

LIFEWAY FOODS INC
Form 10-Q
August 14, 2008

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, 2008

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

For the transition period from _____ to _____

Commission File Number: 000-17363

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

Illinois
(State or Other Jurisdiction of
Incorporation
or Organization)

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

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

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

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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 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. (Check one):

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

As of August 1, 2008, the issuer had 16,732,101 shares of common stock, no par value, outstanding.

LIFEWAY FOODS, INC.

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PART I – FINANCIAL INFORMATION
LIFEWAY FOODS, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2008 AND 2007
AND DECEMBER 31, 2007

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition

June 30, 2008 and 2007 (Unaudited) and December 31, 2007

| | 2008 | (Unaudited) June 30 | 2007 | December 31, 2007 |
|---|---------------|------------------------|------------|----------------------|
| ASSETS | | | | |
| Current assets | | | | |
| Cash and cash equivalents | \$ 342,039 | \$ | 1,014,433 | \$ 595,885 |
| Marketable securities | 6,472,027 | | 8,424,517 | 6,989,474 |
| Inventories | 3,851,725 | | 3,510,597 | 3,506,554 |
| Accounts receivable, net of allowance for doubtful accounts of \$35,011 and \$39,460 at June 30, 2008 and 2007 and \$39,460 at December 31, 2007 | 4,626,287 | | 4,602,313 | 4,209,662 |
| Prepaid expenses and other current assets | 12,582 | | 13,206 | 21,253 |
| Other receivables | 49,571 | | 40,295 | 43,111 |
| Deferred income taxes | 602,227 | | 73,168 | 311,960 |
| Refundable income taxes | — | | — | 240,880 |
| Total current assets | 15,956,458 | | 17,678,529 | 15,918,779 |
| Property and equipment, net | 10,769,676 | | 8,819,215 | 9,678,948 |
| Intangible assets | | | | |
| Goodwill | 5,414,858 | | 3,952,425 | 5,414,858 |
| Other intangible assets, net of accumulated amortization of \$761,699 and \$439,982 at June 30, 2008 and 2007 and \$601,976 at December 31, 2007 | 3,095,939 | | 3,423,514 | 3,255,662 |
| Total intangible assets | 8,510,797 | | 7,375,939 | 8,670,520 |
| Other assets | 500,000 | | — | 500,000 |
| Total assets | \$ 35,736,931 | \$ | 33,873,683 | \$ 34,268,247 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | |
| Current liabilities | | | | |
| Current maturities of notes payable | \$ 1,130,612 | \$ | 1,130,316 | \$ 1,136,126 |
| Accounts payable | 1,873,644 | | 1,527,164 | 1,594,330 |
| Accrued expenses | 548,706 | | 386,749 | 414,039 |
| Margin payable | 407,479 | | — | — |
| Accrued income taxes | 395,093 | | 31,802 | — |
| Total current liabilities | 4,355,534 | | 3,076,031 | 3,144,495 |

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| | | | |
|--|---------------|---------------|---------------|
| Notes payable | 3,517,841 | 4,843,282 | 4,096,797 |
| Deferred income taxes | 1,647,550 | 466,673 | 1,712,795 |
| Stockholders' equity | | | |
| Common stock, no par value; 20,000,000 shares authorized; 17,273,776 shares issued; 16,740,407 shares outstanding at June 30, 2008; 17,273,776 shares issued; 16,889,237 shares outstanding at June 30, 2007; and 17,273,776 shares issues; 16,897,726 shares outstanding at December 31, 2007 | | | |
| | 6,509,267 | 6,509,267 | 6,509,267 |
| Paid-in-capital | 1,149,068 | 1,086,591 | 1,120,669 |
| Treasury stock, at cost | (3,110,637) | (2,085,666) | (2,078,165) |
| Retained earnings | 22,271,730 | 19,850,129 | 20,471,432 |
| Accumulated other comprehensive income (loss), net of taxes | (603,422) | 127,376 | (209,043) |
| Total stockholders' equity | 26,216,006 | 25,487,697 | 25,814,160 |
| Total liabilities and stockholders' equity | \$ 35,736,931 | \$ 33,873,683 | \$ 34,768,247 |

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Consolidated Statements of Income and Comprehensive Income

For the Three and Six Months Ended June 30, 2008 and 2007 (Unaudited)

and The Year Ended December 31, 2007

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | | Year Ended December 31, 2007 |
|---|---|--------------|---|---------------|------------------------------------|
| | 2008 | 2007 | 2008 | 2007 | |
| Sales | \$ 11,523,393 | \$ 9,715,262 | \$ 22,645,631 | \$ 18,737,506 | \$ 38,729,156 |
| Cost of goods sold | 7,455,696 | 5,699,883 | 14,897,779 | 10,984,414 | 25,582,981 |
| Depreciation expense | 195,128 | 186,303 | 384,552 | 351,597 | 726,647 |
| Total cost of goods sold | 7,650,824 | 5,886,186 | 15,282,331 | 11,336,011 | 26,309,628 |
| Gross profit | 3,872,569 | 3,829,076 | 7,363,300 | 7,401,495 | 12,419,528 |
| Selling Expenses General and Administrative | 1,154,126 | 912,262 | 2,213,292 | 1,682,343 | 3,744,388 |
| Amortization expense | 1,092,420 | 1,074,530 | 2,077,466 | 1,995,103 | 3,914,825 |
| | 79,862 | 80,997 | 159,723 | 161,272 | 323,266 |
| Total Operating Expenses | 2,326,408 | 2,067,789 | 4,450,481 | 3,838,718 | 7,982,479 |
| Income from operations | 1,546,161 | 1,761,287 | 2,912,819 | 3,562,777 | 4,437,049 |
| Other income (expense): | | | | | |
| Interest and dividend income | 62,862 | 98,365 | 165,995 | 164,164 | 350,286 |
| Rental Income | 11,647 | 9,581 | 23,294 | 18,181 | 48,305 |
| Interest expense | (68,969) | (109,283) | (154,924) | (218,812) | (410,180) |
| Gain (loss) on sale of marketable securities, net | (87,174) | 439,586 | (36,145) | 454,331 | 539,739 |
| Total other income (Expense) | (81,634) | 438,249 | (1,780) | 417,864 | 528,150 |
| Income before provision for income taxes | 1,464,527 | 2,199,536 | 2,911,039 | 3,980,641 | 4,965,199 |
| Provision for income taxes | 552,809 | 803,510 | 1,110,715 | 1,449,284 | 1,812,539 |
| Net income | \$ 911,718 | \$ 1,396,026 | \$ 1,800,324 | \$ 2,531,357 | \$ 3,152,660 |

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| | | | | | |
|---|------------|--------------|--------------|--------------|--------------|
| Basic and diluted earnings per common share | 0.05 | 0.08 | 0.11 | 0.15 | 0.19 |
| Weighted average number of shares outstanding | 16,765,094 | 16,875,905 | 16,789,727 | 16,885,586 | 16,855,611 |
| COMPREHENSIVE INCOME | | | | | |
| Net income | \$ 911,718 | \$ 1,396,026 | \$ 1,800,324 | \$ 2,531,357 | \$ 3,152,660 |
| Other comprehensive income (loss), net of tax: | | | | | |
| Unrealized gains (losses) on marketable securities (net of tax benefits) | (233,221) | 144,485 | (415,596) | 238,834 | (47,091) |
| Less reclassification adjustment for (gains) losses included in net income (net of taxes) | 51,171 | (258,037) | 21,217 | (265,228) | (315,721) |
| Comprehensive income | \$ 729,668 | \$ 1,282,475 | \$ 1,405,945 | \$ 2,504,963 | \$ 2,789,848 |

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Stockholders' Equity
For the Six Months Ended June 30, 2008 (Unaudited)
and the Year Ended December 31, 2007

| | Common Stock, No Par Value 20,000,000 Shares Authorized | | # of Shares of | Common Stock | Paid In Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss), Net of Tax | |
|--|--|----------------------------|----------------------|-----------------|--------------------|-------------------|----------------------|---|---|
| | # of Shares Issued | # of Shares Outstanding | Treasury Stock | | | | | | |
| | | | | | | | | | |
| Balances at December 31, 2006 | 17,273,776 | 16,897,826 | 375,950 | 6,509,267 | 1,080,911 | (1,334,313) | 17,318,772 | 153,770 | 2 |
| Redemption of stock | — | (75,000) | 75,000 | — | — | (752,603) | — | — | — |
| Issuance of treasury stock for compensation | — | 4,900 | (4,900) | — | 39,758 | 8,751 | — | — | — |
| Other comprehensive income (loss): Unrealized losses on securities, net of taxes and reclassification adjustment | — | — | — | — | — | — | — | (362,813) | — |
| Net income for the year ended December 31, 2007 | — | — | — | — | — | — | 3,152,660 | — | — |
| Balances at December 31, 2007 | 17,273,776 | 16,827,726 | 446,050 | 6,509,267 | 1,120,669 | (2,078,165) | 20,471,432 | (209,043) | 2 |
| Redemption of stock | — | (90,819) | 90,819 | — | — | (1,038,723) | — | — | — |

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| | | | | | | | | |
|--|------------|------------|---------|--------------|--------------|----------------|---------------|--------------|
| Issuance of treasury stock for compensation | — | 3,500 | (3,500) | — | 28,399 | 6,251 | — | — |
| Other comprehensive income (loss): Unrealized gains on securities, net of taxes and reclassification adjustment | — | — | — | — | — | — | — | (394,379) |
| Net income for the six months ended June 30, 2008 | — | — | — | — | — | — | 1,800,324 | — |
| Balances at June 30, 2008 | 17,273,776 | 16,740,407 | 533,369 | \$ 6,509,267 | \$ 1,149,068 | \$ (3,110,637) | \$ 22,271,756 | \$ (603,422) |

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

For the Six Months Ended June 30, 2008 and 2007 (Unaudited)

and the Year Ended December 31, 2007

| | (Unaudited) Six Months Ended | | December 31, |
|--|---------------------------------|------------------|--------------|
| | 2008 | June 30, 2007 | 2007 |
| Cash flows from operating activities: | | | |
| Net income | \$ 1,800,324 | \$ 2,531,357 | \$ 3,152,660 |
| Adjustments to reconcile net income to net cash flows from operating activities, net of acquisition: | | | |
| Depreciation and amortization | 544,275 | 512,869 | 1,049,913 |
| (Gain)Loss on sale of marketable securities, net | 36,145 | (454,331) | (539,739) |
| Deferred income taxes | (78,035) | (5,303) | (223,717) |
| Treasury stock issued for compensation | 34,650 | 6,930 | 48,509 |
| Increase (decrease) in allowance for doubtful accounts | (4,449) | (40,540) | (40,540) |
| (Increase) decrease in operating assets: | | | |
| Accounts receivable | (412,176) | (619,056) | (226,405) |
| Other receivables | (6,460) | 30,755 | 27,939 |
| Inventories | (345,171) | (988,401) | (984,358) |
| Refundable income taxes | 240,880 | 267,771 | 26,891 |
| Prepaid expenses and other current assets | 8,950 | (1,224) | (9,270) |
| Increase (decrease) in operating liabilities: | | | |
| Accounts payable | 279,314 | 64,150 | 131,316 |
| Accrued expenses | 134,667 | (93,352) | (66,062) |
| Accrued income taxes | 395,093 | 31,802 | |
| Net cash provided by operating activities | 2,628,007 | 1,243,427 | 2,347,137 |
| Cash flows from investing activities: | | | |
| Investment in cost method securities | — | — | (500,000) |
| Purchases of marketable securities | (3,490,650) | (3,274,563) | (5,744,697) |
| Sale of marketable securities | 3,299,791 | 3,750,770 | 7,168,246 |
| Increase in margin payable | 407,479 | — | — |
| Purchases of property and equipment | (1,475,280) | (590,096) | (1,824,879) |
| Purchases of organizational costs | — | (5,858) | — |
| Net cash used in investing activities | (1,258,660) | (119,747) | (901,330) |
| Cash flows from financing activities: | | | |
| Proceeds of note payable | — | — | 300,000 |
| Purchases of treasury stock, net | (1,038,723) | (752,603) | (752,603) |
| Repayment of notes payable | (584,470) | (904,456) | (1,945,131) |
| Net cash used in financing activities | (1,623,193) | (1,657,059) | (2,397,734) |
| Net decrease in cash and cash equivalents | (253,846) | (533,379) | (951,927) |
| | 595,885 | 1,547,812 | 1,547,812 |

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Cash and cash equivalents at the beginning of the period

| | | | | | | |
|--|----|---------|----|-----------|----|---------|
| Cash and cash equivalents at the end of the period | \$ | 342,039 | \$ | 1,014,433 | \$ | 595,885 |
|--|----|---------|----|-----------|----|---------|

See accompanying notes to financial statements

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

and December 31, 2007

Note 1 – NATURE OF BUSINESS

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

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Principles of consolidation

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

Use of estimates

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

Revenue Recognition

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

Cash and cash equivalents

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

The Company maintains cash deposits at several institutions located in the greater Chicago, Illinois and Philadelphia, Pennsylvania metropolitan areas. Deposits at each institution are insured up to \$100,000 by the Federal Deposit

Insurance Corporation or the Securities Investor Protector Corporation.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2008 and 2007
and December 31, 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

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

| | June 30, | | December 31, |
|--|--------------|--------------|--------------|
| | 2008 | 2007 | 2007 |
| Amounts insured | \$ 251,589 | \$ 240,374 | \$ 576,563 |
| Uninsured and uncollateralized amounts | 889,463 | 1,185,137 | 523,295 |
| Total bank balances | \$ 1,141,052 | \$ 1,425,511 | \$ 1,099,858 |

Marketable securities

All investment securities are classified either as available-for-sale and are carried at fair value or quoted market prices. Unrealized gains and on available-for-sale securities losses are reported as a separate component of stockholders' equity. Amortization, accretion, interest and dividends, realized gains and losses, and declines in value judged to be other-than-temporary on available-for-sale securities are recorded in other income. Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities, Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) 59, Accounting for Noncurrent Marketable Equity Securities, and Emerging Issue Task Force Abstract 03-01 The Meaning of Other-than-temporary Impairment and its Application to Certain Investments, provide guidance on determining when an investment is other-than-temporarily impaired. This evaluation depends on the specific facts and circumstances. Factors that we consider in determining whether an other-than-temporary decline in value has occurred include: the market value of the security in relation to its cost basis; the financial condition of the investee; and the intent and ability to retain the investment for a sufficient period of time to allow for possible recovery in the market value of the investment.

Accounts receivable

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

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

Inventories

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

Property and equipment

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

renewals and betterments are capitalized.

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LIFEWAY FOODS, INC. AND SUBSIDIARIES
 Notes to Consolidated Financial Statements
 June 30, 2008 and 2007
 and December 31, 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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

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

Intangible assets

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

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

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

Intangible assets are being amortized over the following useful lives:

| Category | Years |
|---|-------|
| Recipes | 4 |
| Customer lists and other customer related intangibles | 15 |
| Lease agreement | 7 |
| Trade names | 15 |
| Formula | 10 |
| Customer relationships | 12 |

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2008 and 2007
and December 31, 2007

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

Income taxes

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

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

As of January 1, 2007, the Company adopted FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109” (FIN 48), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. Pursuant to FIN 48, the Company has analyzed filing positions in all of the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The only periods subject to examination for the Company’s federal return are the 2003 through 2006 tax years. The Company believes that its income tax filing positions and deductions would be sustained on audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

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

Treasury stock

Treasury stock is recorded using the cost method.

Advertising costs

The Company expenses advertising costs as incurred. During the year ended December 31, 2007 and for the six months ended June 30, 2008 and 2007, approximately \$1,642,114, \$893,710 and \$764,805 of such costs respectively, were expensed.

Earning per common share

Earnings per common share were computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. For the six months ended June 30, 2008 and 2007 and the year ended December 31, 2007, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

Reclassification

Certain 2007 amounts have been reclassified to conform to the 2008 presentation.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2008 and 2007
and December 31, 2007

Note 3 – INTANGIBLE ASSETS

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

| | June 30, 2008 | | June 30, 2007 | | December 31, 2007 | |
|---|---------------|-----------------------------|---------------|-----------------------------|-------------------|-----------------------------|
| | Cost | Accumulated Amortization | Cost | Accumulated Amortization | Cost | Accumulated Amortization |
| Recipes | \$ 43,600 | \$ 40,420 | \$ 43,600 | \$ 31,792 | \$ 43,600 | \$ 37,242 |
| Customer lists and other customer related intangibles | 305,200 | 162,228 | 305,200 | 120,809 | 305,200 | 141,518 |
| Lease acquisition | 87,200 | 48,790 | 87,200 | 36,333 | 87,200 | 42,562 |
| Other | 6,638 | 3,984 | 12,496 | 2,655 | 6,638 | 3,319 |
| C u s t o m e r relationship | 985,000 | 157,327 | 985,000 | 75,243 | 985,000 | 116,285 |
| C o n t r a c t u a l backlog | 12,000 | 12,000 | 12,000 | 12,000 | 12,000 | 12,000 |
| Trade names | 1,980,000 | 253,000 | 1,980,000 | 121,000 | 1,980,000 | 187,000 |
| Formula | 438,000 | 83,950 | 438,000 | 40,150 | 438,000 | 62,050 |
| | \$ 3,857,638 | \$ 761,699 | \$ 3,863,496 | \$ 439,982 | \$ 3,857,638 | \$ 601,976 |

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

| | |
|------------|--------------|
| 2009 | \$ 316,267 |
| 2010 | 312,424 |
| 2011 | 296,812 |
| 2012 | 290,583 |
| 2013 | 290,583 |
| Thereafter | 1,589,270 |
| | \$ 3,095,939 |

Amortization expense during the six months June 30, 2008 and 2007 and for the year ended December 31, 2007 was \$159,723, \$161,272 and \$323,266, respectively.

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

and December 31, 2007

Note 4 – MARKETABLE SECURITIES

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

| June 30, 2008 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|-------------------------------|--------------|---------------------|----------------------|---------------|
| Equities | \$ 3,190,184 | \$ 58,147 | \$ (569,316) | \$ 2,679,015 |
| Mutual Funds | 827,737 | 4,371 | (138,044) | 694,064 |
| Preferred Securities | 1,657,944 | 4,395 | (304,967) | 1,357,372 |
| Corporate Bonds | 1,288,708 | 387 | (73,012) | 1,216,083 |
| Municipal Bonds | 4,586 | 352 | — | 4,938 |
| Government agency Obligations | 530,845 | — | (10,290) | 520,555 |
| Total | \$ 7,500,004 | \$ 67,652 | \$ (1,095,629) | \$ 6,472,027 |

| June 30, 2007 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|-------------------------|--------------|---------------------|----------------------|---------------|
| Equities | \$ 3,256,941 | \$ 353,339 | \$ (64,034) | \$ 3,546,246 |
| Mutual Funds | 669,255 | 1,369 | (27,125) | 643,499 |
| Preferred Securities | 1,571,498 | 55 | (51,152) | 1,520,401 |
| Private Investment LP | 600,000 | 126,598 | — | 726,598 |
| Certificates of Deposit | 75,000 | — | (1,242) | 73,758 |
| Corporate Bonds | 1,886,329 | 1,298 | (121,258) | 1,766,369 |
| Municipal Bonds | 24,591 | 127 | (980) | 23,738 |
| Government agency | 124,879 | — | (971) | 123,908 |
| Total | \$ 8,208,493 | \$ 482,786 | \$ (266,762) | \$ 8,424,517 |

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

Proceeds from the sale of marketable securities were \$7,168,246, \$3,299,791 and \$3,750,770 during the year ended December 31, 2007 and for the six months ended June 30, 2008 and 2007, respectively.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2008 and 2007
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Note 4 – MARKETABLE SECURITIES - Continued

Gross gains of \$876,527, \$279,278, and \$453,380 and gross losses of \$336,788, \$366,452, and \$951 were realized on these sales during the year ended December 31, 2007 and for the six months ended June 30, 2008 and 2007, respectively.

The following table shows the gross unrealized losses and fair value of Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2008:

| Description of Securities | Less Than 12 Months | | 12 Months or Greater | | Total | |
|-------------------------------|---------------------|-------------------|----------------------|-------------------|--------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Equities | \$ 1,871,145 | \$ (345,239) | \$ 332,711 | \$ (224,077) | \$ 2,203,856 | \$ (569,316) |
| Mutual Funds | 320,706 | (67,332) | 274,291 | (70,711) | 594,997 | (138,043) |
| Preferred Securities | 389,072 | (46,185) | 875,900 | (258,782) | 1,264,972 | (304,967) |
| Corporate Bonds | 527,880 | (15,806) | 671,766 | (57,207) | 1,199,646 | (73,013) |
| Government Agency Obligations | 520,555 | (10,290) | — | — | 520,555 | (10,290) |
| | \$ 3,629,358 | \$ (484,852) | \$ 2,154,668 | \$ (610,777) | \$ 5,784,026 | \$ (1,095,629) |

Equities, Mutual Funds, Corporate Bonds and Government Agency Obligations - The Company's investments in equity securities, mutual funds and corporate bonds consist of investments in common stock and debt securities of companies in various industries. The Company evaluated the near-term prospects of the issuer in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider any material investments to be other-than-temporarily impaired at June 30, 2008.

Preferred Securities - The Company's investments in preferred securities consist of investments in preferred stock of companies in various industries. The Company evaluated the 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, 2008.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2008 and 2007
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Note 5 – INVENTORIES

Inventories consist of the following:

| | June 30, | | December 31, |
|---------------------|--------------|--------------|--------------|
| | 2008 | 2007 | 2007 |
| Finished goods | \$ 1,276,812 | \$ 1,495,651 | \$ 1,296,985 |
| Production supplies | 1,476,944 | 1,265,816 | 1,383,384 |
| Raw materials | 1,097,969 | 749,130 | 826,185 |
| Total inventories | \$ 3,851,725 | \$ 3,510,597 | \$ 3,506,554 |

Note 6 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

| | June 30, | | December 31 |
|-------------------------------|---------------|--------------|--------------|
| | 2008 | 2007 | 2007 |
| Land | \$ 969,232 | \$ 969,232 | \$ 969,232 |
| Buildings and improvements | 7,054,840 | 6,726,538 | 6,743,647 |
| Machinery and equipment | 8,199,914 | 7,665,098 | 8,159,199 |
| Vehicles | 581,458 | 581,458 | 581,458 |
| Office equipment | 116,203 | 97,839 | 101,583 |
| Construction in process | 1,828,582 | — | 719,830 |
| | 18,750,229 | 16,040,165 | 17,274,949 |
| Less accumulated depreciation | 7,980,553 | 7,220,950 | 7,596,001 |
| Total property and equipment | \$ 10,769,676 | \$ 8,819,215 | \$ 9,678,948 |

Depreciation expense during the years ended December 31, 2007 and for the six months ended June 30, 2008 and 2007 was \$726,647, \$384,552 and \$351,597, respectively.

Note 7 – ACCRUED EXPENSES

Accrued expenses consist of the following:

| | June 30, | | December 31, |
|-----------------------------------|------------|------------|--------------|
| | 2008 | 2007 | 2007 |
| Accrued payroll and payroll taxes | \$ 243,876 | \$ 52,695 | \$ 58,395 |
| Accrued property tax | 293,712 | 273,359 | 285,279 |
| Other | 11,118 | 60,695 | 70,365 |
| | \$ 548,706 | \$ 386,749 | \$ 414,039 |

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

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Note 8 – NOTES PAYABLE

Notes payable consist of the following:

| | June 30, 2008 | 2007 | December 31, 2007 |
|---|------------------|--------------|----------------------|
| Mortgage note payable to a bank, payable in monthly installments of \$3,273 including interest at 7%, with a balloon payment of \$416,825 due September 25, 2011. Collateralized by real estate. | \$ 443,275 | \$ 449,870 | \$ 446,450 |
| Mortgage note payable to a bank, payable in monthly installments of \$19,513 including interest at 5.6%, with a balloon payment of \$2,652,143 due July 14, 2010. Collateralized by real estate. | 2,798,264 | 2,870,749 | 2,834,970 |
| Note payable to Amani Holding LLC, payable in quarterly installments of \$262,500 plus interest at the floating prime rate per annum (7.25% at December 31, 2007) due September 1, 2010 secured by letter of credit | 1,406,914 | 2,652,979 | 1,951,503 |
| Total notes payable | 4,648,453 | 5,973,598 | 5,232,923 |
| Less current maturities | 1,130,612 | 1,130,316 | 1,136,126 |
| Total long-term portion | \$ 3,571,841 | \$ 4,843,282 | \$ 4,096,797 |

Maturities of notes payables are as follows:

| | |
|-----------------------------|--------------|
| For the Year Ended June 30, | |
| 2009 | \$ 1,130,612 |
| 2010 | 437,207 |
| 2011 | 2,661,919 |
| 2012 | 418,715 |
| Total | \$ 4,648,453 |

Note 9 – PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

| | For the Six Months Ended June 30, | | For the Year Ended December 31, |
|----------------------------|--------------------------------------|--------------|---------------------------------------|
| | 2008 | 2007 | 2007 |
| Current: | | | |
| Federal | \$ 969,123 | \$ 1,198,853 | \$ 1,699,408 |
| State and local | 219,627 | 255,734 | 336,848 |
| Total current | 1,188,750 | 1,454,587 | 2,036,256 |
| Deferred | (78,035) | (5,303) | (223,717) |
| Provision for income taxes | \$ 1,110,715 | \$ 1,449,284 | \$ 1,812,539 |

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2008 and 2007
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Note 9 – PROVISION FOR INCOME TAXES - Continued

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, | | For the Year Ended December 31, |
|---|--------------------------------------|--------------|---------------------------------------|
| | 2008 | 2007 | 2007 |
| Federal income tax expense computed at the statutory rate | \$ 989,753 | \$ 1,353,416 | \$ 1,688,168 |
| State and local tax expense, net | 139,730 | 191,071 | 238,330 |
| Permanent differences | (18,768) | (95,203) | (113,969) |
| Provision for income taxes | \$ 1,110,715 | \$ 1,449,284 | \$ 1,812,529 |

Amounts for deferred tax assets and liabilities are as follows:

| | June 30, 2008 | 2007 | December 2007 |
|---|------------------|--------------|------------------|
| Non-current deferred tax liabilities arising from: | | | |
| Temporary differences - | | | |
| accumulated depreciation and amortization | \$ (1,647,550) | \$ (466,673) | \$ (1,712,795) |
| Current deferred tax assets (liabilities) arising from: | | | |
| Unrealized losses (gains) on marketable securities | 424,555 | (89,619) | 147,077 |
| Inventory | 163,212 | 146,489 | 148,586 |
| Allowance for doubtful accounts | 14,460 | 16,298 | 16,297 |
| Total current deferred tax assets (liabilities) | 602,227 | 73,168 | 311,960 |
| Net deferred tax liability | \$ (1,045,323) | \$ (393,505) | \$ (1,400,835) |

Note 10 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

| | For the Years Ended June 30, | | For the Year Ended December 31, |
|--------------|---------------------------------|--------------|---------------------------------------|
| | 2008 | 2007 | 2007 |
| Interest | \$ 154,924 | \$ 110,903 | \$ 430,098 |
| Income taxes | \$ 552,777 | \$ 1,176,031 | \$ 2,026,031 |

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2008 and 2007

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Note 11 – STOCK AWARD AND STOCK OPTION PLANS

The Company has a registration statement filed with the Securities and Exchange Commission in connection with a Consulting Service Compensation Plan covering up to 600,000 of the Company's common stock shares. Pursuant to such Plan, the Company may issue common stock or options to purchase common stock to certain consultants, service providers, and employees of the Company. There were 468,000 shares available for issuance under the Plan at December 31, 2007 and June 30, 2008 and 2007. 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, 2007 and at June 30, 2008 and 2007, there were no stock options outstanding or exercisable.

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

Note 12 – FAIR VALUE MEASUREMENTS

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

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

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

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

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

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2008 and 2007
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Note 12 – FAIR VALUE MEASUREMENTS - Continued

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 at June 30, 2008 |
|--|---|---|--|-----------------------------|
| Assets | | | | |
| Investment securities- available - for - sale | \$ 6,472,027 | \$ — | \$ — | \$ 6,472,027 |

Note 13 – RECENT ACCOUNTING PRONOUNCEMENTS

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 permits entities to elect to measure many financial instruments and certain other items at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for the Company beginning February 3, 2008. The adoption of SFAS No. 159 will not impact the financial condition or results of operations of the Company.

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

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

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

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

Comparison of Quarter Ended June 30, 2008 to Quarter Ended June 30, 2007

The following analysis should be read in conjunction with the unaudited financial statements of the Company and related notes included elsewhere in this quarterly report and the audited financial statements and Management's Discussion and Analysis contained in our Form 10-KSB, for the fiscal year ended December 31, 2007.

Results of Operations

Sales increased by \$1,808,131, (approximately 19%) to \$11,523,393 during the three-month period ended June 30, 2008 from \$9,715,262 during the same three-month period in 2007. 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, for the Lifeway Foods line was approximately 65% during the second quarter 2008, compared to about 59% during the same period in 2007. The increase was primarily attributable to the increased cost of conventional milk, our largest raw material, as well as continuing increases in raw materials and productions supplies derived from oil such as plastics and corrugated boxes.

Operating expenses as a percentage of sales for Lifeway Foods were approximately 20% during the second quarter 2008, compared to about 21% during the same period in 2007. Selling - related expenses increased by 27% in the second quarter 2008 when compared to the same period in 2007. This increase is primarily attributable to our increased efforts to market and improve the awareness of our flagship line, Kefir, as well as Lifeway's kids Kefir drink, ProBugs®.

Income from operations decreased by \$215,126 (approximately 12%) to \$1,546,161 during the three-month period ended June 30, 2008 from \$1,761,287 during the same three-month period in 2007. This decrease was primarily attributable to the increase cost of conventional milk, our largest raw material, as well as continuing increases in raw materials and productions supplies derived from oil such as plastics, and corrugated boxes.

Total other expenses for the second quarter 2008 were \$81,634, compared with total other income of \$438,249 during the same period in 2007. This decrease is primarily attributable to a higher gain on the sale of marketable securities in 2007, when compared to the same period in 2008. Marketable securities are discussed in Note 4 of the Notes to Consolidated Financial Statements.

Provision for income taxes was \$552,809, or a 38% tax rate during the second quarter 2008 compared with \$803,510 or a 36% tax rate during the same period in 2007. Income taxes are discussed in Note 9 of the Notes to Consolidated Financial Statements.

Total net income was \$911,718 or \$.05 per split adjusted share for the second quarter ended June 30, 2008, compared with \$1,396,026, or \$.08 per split adjusted share in the same period in 2007.

Comparison of Six-Month Period Ended June 30, 2008 to Six-Month Period Ended June 30, 2007

Results of Operations

Sales increased by \$3,908,125, (approximately 21%) to \$22,645,631 during the six-month period ended June 30, 2008 from \$18,737,506 during the same six-month period in 2007. 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, were approximately 66% during the six-month period ended June 30, 2008, compared to about 59% during the same period in 2007. The increase was primarily attributable to the increased cost of conventional milk, our largest raw material, as well as continuing increases in raw materials and production supplies derived from oil such as plastics and corrugated boxes.

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Operating expenses as a percentage of sales for Lifeway Foods were approximately 20% during the six-month period ended June 30, 2008, compared to about 21% during the same period in 2007. Selling - related expenses increased by approximately 32% during the first six months of 2008 when compared to the same period in 2007. This increase is primarily attributable to our increased efforts to market and improve the awareness of our flagship line, Kefir, as well as Lifeway's kids Kefir drink, ProBugs®.

Total other expenses during the six-month period ending June 30, 2008 were \$1,780, compared with total other income of \$417,864 during the same period in 2007. This decrease is primarily attributable to a higher gain on the sale of marketable securities in 2007, when compared to the same period in 2008. Marketable securities are discussed in Note 4 of the Notes to Consolidated Financial Statements.

Provision for income taxes was \$1,110,715 or a 38% tax rate during the six-month period ended June 30, 2008 compared with \$1,449,284 or a 36% rate during the same period in 2007. Income taxes are discussed in Note 9 of the Notes to Consolidated Financial Statements.

Total net income was \$1,800,324, or \$.11 per split adjusted share for the six-month period ended June 30, 2008, compared with \$2,531,357, or \$.15 per split adjusted share in the same period in 2007.

Sources and Uses of Cash

Net cash provided by operating activities increased \$1,384,580 to \$2,628,007 during the six-month period ended June 30, 2008 from \$1,243,427 during the same period in 2007. This increase is primarily attributable to the \$643,230 reduction in the decrease in inventories and the \$206,880 reduction in the decrease in accounts receivables during the first six months of 2008, when compared to the same period in 2007.

Net cash used in investing activities was \$1,258,660 during the six months ended June 30, 2008, which is an increase of \$1,138,913 compared to \$119,747 of net cash used in investing activities during the same period in 2007. This increase is primarily attributable to the Company purchasing \$1,475,280 in equipment in the first six months of 2008 when compared to the Company purchasing \$590,096 in equipment during the same period in 2007.

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

We anticipate being able to fund the Company's foreseeable liquidity requirements internally.

Other Developments

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

Critical Accounting Policies

Lifeway's analysis and discussion of its financial condition and results of operations are based upon its consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). The preparation of financial statements in accordance with US GAAP requires

management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. US GAAP provides the framework from which to make these estimates, assumptions and disclosures. Lifeway chooses accounting policies within US GAAP that management believes are appropriate to accurately and fairly report Lifeway's operating results and financial position in a consistent manner. Management

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regularly assesses these policies in light of current and forecasted economic conditions and has discussed the development and selection of critical accounting policies with its audit committee of the Board of Directors. For further information concerning accounting policies, refer to Note 2 -- Nature of Business and Significant Accounting Policies in the Notes to Consolidated Financial Statements.

Forward Looking Statements

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

Changes in economic conditions, commodity prices;

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

Significant changes in the competitive environment; and

Changes in laws, regulations, or tax rates.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4T. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934 (the “Exchange Act”). Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

There was no change in our internal control over financial reporting during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

Not applicable.

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

- (a) Not applicable.
- (b) Not applicable.
- (c) Purchases of Equity Securities

The following table represents the purchasing activity of made by the Company during the second quarter of fiscal 2008:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|--|--|---------------------------------|--|--|
| Month #1 April 1, 2008 – April 30, 2008 | 21,745 | \$ 12.80 | 21,745 | 41,255 |
| Month #2 May 1, 2008 – May 31, 2008 | 24,418 | 12.47 | 24,418 | 16,837 |
| Month #3 June 1, 2008 – June 30, 2008 | 7,656 | 12.12 | 7,656 | 9,181 |
| Total | 53,819 | \$ 12.55 | 53,819 | 9,181 |

Notes to this table: All purchases made pursuant to Company's publicly-announced stock buyback authorized on December 12, 2007 for up to 100,000 shares of Company's common stock.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

Our Annual Meeting of stockholders was held on June 20, 2008. Proxies for the meeting were solicited pursuant to Regulation 14A under the Exchange Act. There was no solicitation of proxies in opposition to management's nominees as listed in the proxy statement and all of management's nominees were elected to our Board of Directors. Details of the voting are provided below:

Proposal 1:

To elect six (6) members of the Company's Board of Directors to serve until the 2009 Annual Meeting of Stockholders (or until successors are elected or directors resign or are removed).

| | | |
|-----------------------|-----|----------|
| Proposal 1 | For | Withhold |
| Election of Directors | | |

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Director

| | | |
|--------------------|------------|---------|
| Ludmila Smolyansky | 16,104,479 | 520,882 |
| | 96.87% | 3.13% |
| Julie Smolyansky | 16,106,079 | 519,282 |
| | 96.88% | 3.12% |
| Pol Sikar | 16,597,264 | 28,097 |
| | 99.83% | 0.17% |
| Renzo Bernardi | 16,597,544 | 27,817 |
| | 99.83% | 0.17% |
| Juan Carlos Dalto | 16,594,044 | 31,317 |
| | 99.81% | 0.19% |
| Julie Oberweis | 16,592,833 | 32,528 |
| | 99.80% | 0.20% |

Proposal 2:

| Proposal 2 | For | Against | Abstain |
|----------------------------------|------------|------------|-----------|
| Auditor Ratification | | | |
| Plante and Moran | 13,121,360 | 37,391 | 3,466,610 |
| Total Votes Represented by Proxy | | 16,625,361 | |
| Percentage of the Outstanding | | 99.19% | |
| Votable Shares | | 16,761,863 | |
| Outstanding Votable Shares | | | |

ITEM 5. OTHER INFORMATION

On August 14, 2008, the Company announced its financial results for the fiscal quarter ended June 30, 2008 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) |
| 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 14, 2008. "Lifeway Foods Reports Record 2nd Quarter and First Half 2008 Results." |

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)

August 14,
Date: 2008

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

August 14 ,
Date: 2008

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

EXHIBIT INDEX

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