$ ( 337,871)     |

For the year ended December 31, 2008, we recorded other than temporary impairments related to investments in marketable securities in certain investments of \$958,879. 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.

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 September 30, 2009.

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 September 30, 2009.



LIFEWAY FOODS, INC. AND SUBSIDIARIES  
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## Note 6 – INVENTORIES

Inventories consist of the following:

|                     | September 30, |              | December 31, |           |
|---------------------|---------------|--------------|--------------|-----------|
|                     | 2009          | 2008         | 2008         | 2008      |
| Finished goods      | \$ 1,626,092  | \$ 1,375,304 | \$           | 1,343,811 |
| Production supplies | 1,718,779     | 1,604,106    |              | 1,291,484 |
| Raw materials       | 761,760       | 1,227,684    |              | 462,247   |
| Total inventories   | \$ 4,106,631  | \$ 4,207,094 | \$           | 3,097,542 |

## Note 7 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

|                               | September 30, |               | December 31, |            |
|-------------------------------|---------------|---------------|--------------|------------|
|                               | 2009          | 2008          | 2008         | 2008       |
| Land                          | \$ 1,178,160  | \$ 969,232    | \$           | 969,232    |
| Buildings and improvements    | 9,967,295     | 7,102,608     |              | 7,138,042  |
| Machinery and equipment       | 12,292,030    | 8,227,558     |              | 8,229,202  |
| Vehicles                      | 961,245       | 610,558       |              | 610,558    |
| Office equipment              | 238,029       | 137,120       |              | 180,351    |
| Construction in process       | —             | 2,120,346     |              | 2,309,045  |
|                               | 24,636,759    | 19,167,422    |              | 19,436,430 |
| Less accumulated depreciation | 10,824,720    | 8,177,922     |              | 8,373,716  |
| Total property and equipment  | \$ 13,812,039 | \$ 10,989,500 | \$           | 11,062,714 |

Depreciation expense during the year ended December 31, 2008 and for the nine months ended September 30, 2009 and 2008 was \$777,715, \$859,044 and \$581,920, respectively.

## Note 8 – ACCRUED EXPENSES

Accrued expenses consist of the following:

|                                   | September 30, |            | December 31, |         |
|-----------------------------------|---------------|------------|--------------|---------|
|                                   | 2009          | 2008       | 2008         | 2008    |
| Accrued payroll and payroll taxes | \$ 234,269    | \$ 111,631 | \$           | 98,089  |
| Accrued property tax              | 376,840       | 363,672    |              | 291,819 |
| Other                             | 72,576        | 57,359     |              | 68,374  |
|                                   | \$ 683,685    | \$ 532,662 | \$           | 458,282 |



## LIFEWAY FOODS, INC. AND SUBSIDIARIES

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## Note 9 – NOTES PAYABLE

Notes payable consist of the following:

|  | September 30,<br>2009 | 2008         | December 31,<br>2008 |
|--|-----------------------|--------------|----------------------|
| 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.   | —                     | \$ 440,874   | \$ 438,926           |
| 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.   | —                     | 2,779,572    | 2,760,288            |
| Note payable to Amani Holding LLC, payable in quarterly installments of \$262,500 plus interest at the floating prime rate per annum (7.25% at December 31, 2007) due September 1, 2010 secured by letter of credit.                       | —                     | 1,124,500    | 837,244              |
| Note payable to Private Bank in monthly installments of \$42,222, plus variable interest rate, currently at 2.945%, with a balloon payment of \$5,066,667 due February 6, 2014. Collateralized by substantially all assets of the Company. | 7,262,222             | —            | —                    |
| Line of credit with Private Bank at variable interest rate, currently at 2.945%, due on February 6, 2010. Collateralized by real estate.   | 2,400,000             | —            | —                    |
| Line of credit with Morgan Stanley at variable interest rate, currently at 2.40%. Secured by marketable securities.  | 1,957,040             | —            | —                    |
| Subordinated notes payable to Ilya Mandel & Michael Edelson, payable in quarterly installments of \$341,875, plus interest at the floating rate per annum (3.3% at September 30, 2009) due February 6, 2011.                               | 2,012,515             | —            | —                    |
| Total notes payable  | 13,631,777            | 4,344,946    | 4,036,458            |
| Less current maturities  | 6,231,204             | 1,125,608    | 928,444              |
| Total long-term portion  | \$ 7,400,573          | \$ 3,219,338 | \$ 3,108,014         |



LIFEWAY FOODS, INC. AND SUBSIDIARIES

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Note 9 – NOTES PAYABLE - Continued

Maturities of notes payables are as follows:

| For the Period Ended September 30, |    |            |
|------------------------------------|----|------------|
| 2010                               | \$ | 6,231,204  |
| 2011                               |    | 1,151,682  |
| 2012                               |    | 506,667    |
| 2013                               |    | 506,667    |
| 2014                               |    | 5,235,557  |
| Total                              | \$ | 13,631,777 |

Note 10 – PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

|                            | For the Nine Months Ended<br>September 30, |              | For the<br>Year Ended<br>December 31, |
|----------------------------|--|--------------|---------------------------------------|
|                            | 2009                                       | 2008         | 2008                                  |
| Current:                   |  |              |                                       |
| Federal                    | \$ 2,293,323                               | \$ 1,267,998 | \$ 1,005,159                          |
| State and local            | 494,875                                    | 235,855      | 184,016                               |
| Total current              | 2,788,198                                  | 1,503,853    | 1,189,175                             |
| Deferred                   | 236,063                                    | (125,221)    | (509,386)                             |
| Provision for income taxes | \$ 3,024,261                               | \$ 1,378,632 | \$ 679,789                            |

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

|  | For the Nine Months Ended<br>September 30, |              | For the<br>Year Ended<br>December 31, |
|--|--|--------------|---------------------------------------|
|  | 2009                                       | 2008         | 2008                                  |
| Federal income tax expense computed<br>at the statutory rate | \$ 2,881,286                               | \$ 1,463,625 | \$ 881,302                            |
| State and local tax expense, net                             | 406,770                                    | 206,629      | 124,419                               |
| Permanent differences  | (263,795)                                  | (291,622)    | (150,772)                             |
| Other  | —  | —            | (175,160)                             |
| Provision for income taxes                                   | \$ 3,024,261                               | \$ 1,378,632 | \$ 679,789                            |



## LIFEWAY FOODS, INC. AND SUBSIDIARIES

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## Note 10 – PROVISION FOR INCOME TAXES - Continued

Amounts for deferred tax assets and liabilities are as follows:

|   | 2009           | September 30,<br>2008 | December 31,<br>2008 |
|---|----------------|-----------------------|----------------------|
| Non-current deferred tax liabilities arising from:                |                |                       |                      |
| Temporary differences - accumulated depreciation and amortization | \$ (2,010,273) | \$ (1,615,421)        | \$ (1,607,155)       |
| Current deferred tax assets arising from:                         |                |                       |                      |
| Unrealized losses on marketable securities                        | 59,619         | 716,749               | 351,020              |
| Impairment of marketable securities                               | 59,003         | —                     | 396,017              |
| Inventory   | 174,013        | 178,271               | 127,177              |
| Allowance for doubtful accounts                                   | 14,460         | 14,459                | 14,460               |
| Allowance for promotions  | 30,975         | —                     | 30,975               |
| Total current deferred tax assets (liabilities)                   | 338,070        | 909,479               | 919,649              |
| Net deferred tax liability  | \$ (1,672,203) | \$ (705,942)          | \$ (687,506)         |

## Note 11 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

|              | For the Nine Months Ended<br>September 30, |            | For the<br>Year Ended<br>December 31, |
|--------------|--|------------|---------------------------------------|
|              | 2009                                       | 2008       | 2008                                  |
| Interest     | \$ 330,095                                 | \$ 222,166 | \$ 307,620                            |
| Income taxes | \$ 2,458,149                               | \$ 937,967 | \$ 1,288,428                          |

## Note 12 – STOCK AWARD AND STOCK OPTION PLANS

The Company has a registration statement filed with the Securities and Exchange Commission in connection with a Consulting Service Compensation Plan covering up to 1,200,000 of the Company's common stock shares. Pursuant to such Plan, the Company may issue common stock or options to purchase common stock to certain consultants, service providers, and employees of the Company. The option price, number of shares, grant date, and vesting terms are determined at the discretion of the Company's Board of Directors.

As of December 31, 2008 and at September 30, 2009 and 2008, there were no stock options outstanding or exercisable. There were approximately 940,000 shares available for issuance under the Plan at September 30, 2009.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

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Note 12 – STOCK AWARD AND STOCK OPTION PLANS - Continued

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 13 – FAIR VALUE MEASUREMENTS

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

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

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

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

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



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## Note 13 – FAIR VALUE MEASUREMENTS - Continued

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 Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) | Balance at<br>September<br>30, 2009 |
|--|---|---|---|-------------------------------------|
| Assets   |   |   |   |                                     |
| Investment securities-<br>available - for - sale | \$ 4,950,457  | —   | —   | \$ 4,950,457                        |

## Note 14 – RECENT ACCOUNTING PRONOUNCEMENTS

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

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

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements  
September 30, 2009 and 2008  
and December 31, 2008

Note 14 – RECENT ACCOUNTING PRONOUNCEMENTS - Continued

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 did not have a material impact on the Company’s financial condition, results of operations or liquidity.

On April 9, 2009, the FASB finalized three FASB Staff Positions (“FSPs”) regarding the accounting treatment for investments including mortgage-backed securities. These FSPs changed the method for determining if an other-than-temporary impairment (“OTTI”) exists and the amount of OTTI to be recorded through an entity’s income statement. The changes brought about by the FSPs provide greater clarity and reflect a more accurate representation of the credit and noncredit components of an OTTI event. The three FSPs are as follows:

FASB ASC 820-10-65-4, Fair Value Measurements and Disclosures provides guidelines for making fair value measurements that determine fair value when the volume and level of activity for assets or liabilities have significantly decreased and identify transactions that are not orderly.

FASB ASC 320-10-65, Investments — Debt and Equity Securities provides additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on securities.

FASB ASC 825-10-65, Financial Instruments enhances consistency in financial reporting by increasing the frequency of fair value disclosures.

The adoption of these did not have a material effect on the Company’s results of operations or financial position.

In May 2009, FASB issued FASB ASC 855, Subsequent Events with the objective to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FASB ASC 855 sets forth: (i) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements; (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements; and (iii) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. FASB ASC 855 is effective for interim and annual financial periods ending after June 15, 2009. The adoption of FASB ASC 855 on June 30, 2009, did not have an impact on the Company’s consolidated financial statements.



LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements  
September 30, 2009 and 2008  
and December 31, 2008

Note 14 – RECENT ACCOUNTING PRONOUNCEMENTS - Continued

In June 2009, FASB issued FASB ASC 810, Consolidation. The objective of FASB ASC 810 is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. FASB ASC 810 shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. The Company is currently evaluating the impact of the adoption of this standard, but does not expect it have a material effect on the Company's financial position or results of operation.

In June 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles." SFAS No. 168 approved the FASB Accounting Standards Codification (the Codification) as the single source of authoritative nongovernmental GAAP. All existing accounting standard documents, such as FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and other related literature, excluding guidance from the Securities and Exchange Commission, have been superseded by the Codification. All other non-grandfathered, non-SEC accounting literature not included in the Codification has become nonauthoritative. The Codification is effective for interim or annual periods ending after September 15, 2009. There have been no changes to the content of our financial statements or disclosures as a result of implementing the Codification during the quarter ended September 30, 2009. However, as a result of implementation of the Codification, previous references to new accounting standards and literature are no longer applicable. All future references to authoritative accounting literature in our consolidated financial statements will be referenced in accordance with the Codification.

Note 15 – SUBSEQUENT EVENTS

None.

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

Comparison of Quarter Ended September 30, 2009 to Quarter Ended September 30, 2008

The following analysis should be read in conjunction with the unaudited financial statements of the Company and related notes included elsewhere in this quarterly report and the audited financial statements and Management's Discussion and Analysis contained in our Form 10-K, for the fiscal year ended December 31, 2008, and in the Management's Discussion and Analysis contained in our Form 10-Q, for the fiscal quarters ended March 31, 2009 and June 30, 2009.

Results of Operations

Total consolidated group sales increased by \$4,193,594, (approximately 37%) to \$15,433,876 during the three-month period ended September 30, 2009 from \$11,240,282 during the same three-month period in 2008. This increase is primarily attributable to increased sales and awareness of Lifeway's flagship line, Kefir, as well as ProBugs® Organic Kefir for kids. Additionally, Lifeway recorded revenues from its February 6, 2009 acquisition of Fresh Made Dairy. Included in the total group sales was approximately \$2,190,000 of revenue related to this acquisition and recorded during the third quarter of 2009.

Cost of goods sold as a percentage of sales, excluding depreciation was approximately 58% during the third quarter 2009, compared to about 67% during the same period in 2008. The decrease was primarily attributable to the decreased cost of conventional milk, our largest raw material, and the cost of transportation and other petroleum based production supplies. The cost of conventional milk was approximately 30% less during the 3rd quarter 2009, when compared to the same period in 2008. Gross profit increased approximately 77% during the third quarter of 2009, when compared with the same period in 2008.

Operating expenses as a percentage of sales were approximately 20% during the third quarter 2009, compared to about 18% during the same period in 2008. This increase is primarily attributable to a 111% increase in amortization expense, a non cash expense, related to the February 6, 2009 acquisition of Fresh Made Dairy.

Total operating income increased by \$1,772,193, (approximately 121%) to \$3,239,432 during the third quarter 2009, from \$1,467,239 during the same period in 2008.

Interest expense during the third quarter 2009 was \$99,864 compared with interest expense of \$71,928 during the same period a year ago. This higher interest expense is primarily attributable to the issuance of the note payable related to the February 6, 2009 Fresh Made Dairy acquisition. Notes payable are discussed in Note 9 of the Notes to Consolidated Financial Statements.

Total income before taxes increased by \$1,884,819 (approximately 168%) to \$3,007,652 during the third quarter 2009, from \$1,122,833 during the same period in 2008.

Provision for income taxes was \$1,636,911, or a 54% tax rate, for the third quarter ended September 30, 2009, compared with a provision for income taxes of \$267,917, or a 24% tax rate, for the same period in 2008. This increase was due to an under estimate of income tax liability in the third quarter 2008, which resulted in an increased adjustment to the provision for income taxes during the third quarter 2009.

Total net income was \$1,370,741 or \$.08 per share for the third quarter ended September 30, 2009, compared with \$854,916 or \$.05 per share in the same period in 2008. This represents a 60% increase in net income from the third quarter 2009 when compared to the same period in 2008.

Comparison of Nine-Month Period Ended September 30, 2009 to Nine-Month Period Ended September 30, 2008

Results of Operations

Sales increased by \$9,763,471, (approximately 29%) to \$43,649,383 during the nine-month period ended September 30, 2009 from \$33,885,912 during the same nine-month period in 2008. This increase is primarily attributable to increased sales and awareness of Lifeway's flagship line, Kefir, as well as Lifeway's kids Kefir drink, ProBugs®. Additionally, Lifeway recorded revenues from its February 6, 2009 acquisition of Fresh Made Dairy. Included in the total group sales was approximately \$5,733,600 of revenue related to this acquisition and recorded during the nine-month period ended September 30, 2009.

Cost of goods sold as a percentage of sales, excluding depreciation expense, was approximately 57% during the nine-month period ended September 30, 2009, compared to about 66% during the same period in 2008. The decrease was primarily attributable to the decreased cost of conventional milk, our largest raw material, and the cost of transportation and other petroleum based production supplies.

Operating expenses as a percentage of sales for Lifeway Foods were approximately 20% during the nine-month period ended September 30, 2009, compared to about 19% during the same period in 2008. This increase is primarily attributable to the increase in professional fees related to the February 6, 2009 acquisition of Fresh Made Dairy and a 112% increased amortization expense, a non cash expense, also related to the Fresh Made Dairy acquisition. Professional fees related to the acquisition were approximately \$260,000. Many of the acquisition related professional fees are non recurring expenses.

Total operating income increased by \$4,557,531, (approximately 104%) to \$8,937,589 during the nine-month period ending September 30, 2009, from \$4,380,058 during the same period in 2008.

Total other expenses during the nine-month period ending September 30, 2009 were \$463,219, compared with total other expenses of \$346,186 during the same period in 2008. This increase is primarily attributable to a higher interest expense related to the February 6, 2009 Fresh Made Dairy acquisition. Interest expenses during the nine-month period ending September 30, 2009 were \$364,337, which includes approximately a \$55,000 pre -payment penalty on one of Lifeway's real estate mortgages related to the financing of the acquisition. This pre-payment expense is a non recurring expense.

Total income before taxes increased by \$4,440,498, (approximately 110%) to \$8,474,370 during the nine-month period ended September 30, 2009, from \$4,033,872 during the same period in 2008.

Provision for income taxes was \$3,024,261, or a 36% tax rate, for the nine-month period ended September 30, 2009, compared with a provision for income taxes of \$1,378,632, or a 34% tax rate, for the same period in 2008.

Total net income was \$5,450,109, or \$.32 per share for the nine-month period ended September 30, 2009, compared with \$2,655,240, or \$.16 per share in the same period in 2008. This represents a 105% increase in net income from the nine-month period ended September 30, 2009 when compared to the same period in 2008.



### Sources and Uses of Cash

Net cash provided by operating activities was \$5,504,144 during the nine-months ended September 30, 2009, which is an increase of \$1,872,155 when compared to the same period in 2008. This increase is primarily attributable to the increase in net income of \$2,794,869.

Net cash used in investing activities was \$3,720,562 during the nine-months ended September 30, 2009, which is an increase of \$2,051,518 when compared to the same period in 2008. This increase is primarily due to the Company's acquisition of Fresh Made Dairy, net of cash acquired. The Company purchased \$1,020,776 worth of property, plant and equipment during the first nine-months of 2009 when compared to the purchase of \$1,892,472 worth of property, plant and equipment during the same period in 2008. This represents a decrease of \$871,696 in the purchase of equipment during the nine-months ended September 30, 2009, when compared to the same period in 2008. The Company also repaid certain of its short term liabilities in the form of a margin loan in the amount of \$407,479 during its second quarter of 2009.

Lifeway had a net increase in cash and cash equivalents of \$527,139 during the nine-months ended September 30, 2009, compared to a net decrease in cash and cash equivalents of \$65,019 during the same period in 2008.

### Assets and Liabilities

Total assets were \$50,515,216 during the nine-months ended September 30, 2009, which is an increase of \$14,067,206 when compared to the same period in 2008. This is primarily due to the Company's acquisition of Fresh Made Dairy, which increased intangible assets by \$10,151,285 as of September 30, 2009 when compared to September 30, 2008. Additionally, the value of the Company's property, plant and equipment was \$13,812,039 as of September 30, 2009, which is an increase of \$2,822,539 from September 30, 2008.

Total current liabilities were \$9,095,186 during the nine-months ended September 30, 2009, which is an increase of \$4,338,387 when compared to the same period in 2008. This is primarily due to the Company's acquisition of Fresh Made, which increased current maturities of notes payable by \$5,105,596 as of September 30, 2009 when compared to September 30, 2008.

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

We anticipate being able to fund the Company's foreseeable liquidity requirements internally. We continue to explore potential acquisition opportunities in our industry in order to boost sales while leveraging our distribution system to consolidate and lower costs.

### Other Developments

On May 28, 2009, Lifeway's Board of Directors approved awards of an aggregate amount of 18,000 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain key employees and consultants for services rendered to the Company. The stock awards were made on May 28, 2009 and have vesting periods of one year. The expense for the awards is measured as of July 14, 2009 at \$14.69 per share for 18,000 shares, or a total stock award expense of \$264,420. This expense will be recognized as the stock awards vest in 12 equal portions of \$22,035, or 1500 shares per month for one year.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not applicable.

ITEM 4T. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

As of September 30, 2009, 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 September 30, 2009 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 as disclosed in our Form 10-K filed on March 31, 2009 which we cannot yet determine have been remedied by implementation of the NAV software as 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-Q fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented.

There was no change in our internal control over financial reporting during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting, other than the following. As of June 1, 2009, the Company implemented the software program Microsoft Business Solutions-Navision ("NAV"). The Company intends for the NAV software to increase the financial reporting ability of the Company over the Company's previous accounting software, to implement additional controls and strengthen the existing controls over the financial reporting process, and to allow for additional documentation of the financial reporting process.

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## PART II — OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS.

None.

## ITEM 1A. RISK FACTORS.

Not applicable.

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

- (a) Not applicable.  
 (b) Not applicable.  
 (c) Purchases of the Company's Securities.

| Period                           | (a) Total<br>Numbers of<br>Shares (or<br>Units)<br>Purchased | (b) Average Price<br>Paid per Share (or<br>Unit) | (c) Total<br>Number of<br>Shares (or<br>Units)<br>Purchased as<br>Part of<br>Announced<br>Plans or<br>Programs | (d) Maximum<br>Number (or<br>Approximate<br>Dollar Value)<br>of Shares (or<br>Units) that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|----------------------------------|--|--|--|---|
| July 1, 2009 to July 31,<br>2009 | 29,652   | 12.47  | 29,652   | 9,998   |
| Aug. 1, 2009 to Aug. 31,<br>2009 | 9,998  | 12.97  | 9,998  | 0   |
| *Total                           | 39,650   | \$ 12.72   | 39,650   | 0   |

\* Pursuant to the share repurchase program approved November 20, 2008 for 100,000 split adjusted shares with a plan expiration date of one year.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

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

None.

## ITEM 5. OTHER INFORMATION.

On November 16, 2009, the Company announced its financial results for the fiscal quarter ended September 30, 2009 and certain other information. A copy of the Company's press release announcing these financial results and certain other information is attached as Exhibit 99.1 hereto. The information contained in Exhibit 99.1 hereto is being furnished, and should not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities imposed by that Section. The information contained in Exhibit 99.1 shall not be incorporated by reference into any registration statement or other document or filing under the Securities

Act of 1933, as amended, except as may be expressly set forth in a specific filing. The press release filed as an exhibit to this report includes “safe harbor” language pursuant to the Private Securities Litigation Reform Act of 1995, as amended, indicating that certain statements about the Company’s business and other matters contained in the press release are “forward-looking.” The press release also cautions investors that “forward-looking” statements may be different from actual operating results. Finally, the press release states that a more thorough discussion of risks and uncertainties which may affect the Company’s operating results is included in the Company’s reports on file with the Securities and Exchange Commission.

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ITEM 6. EXHIBITS.

| Exhibit Number | Description of Document   |
|----------------|---|
| 3.4            | Amended and Restated By-laws (incorporated by reference to Exhibit No. 3.5 of Lifeway's Current Report on Form 8-K dated and filed on December 10, 2002). (File No. 000-17363)  |
| 3.5            | Articles of Incorporation, as amended and currently in effect (incorporated by reference to Exhibit 3.5 of Lifeway's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2000 and filed on August 8, 2000). (File No. 000-17363) |
| 31.1           | Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2           | Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes- Oxley Act of 2002.  |
| 32.1           | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 32.2           | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 99.1           | Press Release dated November 16, 2009.  |



SIGNATURES

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

LIFEWAY FOODS, INC.  
(Registrant)

November 16,  
Date: 2009

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

November 16,  
Date: 2009

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

| Exhibit Number | Description of Document   |
|----------------|---|
| 3.4            | Amended and Restated By-laws (incorporated by reference to Exhibit No. 3.5 of Lifeway's Current Report on Form 8-K dated and filed on December 10, 2002). (File No. 000-17363)  |
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| 99.1           | Press Release dated November 16, 2009.  |



