UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

# FORM 10-Q

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

**For the quarterly period ended: June 30, 2010**

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

**For the transition period from __________ to __________**

**Commission File Number: 000-17363**

# LIFEWAY FOODS, INC.

(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **Illinois** | **36-3442829** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

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

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☒

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 June 30, 2010, the issuer had 16,657,478 shares of common stock, no par value, outstanding.

LIFEWAY FOODS, INC.
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**LIFEWAY FOODS, INC. AND SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2010 AND 2009**
**AND DECEMBER 31, 2009**

## PART I — FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS.

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Consolidated Statements of Financial Condition**
**June 30, 2010 and 2009 (Unaudited) and December 31, 2009**

| | (Unaudited) June 30, 2010 | (Unaudited) June 30, 2009 | December 31, 2009 |
|---|---|---|---|
| **ASSETS** | | | |
| **Current assets** | | | |
| Cash and cash equivalents | $ 858,490 | $ 582,766 | $ 630,407 |
| Investments | 3,411,804 | 4,659,161 | 4,392,125 |
| Certificates of deposits in financial institutions | 550,000 | — | 652,005 |
| Inventories | 4,154,719 | 3,817,195 | 3,296,976 |
| Accounts receivable, net of allowance for doubtful accounts and discounts | 7,780,512 | 6,064,801 | 5,999,738 |
| Prepaid expenses and other current assets | 70,130 | 55,669 | 40,697 |
| Other receivables | 142,389 | 65,730 | 49,758 |
| Deferred income taxes | 389,249 | 638,372 | 251,456 |
| Refundable income taxes | — | 778,125 | 1,308,978 |
| **Total current assets** | **17,357,293** | **16,661,819** | **16,622,140** |
| **Property and equipment, net** | **14,890,327** | **13,793,929** | **14,282,182** |
| **Intangible assets** | | | |
| Goodwill and other non amortizable brand asset | 13,806,091 | 13,806,091 | 13,806,091 |
| Other intangible assets, net of accumulated amortization of $1,949,729 and $1,260,809 at June 30, 2010 and 2009 and $1,598,208 at December 31, 2009 | 5,907,909 | 6,596,829 | 6,259,430 |
| **Total intangible assets** | **19,714,000** | **20,402,920** | **20,065,521** |
| **Other assets** | **500,000** | **500,000** | **500,000** |
| **Total assets** | **$ 52,461,620** | **$ 51,358,668** | **$ 51,469,843** |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | |
| **Current liabilities** | | | |
| Checks written in excess of bank balances | $ 847,374 | $ — | $ 342,976 |
| Current maturities of notes payable | 4,431,873 | 6,219,788 | 4,842,315 |
| Accounts payable | 2,259,236 | 2,024,313 | 2,764,000 |
| Accrued expenses | 531,553 | 617,662 | 614,344 |
| Accrued income tax | 604,323 | — | — |
| **Total current liabilities** | **8,674,359** | **8,861,763** | **8,563,635** |
| **Notes payable** | **6,397,780** | **7,907,847** | **6,890,214** |
| **Deferred income taxes** | **3,262,795** | **3,593,740** | **3,444,664** |
| **Total liabilities** | **18,334,934** | **20,363,350** | **18,898,513** |
| **Stockholders' equity** | | | |
| Common stock, no par value; 20,000,000 shares authorized; 17,273,776 shares issued;16,657,478 shares outstanding at June 30, 2010; 17,273,776 shares issued: 16,812,955 shares outstanding at June 30, 2009; 17,273,776 shares issued; 16,778,555 shares outstanding at December 31, 2009 | 6,509,267 | 6,509,267 | 6,509,267 |
| Paid-in-capital | 2,018,727 | 1,912,845 | 1,965,786 |
| Treasury stock, at cost | ( 5,256,054) | ( 3,353,490) | ( 3,846,773) |
| Retained earnings | 30,906,602 | 26,463,077 | 27,953,409 |
| Accumulated other comprehensive loss, net of taxes | ( 51,856) | ( 536,381) | ( 10,359) |

| | | | |
|---|---|---|---|
| **Total stockholders' equity** | **34,126,686** | **30,995,318** | **32,571,330** |
| **Total liabilities and stockholders' equity** | **$ 52,461,620** | **$ 51,358,668** | **$ 51,469,843** |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Consolidated Statements of Income and Comprehensive Income**
**For the Three and Six Months Ended June 30, 2010 and 2009 (Unaudited)**
**and for the Year Ended December 31, 2009**

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | | Year Ended December 31, |
|---|---|---|---|---|---|
| | **2010** | **2009** | **2010** | **2009** | **2009** |
| **Sales** | 15,546,556 | 14,479,429 | 31,510,715 | 28,215,509 | 58,115,878 |
| Cost of goods sold | 9,273,872 | 7,978,110 | 17,892,871 | 16,102,691 | 36,083,553 |
| Depreciation expense | 281,220 | 353,654 | 684,595 | 570,428 | 1,134,404 |
| Total cost of goods sold | 9,555,092 | 8,331,764 | 18,577,466 | 16,673,119 | 37,217,957 |
| **Gross profit** | **5,991,464** | **6,147,665** | **12,933,249** | **11,542,390** | **20,897,921** |
| Selling expenses | 2,183,304 | 1,386,815 | 4,710,777 | 2,694,740 | 5,987,917 |
| General and administrative | 1,478,062 | 1,437,505 | 2,968,219 | 2,810,103 | 5,294,550 |
| Amortization expense | 175,761 | 168,698 | 351,521 | 339,388 | 676,786 |
| **Total Operating Expenses** | **3,837,127** | **2,993,018** | **8,030,517** | **5,844,231** | **11,959,253** |
| **Income from operations** | **2,154,337** | **3,154,647** | **4,902,732** | **5,698,159** | **8,938,668** |
| Other income (expense): | | | | | |
| Interest and dividend income | 53,176 | 48,506 | 107,684 | 110,717 | 199,047 |
| Rental Income | 2,800 | 11,947 | 4,035 | 21,294 | 35,240 |
| Interest expense | ( 80,164) | ( 110,090) | ( 176,106) | ( 264,473) | ( 442,703) |
| Loss on Disposition of Equipment | — | ( 2,825) | — | ( 2,825) | ( 2,826) |
| Gain (loss) on sale of marketable securities, net | 84,043 | 53,638 | 54,784 | ( 96,152) | ( 278,474) |
| Total other income (expense) | 59,855 | 1,176 | ( 9,603) | ( 231,439) | ( 489,716) |
| **Income before provision for income taxes** | **2,214,192** | **3,155,823** | **4,893,129** | **5,466,720** | **8,448,952** |
| Provision for income taxes | 1,029,688 | 623,918 | 1,939,936 | 1,387,350 | 2,879,250 |
| **Net income** | **$ 1,184,504** | **$ 2,531,905** | **$ 2,953,193** | **$ 4,079,370** | **$ 5,569,702** |
| **Basic and diluted earnings per common share** | 0.07 | 0.15 | 0.18 | 0.24 | 0.33 |
| **Weighted average number of shares outstanding** | **16,701,539** | **16,823,691** | **16,731,549** | **16,823,691** | **16,798,164** |
| **COMPREHENSIVE INCOME** | | | | | |
| **Net income** | **$ 1,184,504** | **$ 2,531,905** | **$ 2,953,193** | **$ 4,079,370** | **$ 5,569,702** |
| Other comprehensive income (loss), net of tax: | | | | | |
| Unrealized gains (losses) on investments (net of tax) | ( 55,842) | 338,409 | ( 9,339) | ( 93,913) | 325,086 |

| | | | | | |
|---|---|---|---|---|---|
| Less reclassification adjustment for (gains) losses included in net income (net of taxes) | (49,333) | (31,486) | (32,158) | 56,441 | 163,464 |
| **Comprehensive income** | **$ 1,079,329** | **$ 2,838,828** | **$ 2,911,696** | **$ 4,041,898** | **$ 6,058,252** |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Consolidated Statements of Changes in Stockholders' Equity**
**For the Six Months Ended June 30, 2010 and 2009 (Unaudited)**
**and for the Year Ended December 31, 2009**

| | Common Stock, No Par Value 20,000,000 Shares Authorized | | # of Shares of | | | | | Accumulated Other Comprehensive | |
|---|---|---|---|---|---|---|---|---|---|
| | # of Shares Issued | # of Shares Outstanding | Treasury Stock | Common Stock | Paid In Capital | Treasury Stock | Retained Earnings | Income (Loss), Net of Tax | Total |
| **Balances at December 31, 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,(** |
| Redemption of stock | — | ( 87,991) | 87,991 | — | — | ( 905,607) | — | — | ( 905,( |
| Issuance of treasury stock for compensation | — | 13,132 | ( 13,132) | — | 119,039 | 25,597 | — | — | 144,( |
| Issuance of treasury stock for Fresh Made acquisition | — | 128,947 | ( 128,947) | — | 644,738 | 335,262 | — | — | 980,( |
| Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment | — | — | — | — | — | — | — | 488,550 | 488,: |
| Net income for the year ended December 31, 2009 | — | — | — | — | — | — | 5,569,702 | — | 5,569,7 |
| **Balances at December 31, 2009** | **17,273,776** | **16,778,555** | **495,221** | **$6,509,267** | **$1,965,786** | **$ (3,846,773)** | **$27,953,409** | **$ (10,359)** | **$32,571,:** |
| **Balances at January 1, 2009** | **17,273,776** | **16,724,467** | **549,309** | **$6,509,267** | **$1,202,009** | **$ (3,302,025)** | **$22,383,707** | **$ (498,909)** | **$26,294,(** |
| Redemption of stock | — | ( 48,341) | 48,341 | — | — | ( 402,947) | — | — | ( 402,9 |
| Issuance of treasury stock for compensation | — | 7,882 | ( 7,882) | — | 66,098 | 16,220 | — | — | 82,: |
| Issuance of treasury stock for Fresh Made | | | | | | | | | |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| acquisition | — | 128,947 | ( 128,947) | — | 644,738 | 335,262 | — | — | 980,( |
| Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment | — | — | — | — | — | — | — | ( 37,472) | (37,4 |
| Net income for the six months ended June 30, 2009 | — | — | — | — | — | — | 4,079,370 | — | 4,079,3 |
| **Balances at June 30, 2009** | **17,273,776** | **16,812,955** | **460,821** | **$6,509,267** | **$1,912,845** | **$ (3,353,490)** | **$26,463,077** | **$ (536,381)** | **$30,995,3** |
| **Balances at January 1, 2010** | **17,273,776** | **16,778,555** | **495,221** | **$6,509,267** | **$1,965,786** | **$ (3,846,773)** | **$27,953,409** | **$ (10,359)** | **$32,571,3** |
| Redemption of stock | — | ( 129,841) | 129,841 | — | — | ( 1,418,657) | — | — | ( 1,418,6 |
| Issuance of treasury stock for compensation | — | 8,764 | ( 8,764) | — | 52,941 | 9,376 | — | — | 62,3 |
| Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment | — | — | — | — | — | — | — | ( 41,497) | ( 41,4 |
| Net income for the six months ended June 30, 2010 | — | — | — | — | — | — | 2,953,193 | — | 2,953,1 |
| **Balances at June 30, 2010** | **17,273,776** | **16,657,478** | **616,298** | **$6,509,267** | **$2,018,727** | **$ (5,256,054)** | **$30,906,602** | **$ (51,856)** | **$34,126,6** |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Consolidated Statements of Cash Flows**
**For the Six Months Ended June 30, 2010 and 2009 (Unaudited)**
**and for the Year Ended December 31, 2009**

| | (Unaudited) June 30, 2010 | (Unaudited) June 30, 2009 | December 31, 2009 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| **Net income** | $ 2,953,193 | $ 4,079,370 | $ 5,569,702 |
| Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition: | | | |
| Depreciation and amortization | 1,036,116 | 909,816 | 1,811,190 |
| (Gain) Loss on sale of investments, net | ( 54,784) | 96,152 | 278,474 |
| Loss on disposition of assets | — | 2,825 | 2,826 |
| Deferred income taxes | ( 290,465) | 179,796 | 389,754 |
| Treasury stock issued for compensation | 62,317 | 82,318 | 144,636 |
| Decrease in allowance for doubtful accounts | — | — | ( 75,000) |
| (Increase) decrease in operating assets: | | | |
| Accounts receivable | ( 1,780,774) | ( 752,978) | ( 612,915) |
| Other receivables | ( 92,631) | ( 25,416) | ( 7,758) |
| Inventories | ( 857,743) | ( 346,800) | 173,419 |
| Refundable income taxes | 1,308,978 | ( 435,205) | ( 475,635) |
| Prepaid expenses and other current assets | ( 29,433) | 5,029 | 9,506 |
| Increase (decrease) in operating liabilities: | | | |
| Accounts payable | ( 504,764) | ( 440,911) | 298,800 |
| Accrued expenses | ( 82,791) | 36,719 | 96,062 |
| Accrued income taxes | 604,323 | — | — |
| **Net cash provided by operating activities** | **2,271,542** | **3,390,715** | **7,603,061** |
| **Cash flows from investing activities:** | | | |
| Purchases of investments | ( 538,852) | ( 3,342,662) | ( 6,156,682) |
| Proceeds from sale of investments | 1,502,724 | 4,127,666 | 6,928,321 |
| Proceeds from redemption of certificates of deposit | 102,545 | — | — |
| Purchases of property and equipment | ( 1,292,741) | ( 714,052) | ( 1,766,280) |
| Acquisition of Fresh Made, net of cash acquired | — | ( 10,498,224) | ( 11,042,546) |
| **Net cash used in investing activities** | **( 226,324)** | **( 10,427,272)** | **( 12,037,187)** |
| **Cash flows from financing activities:** | | | |
| Proceeds of note payable | 250,000 | 9,342,085 | 9,353,504 |
| Checks written in excess of bank balances | 504,398 | — | 342,976 |
| Purchases of treasury stock | ( 1,418,657) | ( 402,947) | ( 905,607) |
| Repayment of notes payable | ( 1,152,876) | ( 1,597,063) | ( 4,003,588) |
| **Net cash (used in) provided by in financing activities** | **( 1,817,135)** | **7,342,075** | **4,787,285** |
| **Net increase in cash and cash equivalents** | **228,083** | **305,518** | **353,159** |
| Cash and cash equivalents at the beginning of the period | 630,407 | 277,248 | 277,248 |
| **Cash and cash equivalents at the end of the period** | **$ 858,490** | **$ 582,766** | **$ 630,407** |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements**
**June 30, 2010 and 2009**
**and December 31, 2009**

## 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:

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

Principles of consolidation
The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, LFI Enterprises, Inc., Helios Nutrition, Ltd., Pride of Main Street, L.L.C., Starfruit, L.L.C., Fresh Made, Inc and Starfruit Franchisor, L.L.C. All significant intercompany accounts and transactions have been eliminated. The financial statements include the results of operations from Fresh Made, Inc from February 6, 2009 through the end of the period (see Note 3).

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

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

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements**
**June 30, 2010 and 2009**
**and December 31, 2009**

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

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

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

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

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

Accounts receivable are recorded at invoice amounts, and reduced to their estimated net realizable value by recognition of an allowance for doubtful accounts and net of anticipated discounts. 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 is stated at depreciated cost or fair value where depreciated cost is not recoverable. Depreciation is computed using the straight-line method. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to income as incurred; significant renewals and betterments are capitalized.

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

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

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements**
**June 30, 2010 and 2009**
**and December 31, 2009**

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

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

The Company reviews intangible assets and their related useful lives at least once 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 |
| Trade names | 15 |
| Formula | 10 |
| Customer relationships | 12 |

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 investments, capitalization of indirect costs for tax purposes, purchase price adjustments, and the recognition of an allowance for doubtful accounts for financial statement purposes.

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Notes to Consolidated Financial Statements**
**June 30, 2010 and 2009**
**and December 31, 2009**

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

The Company has analyzed filing positions in all of the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The only periods subject to examination for the Company's federal return are the 2006 through 2009 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.

Subsequent to June 30, 2010, the IRS completed a review of the Company's 2007 and 2008 federal tax return filings, resulting in a liability of approximately $220,000 being recognized as of June 30, 2010. The Company's policy for recording interest and penalties associated with audits is to record such items as a component of income before taxes. There were no such items during the periods covered in this report.

Treasury stock
Treasury stock is recorded using the cost method.

Advertising costs
The Company expenses advertising costs as incurred. During the year ended December 31, 2009 and for the six months ended June 30, 2010 and 2009, approximately $1,689,540, $2,272,520 and $780,116 of such costs respectively, were expensed.

Earnings per common share
Earnings per common share were computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. For the six months ended June 30, 2010 and 2009 and for the year ended December 31, 2009, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

Reclassification
Certain 2009 balance sheet amounts have been reclassified to conform to the 2010 presentation.

**Note 3 – ACQUISITION**

On February 6, 2009, we completed a Stock Purchase Agreement (the "Stock Agreement") under which Lifeway purchased 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 in cash, a note in the principal amount of $2,735,000, due on August 1, 2010 as amended and restated, 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. 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, we entered into and consummated a Real Property Purchase Agreement (the "Real Property Agreement") under which we acquired 1.1355 acres of land in Philadelphia, PA (the "Property"). The consideration for the Property was approximately $2,000,000.

The acquisition was consummated to expand the geographic footprint of Lifeway as well as grow market share. 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

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
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**Note 3 – ACQUISITION - Continued**

fair value as of the merger date. Acquisition costs for legal and professional fees have been included in General and Administrative costs. None of the goodwill resulting from the acquisition is tax deductible.

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

| | | |
|---|---|---|
| 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 | | 8,391,000 |
| Current liabilities | | ( 461,000) |
| Deferred tax liability associated with purchase adjustments | | ( 1,652,000) |
| Total fair value of assets acquired and liabilities assumed | $ | 14,028,000 |

The following pro forma disclosures, including the effect of purchase accounting adjustments, depict the results of operations for the six months ended June 30, 2009 and the year ended December 31, 2009 as though the merger with Fresh had taken place as of January 1, 2009:

| | For the Six Months Ended June 30, 2009 | For the Year Ended December 31, 2009 |
|---|---|---|
| Gross revenue | $ 29,331,092 | $ 59,231,461 |
| Net income | $ 4,128,139 | $ 5,618,471 |
| Earnings per share | $ 0.25 | $ 0.33 |

**Note 4 – INTANGIBLE ASSETS**

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

| | June 30, 2010 | | June 30, 2009 | | December 31, 2009 | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated Amortization | Cost | Accumulated Amortization | Cost | Accumulated Amortization |
| Recipes | $ 43,600 | $ 43,600 | $ 43,600 | $ 43,600 | $ 43,600 | $ 43,600 |
| Customer lists and other customer related intangibles | 4,305,200 | 803,744 | 4,305,200 | 385,166 | 4,305,200 | 587,393 |
| Lease acquisition | 87,200 | 73,707 | 87,200 | 61,245 | 87,200 | 67,473 |
| Other | 6,638 | 6,638 | 6,638 | 6,638 | 6,638 | 6,638 |
| Customer relationship | 985,000 | 321,490 | 985,000 | 239,410 | 985,000 | 280,454 |
| Contractual backlog | 12,000 | 12,000 | 12,000 | 12,000 | 12,000 | 12,000 |
| Trade names | 1,980,000 | 517,000 | 1,980,000 | 385,000 | 1,980,000 | 451,000 |
| Formula | 438,000 | 171,550 | 438,000 | 127,750 | 438,000 | 149,650 |
| | $ 7,857,638 | $ 1,949,729 | $ 7,857,638 | $ 1,260,809 | $ 7,857,638 | $ 1,598,208 |

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**Note 4 – INTANGIBLE ASSETS - Continued**

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

| | | |
|---|---|---|
| 2011 | $ | 703,040 |
| 2012 | | 690,583 |
| 2013 | | 690,583 |
| 2014 | | 676,958 |
| 2015 | | 657,883 |
| Thereafter | | 2,488,862 |
| | $ | 5,907,909 |

Amortization expense during the six months ended June 30, 2010 and 2009 and for the year ended December 31, 2009 was $351,521, $339,388 and $676,786, respectively.

**Note 5 – INVESTMENTS**

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

| June 30, 2010 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Equities | $ 653,068 | $ 26,400 | $ ( 117,892) | $ 561,576 |
| Mutual Funds | 206,961 | 3,056 | ( 7,853) | 202,164 |
| Preferred Securities | 272,629 | 6,650 | ( 64,789) | 214,490 |
| Corporate Bonds | 1,751,719 | 89,355 | ( 30,140) | 1,810,934 |
| Government Agency Obligations | 615,767 | 8,625 | ( 1,752) | 622,640 |
| Total | $ 3,500,144 | $ 134,086 | $ ( 222,426) | $ 3,411,804 |

| June 30, 2009 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Equities | $ 1,536,976 | $ 57,665 | $ ( 178,926) | $ 1,415,715 |
| Mutual Funds | 617,082 | 842 | ( 267,818) | 350,106 |
| Preferred Securities | 680,527 | 14,361 | ( 207,218) | 487,670 |
| Corporate Bonds | 506,165 | 5,836 | ( 7,781) | 504,220 |
| Government Agency Obligations | 1,889,963 | 15,201 | ( 3,714) | 1,901,450 |
| Total | $ 5,230,713 | $ 93,905 | $ ( 665,457) | $ 4,659,161 |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
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**Note 5 – INVESTMENTS - Continued**

| December 31, 2009 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Equities | $ 1,385,524 | $ 177,024 | $ (128,547) | $ 1,434,001 |
| Mutual Funds | 172,543 | 7,453 | ( 22,833) | 157,163 |
| Preferred Securities | 388,705 | 6,700 | ( 95,753) | 299,652 |
| Corporate Bonds | 1,569,245 | 65,226 | ( 6,772) | 1,627,699 |
| Government Agency Obligations | 893,755 | 2,989 | ( 23,134) | 873,610 |
| Total | $ 4,409,772 | $ 259,392 | $ (277,039) | $ 4,392,125 |

Proceeds from the sale of investments were $6,928,321, $1,605,269 and $4,127,666 during the year ended December 31, 2009 and for the six months ended June 30, 2010 and 2009, respectively.

Gross gains of $351,419, $120,850 and $235,408 and gross losses of $629,893, $66,066 and $331,562 were realized on these sales during the year ended December 31, 2009 and for the six months ended June 30, 2010 and 2009, respectively.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2010 and 2009 and at December 31, 2009:

| | Less Than 12 Months | | 12 Months or Greater | | Total | |
|---|---|---|---|---|---|---|
| June 30, 2010 | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Equities | $ 58,222 | $ ( 10,953) | $ 154,154 | $ (106,939) | $ 212,376 | $ ( 117,892) |
| Mutual Funds | 278 | ( 4) | 99,486 | ( 7,849) | 99,764 | ( 7,853) |
| Preferred Securities | — | — | 193,090 | ( 64,789) | 193,090 | ( 64,789) |
| Corporate Bonds | 499,285 | ( 26,989) | 181,076 | ( 3,151) | 680,361 | ( 30,140) |
| Government Agency Obligations | — | — | 84,775 | ( 1,752) | 84,775 | ( 1,752) |
| | $ 557,785 | $ ( 37,946) | $ 712,581 | $ (184,480) | $ 1,270,366 | $ (222,426) |

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**Note 5 – INVESTMENTS - Continued**

| June 30, 2009 | Less Than 12 Months Fair Value | Less Than 12 Months Unrealized Losses | 12 Months or Greater Fair Value | 12 Months or Greater Unrealized Losses | Total Fair Value | Total Unrealized Losses |
|---|---|---|---|---|---|---|
| Equities | $ 537,047 | $ ( 113,772) | $ 270,700 | $ ( 65,154) | $ 807,747 | $ ( 178,926) |
| Mutual Funds | 95,391 | ( 33,238) | 248,327 | (234,580) | 343,718 | ( 267,818) |
| Preferred Securities | 21,527 | ( 3,368) | 365,740 | (203,850) | 387,267 | ( 207,218) |
| Corporate Bonds | — | — | 212,531 | ( 7,781) | 212,531 | ( 7,781) |
| Government Agency Obligations | — | — | 202,046 | ( 3,714) | 202,046 | ( 3,714) |
| | $ 653,965 | $ ( 150,378) | $ 1,299,344 | $ (515,079) | $ 1,953,309 | $ ( 665,457) |

| December 31, 2009 | Less Than 12 Months Fair Value | Less Than 12 Months Unrealized Losses | 12 Months or Greater Fair Value | 12 Months or Greater Unrealized Losses | Total Fair Value | Total Unrealized Losses |
|---|---|---|---|---|---|---|
| Equities | $ 128,959 | $ ( 27,142) | $ 230,502 | $ ( 101,405) | $ 359,461 | $ ( 128,547) |
| Mutual Funds | 1,694 | ( 321) | 131,870 | ( 22,512) | 133,564 | ( 22,833) |
| Preferred Securities | — | — | 278,202 | ( 95,753) | 278,202 | ( 95,753) |
| Corporate Bonds | 178,874 | ( 3,176) | 124,395 | ( 3,596) | 303,269 | ( 6,772) |
| Government Agency Obligations | 564,941 | ( 20,096) | 161,466 | ( 3,038) | 726,407 | ( 23,134) |
| | $ 874,468 | $ ( 50,735) | $ 926,435 | $ ( 226,304) | $ 1,800,903 | $ ( 277,039) |

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 June 30, 2010.

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 June 30, 2010.

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

Inventories consist of the following:

| | June 30, 2010 | June 30, 2009 | December 31, 2009 |
|---|---|---|---|
| Finished goods | $ 1,405,538 | $ 1,500,090 | $ 1,101,885 |
| Production supplies | 1,657,546 | 1,704,240 | 1,367,457 |
| Raw materials | 1,091,635 | 612,865 | 827,634 |
| Total inventories | $ 4,154,719 | $ 3,817,195 | $ 3,296,976 |

**Note 7 – PROPERTY AND EQUIPMENT**

Property and equipment consist of the following:

| | June 30, 2010 | June 30, 2009 | December 31 2009 |
|---|---|---|---|
| Land | $ 1,178,160 | $ 1,178,160 | $ 1,178,160 |
| Buildings and improvements | 11,051,821 | 9,769,348 | 10,380,393 |
| Machinery and equipment | 13,182,669 | 12,213,069 | 12,525,241 |
| Vehicles | 963,245 | 961,245 | 961,245 |
| Office equipment | 299,110 | 208,213 | 255,616 |
| Construction in process | — | — | 81,608 |
| | 26,675,005 | 24,330,035 | 25,382,263 |
| Less accumulated depreciation | 11,784,676 | 10,536,106 | 11,100,081 |
| Total property and equipment | $ 14,890,327 | $ 13,793,929 | $ 14,282,182 |

Depreciation expense during the six months ended June 30, 2010 and 2009 and for the year ended December 31, 2009 was $684,595, $570,428, and $1,134,404 respectively.

**Note 8 – ACCRUED EXPENSES**

Accrued expenses consist of the following:

| | June 30, 2010 | June 30, 2009 | December 31, 2009 |
|---|---|---|---|
| Accrued payroll and payroll taxes | $ 161,175 | $ 219,842 | $ 191,744 |
| Accrued property tax | 299,254 | 300,446 | 306,707 |
| Other | 71,124 | 97,374 | 115,893 |
| | $ 531,553 | $ 617,662 | $ 614,344 |

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**Note 9 – NOTES PAYABLE**

Notes payable consist of the following:

| | June 30, 2010 | June 30, 2009 | December 31 2009 |
|---|---|---|---|
| Note payable to Private Bank in monthly installments of $42,222, plus variable interest rate, currently at 2.756%, with a balloon payment of $5,066,667 due February 6, 2014. Collateralized by substantially all assets of the Company. | $ 6,904,444 | $ 7,388,889 | $ 7,135,556 |
| Line of credit with Private Bank at variable interest rate, currently at 2.781%, due on February 6, 2011. Collateralized by substantially all assets of the Company. | 750,000 | 2,400,000 | 500,000 |
| Line of credit with Morgan Stanley at variable interest rate, currently at 2.23% due on demand. Collateralized by investments. | 2,303,090 | 1,945,621 | 2,468,151 |
| Notes payable to Ilya Mandel & Michael Edelson, subordinated to Private Bank, payable in quarterly installments of $341,875, plus interest at the floating rate per annum (3.25% at June 30, 2010) due August 1, 2010, as amended and restated. Collateralized by a mortgage on specific real estate and shares of the Company's common stock. | 872,119 | 2,393,125 | 1,628,822 |
| Total notes payable | 10,829,653 | 14,127,635 | 11,732,529 |
| Less current maturities | 4,431,873 | 6,219,788 | 4,842,315 |
| Total long-term portion | $ 6,397,780 | $ 7,907,847 | $ 6,890,214 |

Maturities of notes payables are as follows:

For the Period Ended June 30,

| | |
|---|---|
| 2011 | $ 4,431,873 |
| 2012 | 506,664 |
| 2013 | 506,664 |
| 2014 | 5,384,452 |
| Total | $ 10,829,653 |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
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**Note 10 – PROVISION FOR INCOME TAXES**

The provision for income taxes consists of the following:

| | For the Six Months Ended June 30, 2010 | For the Six Months Ended June 30, 2009 | For the Year Ended December 31, 2009 |
|---|---|---|---|
| Current: | | | |
| Federal | $ 1,759,484 | $ 974,423 | $ 2,045,904 |
| State and local | 470,917 | 233,131 | 443,592 |
| Total current | 2,230,401 | 1,207,555 | 2,489,496 |
| Deferred | ( 290,465) | 179,796 | 389,754 |
| Provision for income taxes | $ 1,939,936 | $ 1,387,350 | $ 2,879,250 |

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

| | For the Six Months Ended June 30, 2010 | For the Six Months Ended June 30, 2009 | For the Year Ended December 31, 2009 |
|---|---|---|---|
| Federal income tax expense computed at the statutory rate | $ 1,663,664 | $ 1,858,685 | $ 2,872,644 |
| State and local tax expense, net | 234,870 | 262,403 | 405,550 |
| Permanent differences | ( 92,868) | ( 733,738) | ( 178,160) |
| Tax credits and other | 134,270 | — | ( 220,784) |
| Provision for income taxes | $ 1,939,936 | $ 1,387,350 | $ 2,879,250 |

Amounts for deferred tax assets and liabilities are as follows:

| | June 30, 2010 | June 30, 2009 | December 31, 2009 |
|---|---|---|---|
| Non-current deferred tax assets (liabilities) arising from: | | | |
| Temporary differences - | | | |
| Accumulated depreciation | $ ( 2,014,477) | $ ( 1,941,740) | $ ( 2,129,680) |
| Purchase accounting adjustments | ( 1,585,334) | (1,652,000) | ( 1,652,000) |
| Capital loss carry-forwards | 337,016 | — | 337,016 |
| Total non-current net deferred tax liabilities | ( 3,262,795) | ( 3,593,740) | ( 3,444,664) |
| Current deferred tax assets arising from: | | | |
| Unrealized (gains) losses on investments | 95,488 | 431,188 | 7,288 |
| Impairment of investments | — | — | 59,003 |
| Inventory | 176,051 | 161,749 | 139,730 |
| Allowance for doubtful accounts and discounts | 117,710 | 45,435 | 45,435 |
| Total current deferred tax assets | 389,249 | 638,372 | 251,456 |
| Net deferred tax liability | $ ( 2,873,546) | $ ( 2,955,368) | $ ( 3,193,208) |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
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**Note 11 – SUPPLEMENTAL CASH FLOW INFORMATION**

Cash paid for interest and income taxes are as follows:

| | For the Six Months Ended June 30, | | For the Year Ended December 31, |
|---|---|---|---|
| | 2010 | 2009 | 2009 |
| Interest | $ 211,836 | $ 250,553 | $ 419,186 |
| Income taxes | $ 317,346 | $ 1,563,750 | $ 3,432,228 |

**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, 2009 and at June 30, 2010 and 2009, there were no stock options outstanding or exercisable. There were approximately 940,000 shares available for issuance under the Plan at June 30, 2010.

On May 28, 2009, Lifeway's Board of Directors approved awards of an aggregate amount of 18,000 shares to be awarded under its Employee and Consulting Services and Compensation Plan to certain key employees and consultants for services rendered to the Company. The stock awards were made on May 28, 2009 and have vesting periods of one year. The expense for the awards is measured as of July 14, 2009 at $14.69 per share for 18,000 shares, or a total stock award expense of $264,420. This expense was recognized as the stock awards vested in 12 equal portions of $22,035, or 1,500 shares per month for one year.

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 had vesting periods of one year. The expense for the awards was 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 was recognized as the stock awards vested in 12 equal portions of $10,386, or 875 shares per month for one year.

**Note 13 – FAIR VALUE MEASUREMENTS**

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

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

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

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**Note 13 – FAIR VALUE MEASUREMENTS - Continued**

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 Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Balance |
|---|---|---|---|---|
| Assets | | | | |
| Investment securities- available - for – sale June 30, 2010 | $ 3,411,804 | — | — | $ 3,411,804 |
| December 31, 2009 | $ 4,392,125 | — | — | $ 4,392,125 |
| June 30, 2009 | $ 4,659,161 | — | — | $ 4,659,161 |

**Note 14 – RECENT ACCOUNTING PRONOUNCEMENTS**

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. The adoption of this standard did not have an impact on the Company's financial position or results of operation.

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

Comparison of Quarter Ended June 30, 2010 to Quarter Ended June 30, 2009.

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, 2009, and in the Management's Discussion and Analysis contained in our Form 10-Q, for the fiscal quarter ended March 31, 2010.

Results of Operations

Total consolidated group sales increased by $1,067,127 (approximately 7%) to $15,546,556 during the three month period ended June 30, 2010 from $14,479,429 during the three month period ended June 30, 2009. This increase is primarily attributable to increased sales and awareness of Lifeway's flagship line, Kefir, as well as ProBugs™ Organic Kefir for kids.

Cost of goods sold as a percentage of sales was approximately 61% during the second quarter 2010, compared to about 58% during the same period in 2009. The increase was primarily attributable to the higher cost of conventional milk, our largest raw material, to more normalized levels. The 2009 second quarter experienced some of the lowest prices for milk on record. The cost of conventional milk was approximately 45% higher during the second quarter 2010 when compared to the second quarter 2009. Gross profit decreased approximately 2% during the second quarter of 2010, when compared with the same period in 2009.

Operating expenses as a percentage of sales were approximately 25% during the second quarter of 2010 compared to approximately 21% during the same period in 2009. This increase was primarily attributable to a $796,489 increase of selling and marketing related expenses resulting from the Company's advertising and marketing promotions. General and administrative expenses remained flat.

Total operating income decreased by $1,000,310 (approximately 32%) to $2,154,337 during the second quarter 2010, from $3,154,647 during the same period in 2009.

Interest expense during the second quarter 2010 decreased to $80,164 compared to interest expense of $110,090 during the same period a year ago. This lower interest expense is primarily attributable to a reduction of principal in the note payable related to the February 6, 2009 Fresh Made acquisition. Notes payable are discussed in Note 9 of the Notes to Consolidated Financial Statements.

Provision for income taxes was $1,029,688, or a 47% effective tax rate, for the 2010 second quarter compared with $623,918, or a 20% effective tax rate, during the same period in 2009. In addition to the higher rate, the Company's tax expense was higher due to disallowed research and development credits from 2007 and 2008 that resulted in $220,000 in additional taxes being accrued for during the 2010 second quarter. Income taxes are discussed in Note 10 of the Notes to Consolidated Financial Statements. The difference in rates was due to a lower level of permanent tax differences in relation to pre-tax net income.

Total net income was $1,184,504, or $0.07 per share, for the second quarter ended June 30, 2010 compared to $2,531,905, or $0.15 per share, for the same period in 2009. This represents a 53% decrease in net income from the second quarter 2010 when compared to the same period in 2009.

*Results of Operations*

Sales increased by $3,295,206, (approximately 12%) to $31,510,715 during the six month period ended June 30, 2010 from $28,215,509 during the same six-month period in 2009. 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®.

Cost of goods sold as a percentage of sales, excluding depreciation expense, was approximately 57% during the six month period ended June 30, 2010, as well as for the same period in 2009.

Operating expenses as a percentage of sales for Lifeway Foods were approximately 25% during the six-month period ended June 30, 2010, compared to 21% during the same period in 2009. This increase was primarily attributable to the increase of selling and marketing related expenses resulting from the Company's advertising and marketing promotions.

Total other expenses during the six-month period ending June 30, 2010 were $9,603, compared with total other expenses of $231,439 during the same period in 2009. This decrease is primarily attributable to a higher interest expense in the year ago period related to the February 6, 2009 Fresh Made acquisition. Interest expenses during the six-month period ending June 30, 2009 were $264,473, 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 was a non recurring expense.

Provision for income taxes was $1,939,936, or a 40% effective tax rate, for the six months ended June 30, 2010 compared to $1,387,350, or a 25% effective tax rate, during the same period in 2009. In addition to the higher rate, the Company's tax expense was higher due to disallowed research and development credits from 2007 and 2008 that resulted in $220,000 in additional taxes being accrued for during the 2010 second quarter. Income taxes are discussed in Note 10 of the Notes to Consolidated Financial Statements. The difference in rates was due to a lower level of permanent tax differences in relation to pre-tax net income.

Total net income was $2,953,193, or $0.18 per share for the six-month period ended June 30, 2010 compared to $4,079,370, or $0.24 per share, for the same period in 2009.

*Sources and Uses of Cash*

On February 6, 2009, Lifeway entered into a Loan and Security Agreement with The Private Bank & Trust (the "Loan Agreement") which provided for (i) a term loan to Lifeway in the principal amount of $7,600,000, due on February 6, 2014 (the Term Loan") with annual interest rate equal to either the London Inter-Bank Offer Rate ("LIBOR"), plus 2.5% or the prime lending rate, and (ii) a revolving line of credit in the principal amount of $5,000,000 (the "Line of Credit," together with the Term Loan, the "Loans"), which originally matured February 6, 2010. The original maturity date was extended to February 6, 2011 on February 6, 2010 pursuant to a Third Modification Agreement as previously disclosed. The Line of Credit has an annual interest rate equal to either LIBOR, plus 2.5% or the prime lending rate. The Loans are secured by all of the assets of Lifeway, including a first mortgage on Lifeway's real property located in Skokie, Illinois, Niles, Illinois and Morton Grove, Illinois. A portion of the proceeds of the Loans was used to pay off previously existing mortgage loans. At December 31, 2009, the Loans had a balance of $7,135,556, and $500,000, respectively.

Net cash provided by operating activities was $2,271,542 during the six months ended June 30, 2010, which is a decrease of $1,119,173 when compared to the same period in 2009. This decrease is primarily attributable to the decrease in net income of $1,126,177.

Net cash used in investing activities was $226,324 during the six months ended June 30, 2010, which is a decrease of $10,200,948 when compared to the same period in 2009. This decrease is primarily due to the Company's 2009 acquisition of Fresh Made, net of cash acquired. The Company purchased $1,292,741 worth of property, plant and equipment during the first six months of 2010 when compared to the purchase of $714,052 worth of property, plant in equipment during the same period in 2009. This represents an increase of $578,689 in the purchase of equipment during the six months ended June 30, 2010, when compared to the same period in 2009. The Company also repurchased 129,841 of its common stock at a cost of $1,418,657 during the six month period ending June 30, 2010.

Lifeway had a net increase in cash and cash equivalents of $228,083 during the six months ended June 30, 2010, compared to a net increase in cash and cash equivalents of $305,518 during the same period in 2009. Lifeway had cash and cash equivalents at the end June 30, 2010 of $858,490, compared to cash and cash equivalents at the end June 30, 2009 of $582,766.

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.

***Assets and Liabilities***

Total assets were $52,461,620 as of June 30, 2010, which is an increase of $991,777 when compared to December 31, 2009, and an increase of $1,102,952 when compared to June 30, 2009. This is primarily due to the increase in the value of the Company's property, plant and equipment was $14,890,327 as of June 30, 2010, which is an increase of $1,096,398 from June 30, 2009.

Total current liabilities were $8,674,359 as of June 30, 2010, which is an increase of $110,724 when compared to December 31, 2009. This is primarily due a $604,323 increase in accrued income taxes during the first half of 2010. Total current liabilities were $8,674,359 as of June 30, 2010, which is a decrease of $187,404 when compared to June 30, 2009. This is primarily due the Company's repayment of current notes payables of $1,787,915.

Long term notes payables decreased by $492,434 as of June 30, 2010, when compared to December 31, 2009. Long term notes payables decreased by $1,510,067 as of June 30, 2010, when compared to June 30, 2009. The balance of the long term notes payable as of June 30, 2010 was $6,397,780.

Total stockholder's equity was $34,126,686 as of June 30, 2010, which is an increase of $1,555,356 when compared to December 31, 2009. This is primarily due the increase in retained earnings of $2,953,193 as of June 30, 2010, when compared to December 31, 2009. Total stockholder's equity was $34,126,686 as of June 30, 2010, which is an increase of $3,131,368 when compared to June 30, 2009. This is primarily due the increase in retained earnings by $4,443,525 as of June 30, 2010, when compared to June 30, 2009.

***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 1,500 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 June 30, 2010, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial and Accounting Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial and Accounting Officer concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of June 30, 2010 in ensuring that information required to be disclosed by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified under the Exchange Act rules and forms due to the material weaknesses described in our Form 10-K filed on March 31, 2010. 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.

# PART II — OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS.

None.

## ITEM 1A. RISK FACTORS.

Not applicable.

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

**(c) PURCHASES OF THE COMPANY'S SECURITIES**

| Period | (a) Total Numbers of Shares (or Units) Purchased | (b) Average Price Paid per Share (or Unit) | (c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| April 1, 2010 to April 30, 2010 | 38,388 | 11.25 | 38,388 | 33,247 |
| May 1, 2010 to May 31, 2010 | 33,380 | 10.41 | 33,380 | 199,867 |
| June 1, 2010 to June 30, 2010* | 29,708 | 9.98 | 29,708 | 170,159 |
| *Total | 101,476 | $ 10.60 | 101,476 | 170,159 |

The Company established a share repurchase program approved December 17, 2009 (for 100,000 shares with a plan expiration date of one year) and on May 7, 2010, the Company approved a new share repurchase program of up to 200,000 shares with a plan expiration date of one year from the date of the first purchase.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

**ITEM 4. REMOVED AND RESERVED.**

**ITEM 5. OTHER INFORMATION.**

On August 16, 2010, the Company announced its financial results for the fiscal quarter ended June 30, 2010 and certain other information. A copy of the Company's press release announcing these financial results and certain other information is attached as Exhibit 99.1 hereto. The information contained in Exhibit 99.1 hereto is being furnished, and should not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities imposed by that Section. The information contained in Exhibit 99.1 shall not be incorporated by reference into any registration statement or other document or filing under the Securities Act of 1933, as amended, except as may be expressly set forth in a specific filing. The press release filed as an exhibit to this report includes "safe harbor" language pursuant to the Private Securities Litigation Reform Act of 1995, as amended, indicating that certain statements about the Company's business and other matters contained in the press release are "forward-looking." The press release also cautions investors that "forward-looking" statements may be different from actual operating results. Finally, the press release states that a more thorough discussion of risks and uncertainties which may affect the Company's operating results is included in the Company's reports on file with the Securities and Exchange Commission.

**ITEM 6. EXHIBITS.**

| Exhibit Number | Description of Document |
|---|---|
| 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) |
| 4.1 | Amended and Restated Non-Negotiable Promissory Note. |
| 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 August 16, 2010. |

## SIGNATURES

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

**LIFEWAY FOODS, INC.**
(Registrant)

Date: August 16, 2010

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

Date: August 16, 2010

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

**EXHIBIT INDEX**

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| 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 August 16, 2010. |

**EXHIBIT 4.1**

**AMENDED AND RESTATED**
**NON-NEGOTIABLE PROMISSORY NOTE**

Philadelphia, Pennsylvania

$1,242,164.95 Dated as of February 2, 2010

FOR VALUE RECEIVED, **Lifeway Foods, Inc.**, an Illinois corporation ("**Lifeway**") and **Fresh Made, Inc.**, a Pennsylvania corporation ("**Fresh Made**") and a wholly-owned subsidiary of Lifeway (Lifeway and Fresh Made together, jointly and severally, "**Maker**") promises to pay to the order of **Ilya Mandel**, an individual, and the Estate of **Michael Edelson**, Deceased (DOD: 10/24/2009) (collectively "**Holders**") the principal amount of One Million Two Hundred Forty-Two Thousand One Hundred Sixty-Four Dollars and Ninety-Five Cents ($1,242,164.95) with interest on the unpaid principal balance from the date hereof at the Prime Rate (as defined below) per annum, which sum will be payable in one (1) installment of principal in the amount of Three Hundred Forty-One Thousand Eight Hundred Seventy-Five Dollars ($341,875.00), plus interest, due and payable on the first day of May 1, 2010, and one (1) final installment of the outstanding principal balance of this Note plus accrued and unpaid interest, due and payable on August 1, 2010. All installments shall be paid (and any notice to be given shall be in writing which shall be deemed to have been duly given (i) on the third business day after the day of registration, if sent by registered or certified mail, postage prepaid, (ii) on the next business day following the documented acceptance thereof for next-day delivery by a national overnight air courier service, if so sent, or (iii) on the date sent by facsimile transmission or electronic mail; otherwise it shall be deemed to have been given when actually received at such address) to Holders at c/o Fox Rothschild LLP, Building #10 Sentry Parkway East, 300 Walton Drive, Suite 200, P.O. Box 3001, Blue Bell, PA 19422-3001, to the attention of "Mandel & Edelson Account" or such other address as Holders may provide to Maker by written notice.

The "**Prime Rate**" shall mean the prime rate of interest as reported on the date prior to the date hereof in The Wall Street Journal.

Upon the failure to make any payment of principal and/or interest on this Note upon any due date or maturity of this Note, whether by acceleration, demand or otherwise, and/or upon the occurrence of an Event of Default and/or during any continuance thereof, this Note shall bear interest at the Prime Rate plus three percent (3%) per annum (the "**Default Rate**").

This Note is a replacement of that certain $2,735,000 Non-Negotiable Promissory Note dated February 6, 2009 (the "**Replaced Note**") executed by Maker and payable to the Holders, and nothing contained herein shall be construed (a) to be a novation of or to deem paid or forgiven the unpaid principal balance of, or unpaid accrued interest on, said Replaced Note outstanding at the time of its replacement by this Note; or (b) to release, cancel, terminate or otherwise adversely affect all or any part of any lien, security interest or other encumbrance heretofore granted to or for the benefit of the Holders of said Replaced Note.

This Note is being executed and delivered by Maker pursuant to the terms and conditions of that certain Stock Purchase Agreement, dated as of February 6, 2009, between Maker, as Buyer, and Holders, as Sellers (the "**Stock Purchase Agreement**") incorporated herein by reference as fully and with the same effect as if set forth herein at length, a copy of which is attached as **Exhibit "A"** hereto. Capitalized terms used herein but not defined shall have the meanings ascribed to them in the Stock Purchase Agreement. Under the Stock Purchase Agreement, Holders sold to Maker and Maker purchased from Holders all of the issued and outstanding shares of capital stock (the "**Shares**") of Fresh Made, Inc. (the "**Company**").

This Note is secured by certain collateral, as provided in that certain Security Agreement, dated as of February 6, 2009, executed by Maker in favor of Holders (as amended on the date of this Note, the "**Security Agreement**"), including certain shares of stock of Maker, as provided in that certain Stock Pledge, dated as of February 6, 2009, executed by Maker in favor of Holders (the "**Stock Pledge**") and a mortgage on certain real property owned by the Company (the "**Mortgaged Property**"), as provided in that certain Mortgage, dated as of February 6, 2009, executed by Maker in favor of Holders (the "**Mortgage**"), and together with the Security Agreement, the Stock Pledge and any other document now or hereafter given to evidence or secure payment of this Note, as such documents may hereafter be amended, restated or replaced from time to time, are hereinafter collectively referred to as the "**Security Documents**"). Reference is hereby made to the Security Documents (copies of which Security Documents are attached as **Exhibit "B"** hereto and incorporated herein by reference as fully and with the same effect as if set forth herein at length) for a statement of the covenants and agreements contained therein, a statement of the rights, remedies, and security afforded thereby, and all matters therein contained.

All installments shall be applied first to the payment of accrued interest and second to the payment of principal. Principal and interest may be prepaid, in whole or in part, at any time without penalty; provided, however, that in the event of a partial prepayment, the amount of the quarterly installment will remain unchanged, but the number of quarterly installments needed to amortize this Note shall be decreased to reflect the reduced amount of principal outstanding on this Note, such reduction to be made starting from the end of the amortization term.

The following shall constitute an "**Event of Default**" under this Note: (a) if Maker fails to make any payment due under this Note within five (5) days after the due date therefor (the "**Grace Period**"), whether on a payment date, at maturity, by acceleration and/or otherwise; (b) the liquidation, dissolution, termination of existence or insolvency of Maker; (c) the assignment for the benefit of any of the creditors of Maker, or the commencement against Maker of proceedings under the Federal Bankruptcy Code or under any bankruptcy or insolvency laws or any laws relating to the relief of debtors, readjustment of indebtedness or reorganization, or if all or any part of the assets of Maker are attached, seized, subjected to a writ or distress warrant, or levied upon, or come within the possession or control of any receiver, trustee, custodian or assignee for the benefit of creditors, or the entry of judgment against Maker or the issuing of any attachment or garnishment against any property of Maker for any amount in excess of ten percent (10%) of the then outstanding principal balance due and payable under this Note; (d) the appointment of a receiver for Maker; (e) the suspension by Maker of the payment of its obligations or the admission by Maker that it is unable to pay its debts generally as they become due; (f) the default of Maker under any loan, extension of credit, security agreement, purchase or sales agreement, or any other agreement, in favor of a bank, financial institution or any other creditor and/or any other person or entity, that materially affects the business and/or any of the property of Maker, the ability of Maker to repay and/or perform any of its obligations under this Note and/or under the Stock Purchase Agreement; (g) if a bank, other lender or any other creditor tries to take any of Maker's property on or in which Holder has a lien or security interest; (h) the material nonperformance of, or noncompliance with, any of the other agreements, conditions, covenants, or provisions contained in this Note and/or the Stock Purchase Agreement, which nonperformance or noncompliance continues for a period of ten (10) days after written notice thereof by Holder to Maker; provided, however, that if the nature of Maker's nonperformance or noncompliance is both non-monetary and such that more than ten (10) days is reasonably required to cure the same, then such nonperformance or noncompliance shall not be deemed an Event of Default under this Note if Maker commences such cure as promptly as reasonably possible within such ten (10) day period, diligently prosecutes such cure to completion, and in any event completes such cure within forty-five (45) days from the date of Holder's written notice thereof; or (i) the sale, lease, transfer, assignment, encumbrance, or other disposition of the Mortgaged Property and/or all or substantially all of the other assets of Maker, including any attempt to accomplish the foregoing.

If an Event of Default should occur, Holders, at their option, may declare the outstanding principal balance of, and all accrued but unpaid interest on, this Note to be immediately due and payable without presentment, demand, protest, or notice of any kind, all of which are hereby expressly waived. If an Event of Default should occur, in addition to any of the other rights, remedies and options available to Holders, or any of them, at law and/or in equity, and/or under this Note, the Stock Purchase Agreement, the Security Documents and/or otherwise, Section 8.11 of the Stock Purchase Agreement shall be null and void, and Holders, or any of them, may, directly or indirectly, resume any one or more of the businesses of the Company as operated by the Company prior to the Closing of the Transaction.

In the event that Maker makes any claim(s) against Holders for indemnification and/or payment of damages to which Maker or any Buyer Indemnified Party may be entitled under Section 9.2 of the Stock Purchase Agreement (subject to the limitations and other provisions of Sections 9.4 and 9.8 of the Stock Purchase Agreement) and Holders, being otherwise obligated to provide such indemnification and/or to make such payment, fails to do so, Maker shall have the right to offset the amount(s) of Maker's claim(s), as aforesaid, for indemnification and/or payment of damages, (i) first, by withholding and setting-off against the first-occurring payments due to Holders under this Note the amount of any such claim(s) for indemnification or payment of damages to which Maker or any Buyer Indemnified Party may be entitled under Section 9.2 of the Stock Purchase Agreement; (ii) second, to the extent not satisfied by (i), by the Holders surrender to Lifeway of the appropriate number of the Lifeway Shares then owned by Holders (based on the fair market value of the Lifeway Shares on the day the claim is resolved) and the canceling of such Lifeway Shares by Lifeway; and (iii) third, to the extent that (i) and (ii) are exhausted and such claim(s) against Holders for indemnification and/or payment of damages are still not satisfied, by pursuing any remaining claims directly against Holders on a joint and several basis.

Maker shall pay to Holders, upon demand, any and all costs of investigation, collection and attorneys' fees, incurred and/or paid by Holders in enforcing this Note, when this Note and/or any payment(s) of principal and/or interest at any time, and from time to time, becomes due and payable, whether by acceleration or otherwise, and/or due to the occurrence of an Event of Default or for any other reason.

This Note may be amended, modified or waived prospectively or retroactively only by a written instrument signed by Maker and Holders. No delay or omission of Holders in exercising any right and/or remedy under this Note shall operate as a waiver of that or any other right or remedy. No waiver of any single breach or other default shall be deemed a waiver of any other breach or other default.

This Note is non-negotiable and may not be transferred or assigned by Holders.

This Note shall be construed in accordance with and governed by the domestic substantive laws of the State of Pennsylvania without giving effect to any choice of law or conflicts of law provision or rule that would cause the application of domestic substantive laws of any other jurisdiction. Maker and Holders consent to and submit to the exclusive jurisdiction of the courts of Pennsylvania, located in the County of Philadelphia, for any proceeding arising out of or related to this Note, and further agree that service of process or delivery of documents by U.S. certified mail to its respective address set forth in the Stock Purchase Agreement shall be effective for any purpose.

The terms and provisions of this Note shall be binding upon Maker and its successors and permitted assigns, and shall inure to the benefit of Holders and their respective personal representatives, successors and assigns.

If any provision of this Note or the application thereof to any person, entity or circumstance should, for any reason and to any extent, be invalid or unenforceable, the remainder of this Note and the application of such provision to other persons, entities or circumstances shall not be affected thereby, but rather shall be enforced to the greatest extent permitted by law.

IN WITNESS WHEREOF, each Maker has caused this Note to be duly executed by and in its name, by the undersigned duly authorized officer of each such Maker, on and as of the date set forth at the beginning of this Note, intending to be jointly and severally legally bound hereby.

**Lifeway Foods, Inc.**

By: /s/ Edward Smolyansky
Name: Edward Smolyansky
Title: Treasurer
[CORPORATE SEAL]

**Fresh Made, Inc.**

By: /s/ Edward Smolyansky
Name: Edward Smolyansky
Title: President
[CORPORATE SEAL]

**MAKER**

Accepted by:

/s/ Ilya Mandel
Ilya Mandel

/s/ Klara Edelson
By: Executrix of the Estate of Michael Edelson, Deceased (DOD: 10/24/2009)

**HOLDERS**

EX-31.1 3 exh31-1_16885.htm 302 CERTIFICATION OF THE C.E.O.

**EXHIBIT 31.1**

SECTION 302 CERTIFICATION OF C.E.O.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Julie Smolyansky, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lifeway Foods, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter n the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 16, 2010

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

EX-31.2 4 exh31-2_16885.htm 302 CERTIFICATION OF THE C.F.O.

**EXHIBIT 31.2**

SECTION 302 CERTIFICATION OF C.F.O.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Edward P. Smolyansky, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lifeway Foods, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 16, 2010

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

EX-32.1 5 exh32-1_16885.htm 906 CERTIFICATION OF THE C.E.O.

**EXHIBIT 32.1**

SECTION 906 CERTIFICATION OF C.E.O.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Lifeway Foods, Inc. (the “Company”) for the period ended June 30, 2010 as filed with the SEC (the “Report”), the undersigned, in the capacity and on the date indicated below, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to her knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operation of the Company.

Date: August 16, 2010

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

EX-32.2 6 exh32-2_16885.htm 906 CERTIFICATION OF THE C.F.O.

**EXHIBIT 32.2**

SECTION 906 CERTIFICATION OF C.F.O.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Lifeway Foods, Inc. (the "Company") for the period ended June 30, 2010 as filed with the SEC (the "Report"), the undersigned, in the capacity and on the date indicated below, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operation of the Company.

Date: August 16, 2010

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

EX-99.1 7 exh99-1_16885.htm PRESS RELEASE DATED AUGUST 16, 2010

**EXHIBIT 99.1**

**Lifeway Foods, Inc.**
For Immediate Release

**Lifeway Foods Reports Record 2nd Quarter 2010 Financial Results**

**Morton Grove, IL—August 16, 2010**—Lifeway Foods, Inc., (Nasdaq: LWAY), makers of the nutritious, probiotic dairy beverage, Kefir, today reported financial results for the second quarter ended June 30, 2010. In addition, the company announced an exclusive, nationwide distribution agreement with Whole Foods to bring three flavors of their new BioKefir™ drink to all store locations.

**Financial Highlights for Second Quarter 2010**

- Sales increased more than seven percent to $15,546,556
- Increased marketing fueling organic growth
- Working capital increased more than 11 percent to $8,682,934

**Other Recent Highlights**

- Signed a 90-day exclusive distribution agreement with Whole Foods to bring three flavors of new Bio Kefir to store locations nationwide
- Paid outstanding debt notes totaling approximately $850,000 on August 5th, six months ahead of schedule, due to strong cash flow
- Purchased 101,476 shares during the second quarter, due to strong cash flow

For the quarter ended June 30, 2010, total sales increased more than seven percent to $15,546,556 from $14,479,429 during the same period a year ago. Total net income was $1,184,504, or $0.07 per share, compared to $2,531,905, or $0.15 per share, in the same period in 2009. This decrease in net income, of approximately 53 percent, is due largely to disallowed research and development credits from 2007 and 2008 that resulted in approximately $220,000 in additional taxes that were paid in the 2010 second quarter and represent a non-recurring expense.

Sales increased by $3,295,206, (approximately 12%) to $31,510,715 during the six month period ended June 30, 2010 from $28,215,509 during the same six-month period in 2009. 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®.

"We are pleased with our continued growth in sales as it was purely organic and not the result of new distribution," said Edward Smolyansky, Lifeway Food Inc.'s Chief Financial Officer. "The decrease in net income was primarily driven by three factors including higher conventional milk prices, which rose about 45% from last years second quarter record lows, the payment of past taxes from disallowed R&D unit credits, and our increased advertising and marketing initiatives. We believe our marketing program is building greater awareness of the health benefits of Kefir, and is driving demand for Lifeway's flagship line, as well as ProBugs™ Organic Kefir for kids."

Cost of goods sold as a percentage of sales was approximately 61 percent, compared to approximately 58 percent during the same period in 2009. The increase was primarily due to a 45 percent rise in the costs for conventional milk, our largest raw material, when compared to the second quarter 2009. However, the increase represents a return to more normalized levels from the historically low prices a year ago. Gross profit decreased approximately two percent during the second quarter compared with the same period in 2009.

Operating expenses as a percentage of sales were approximately 25 percent, compared to about 21 percent during the same period in 2009. This increase is primarily attributable to increased advertising and marketing expenditures. The company also had expenses of approximately $100,000 related to the development of it's new BioKefir™ product line.

Total operating income decreased by $1,000,310 (approximately 32 percent) to $2,154,337, from $3,154,647 during the same period a year ago.

Net cash provided by operating activities was $2,271,542 during the six months ended June 30, 2010, which is a decrease of $1,119,173 when compared to the same period in 2009.

Interest expense during the second quarter 2010 decreased to $80,164 compared to $110,090 during the same period a year ago. This lower interest expense is primarily due to a reduction of principal in the note payable related to the February 6, 2009 Fresh Made acquisition.

Provision for income taxes for the second quarter 2010 was $1,029,688, or a 47 percent effective tax rate, compared to $623,918, or a 20 percent effective tax rate, during the same period in 2009. In addition to the higher rate, the company's tax expense was higher due to disallowed research and development credits from 2007 and 2008 that resulted in approximately $220,000 in additional taxes being paid in the 2010 second quarter.

During the second quarter 2010, Lifeway Foods continued to strengthen its balance sheet. The company's working capital increased more than 11 percent to $8,682,934, from $7,800,056 during the same period a year ago. The company's current ratio remains strong at 2.0 to 1. In addition, the company reported that it paid off approximately $850,000 of its notes payable from its strong cash flow, six months ahead of schedule on August 5, 2010.

Additionally, the company reported that it repurchased 101,476 shares during the 2010 second quarter and has approximately 170,000 shares remaining in its current buy-back program. The stock buy-backs were made as a result of the company's strong cash flow.

"We are encouraged about our progress in the third quarter, especially given the tough economic environment. We are excited about our exclusive product launch with Whole Foods as they begin to carry three flavors of our Bio Kefir in their stores nationwide. Whole Foods will have a 90-day exclusive to this product, and we expect to begin shipping by the end of August," Smolyansky said.

**About Lifeway Foods**
**Lifeway, recently named Fortune Small Business' 97th Fastest Growing Small Business, and one of only 4 companies to ever be named to the list four straight years in a row, is America's leading supplier of the cultured dairy product known as kefir, and now America's only supplier of Organic Kefir. Lifeway Kefir is a dairy beverage that contains Lifeway's exclusive 10 Live and Active probiotic cultures. While most regular yogurt only contains two or three of these "friendly" cultures, Lifeway kefir products offer more nutritional benefits. Lifeway offers 12 different flavors of its Kefir beverage, Organic Kefir and SoyTreat (a soy based kefir). Lifeway recently introduced a series of innovative new products such as pomegranate kefir, Greek-style kefir, a children's line of organic kefir products called ProBugs (TM) in a no-spill pouch in kid-friendly flavors like Orange Creamy Crawler and Sublime Slime Lime, and a line of organic whole milk kefir. Lifeway**

**also produces a line of products marketed in US Hispanic communities, called La Fruta, Drinkable Yogurt (yogurt drinks distinct from kefir). In addition to its line of Kefir products, the company produces a variety of cheese products and recently introduced a line of organic pudding called It's Pudding!**

Live conference calls will now be on an annual basis to discuss fiscal full year results. For more information, contact Lifeway Foods, Inc. at (847) 967-1010 or e-mail at info@lifeway.net and visit http://www.lifeway.net .

**This news release contains forward-looking statements. Investors are cautioned that actual results may differ materially from such forward-looking statements. Forward-looking statements involve risks and uncertainties including, but not limited to, competitive pressures and other important factors detailed in the Company's reports filed with the Securities and Exchange Commission.**

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Consolidated Statements of Income and Comprehensive Income**
**For the Three and Six Months Ended June 30, 2010 and 2009 (Unaudited)**
**and for the Year Ended December 31, 2009**

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2010** | **2009** | **2010** | **2009** |
| **Sales** | 15,546,556 | 14,479,429 | 31,510,715 | 28,215,509 |
| Cost of goods sold | 9,273,872 | 7,978,110 | 17,892,871 | 16,102,691 |
| Depreciation expense | 281,220 | 353,654 | 684,595 | 570,428 |
| Total cost of goods sold | 9,555,092 | 8,331,764 | 18,577,466 | 16,673,119 |
| **Gross profit** | **5,991,464** | **6,147,665** | **12,933,249** | **11,542,390** |
| Selling expenses | 2,183,304 | 1,386,815 | 4,710,777 | 2,694,740 |
| General and administrative | 1,478,062 | 1,437,505 | 2,968,219 | 2,810,103 |
| Amortization expense | 175,761 | 168,698 | 351,521 | 339,388 |
| **Total Operating Expenses** | **3,837,127** | **2,993,018** | **8,030,517** | **5,844,231** |
| **Income from operations** | **2,154,337** | **3,154,647** | **4,902,732** | **5,698,159** |
| Other income (expense): | | | | |
| Interest and dividend income | 53,176 | 48,506 | 107,684 | 110,717 |
| Rental Income | 2,800 | 11,947 | 4,035 | 21,294 |
| Interest expense | (80,164) | (110,090) | (176,106) | (264,473) |
| Loss on Disposition of Equipment | --- | (2,825) | --- | (2,825) |
| Gain (loss) on sale of marketable securities, net | 84,043 | 53,638 | 54,784 | (96,152) |
| Total other income (expense) | 59,855 | 1,176 | (9,603) | (231,439) |
| **Income before provision for income taxes** | **2,214,192** | **3,155,823** | **4,893,129** | **5,466,720** |
| Provision for income taxes | 1,029,688 | 623,918 | 1,939,936 | 1,387,350 |
| **Net income** | **$ 1,184,504** | **$ 2,531,905** | **$ 2,953,193** | **$ 4,079,370** |
| **Basic and diluted earnings per common share** | 0.07 | 0.15 | 0.18 | 0.24 |
| **Weighted average number of shares outstanding** | **16,701,539** | **16,823,691** | **16,731,549** | **16,823,691** |

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**
**Condensed Consolidated Statements of Cash Flows**
**For the Six Months Ended June 30, 2010 and 2009 (Unaudited)**
**and for the Year Ended December 31, 2009**

| | (Unaudited) June 30, 2010 | 2009 | December 31, 2009 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| **Net income** | $ **2,953,193** | $ **4,079,370** | $ **5,569,702** |
| Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition: | | | |
| Depreciation and amortization | 1,036,116 | 909,816 | 1,811,190 |
| (Gain) Loss on sale of investments, net | ( 54,784) | 96,152 | 278,474 |
| Loss on disposition of assets | --- | 2,825 | 2,826 |
| Deferred income taxes | ( 290,465) | 179,796 | 389,754 |
| Treasury stock issued for compensation | 62,317 | 82,318 | 144,636 |
| Decrease in allowance for doubtful accounts | --- | --- | ( 75,000) |
| (Increase) decrease in operating assets: | | | |
| Accounts receivable | ( 1,780,774) | ( 752,978) | ( 612,915) |
| Other receivables | ( 92,631) | ( 25,416) | ( 7,758) |
| Inventories | ( 857,743) | ( 346,800) | 173,419 |
| Refundable income taxes | 1,308,978 | ( 435,205) | ( 475,635) |
| Prepaid expenses and other current assets | ( 29,433) | 5,029 | 9,506 |
| Increase (decrease) in operating liabilities: | | | |
| Accounts payable | ( 504,764) | ( 440,911) | 298,800 |
| Accrued expenses | ( 82,791) | 36,719 | 96,062 |
| Accrued income taxes | 604,323 | --- | --- |
| **Net cash provided by financing activities** | **2,271,542** | **3,390,715** | **7,603,061** |
| **Cash flows from investing activities:** | | | |
| Purchases of investments | ( 538,852) | ( 3,342,662) | ( 6,156,682) |
| Proceeds from sale of investments | 1,502,724 | 4,127,666 | 6,928,321 |
| Proceeds from redemption of certificates of deposit | 102,545 | --- | --- |
| Purchases of property and equipment | ( 1,292,741) | ( 714,052) | ( 1,766,280) |
| Acquisition of Fresh Made, net of cash acquired | --- | ( 10,498,224) | ( 11,042,546) |
| **Net cash used in investing activities** | **( 226,324)** | **( 10,427,272)** | **( 12,037,187)** |
| **Cash flows from financing activities:** | | | |
| Proceeds of note payable | 250,000 | 9,342,085 | 9,353,504 |
| Checks written in excess of bank balances | 504,398 | --- | 342,976 |
| Purchases of treasury stock | ( 1,418,657) | ( 402,947) | ( 905,607) |
| Repayment of notes payable | ( 1,152,876) | ( 1,597,063) | ( 4,003,588) |
| **Net cash (used in) provided by in financing activities** | **( 1,817,135)** | **7,342,075** | **4,787,285** |
| **Net increase in cash and cash equivalents** | **228,083** | **305,518** | **353,159** |
| Cash and cash equivalents at the beginning of the period | 630,407 | 277,248 | 277,248 |
| **Cash and cash equivalents at the end of the period** | **$ 858,490** | **$ 582,766** | **$ 630,407** |