

LIFEWAY FOODS INC  
Form 10-K  
April 02, 2014

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2013

£ 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.  
(Name of registrant as specified in its charter)

Illinois  
(State or other jurisdiction of  
incorporation or organization)

36-3442829  
(IRS Employer  
Identification No.)

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

(847) 967-1010  
(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class	Name of each exchange on which registered
Common Stock, No Par Value	Nasdaq Global Market

Securities registered under Section 12(g) of the Exchange Act:

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None

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

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

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

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

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

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the stock was last sold as of June 30, 2013 (\$17.36 per share as quoted on the Nasdaq Global Market) was \$80,688,689.

As of March 28, 2014, 16,346,017 shares of the registrant's common stock, no par value, were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE:

None.

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LIFEWAY FOODS, INC.

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

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

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

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

## PART I

### ITEM 1. BUSINESS.

#### BUSINESS DEVELOPMENT

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

#### SUBSIDIARY ENTITIES

On August 3, 2006, the Company acquired all of the issued and outstanding stock of Helios Nutrition, Ltd. (“Helios”). Pride of Main Street Dairy, L.L.C., a Minnesota limited liability company, is 100% owned by Helios.

Starfruit, L.L.C. and Starfruit Franchisor, L.L.C. are both wholly-owned subsidiaries formed on March 26, 2007 and July 15, 2008, respectively, in connection with the Company’s Starfruit cafe activities.

On February 6, 2009, the Company acquired all of the issued and outstanding stock of Fresh Made, Inc., a Pennsylvania corporation (“Fresh Made”).

On October 14, 2010, Lifeway First Juice, Inc., an Illinois corporation and a wholly-owned subsidiary of the Company (“Lifeway First Juice”) acquired substantially all of the assets of First Juice, Inc., a Delaware corporation (“First Juice”).

On July 2, 2013, the Company, through its wholly-owned subsidiary Lifeway Wisconsin, Inc., an Illinois corporation (“Lifeway Wisconsin”) acquired substantially all of the assets of Golden Guernsey Dairy Limited Liability Company, a Wisconsin limited liability company (“Golden Guernsey”).

#### BUSINESS OF ISSUER

##### PRODUCTS

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

Kefir contains a unique mixture of several live microorganisms and nutrients such as proteins, minerals and vitamins. Kefir is a good source of calcium, protein and B Vitamins. In addition, because the fermentation process does not produce a highly sour-tasting product, the end product has fewer calories than some similar products in the dairy category.

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

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

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

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

**PROBUGS.** "ProBugs" is a kefir product that contains ten live and active kefir cultures. Aimed at children ages 2-9, ProBugs comes in three flavors, "Sublime Slime Lime®," "Orange Creamy Crawler®" and "Goo-Berry Pie®" and is packaged in no spill spout pouches designed as cartoon bug characters Peter, Polly and Penelope ProBug®.

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

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

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

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

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

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

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



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

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

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

## DISTRIBUTION

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

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

Distributors are provided Lifeway products at wholesale prices for distribution to their retail accounts. Lifeway believes that the price at which its products are sold to its distributors is competitive with the prices generally paid by distributors for similar products in the markets served. In all areas served, distributors currently deliver the products directly to the refrigerated cases of dairy sections of their retail customers. Each distributor carries a line of Lifeway’s products on its trucks, checks the retail stores for space allocated to Lifeway’s products, determines inventory requirements of the store and places Lifeway products directly into the retailers’ dairy cases. Lifeway believes this method of distribution best serves the needs of each retail store, and is the best available means to ensure consistency and quality of product handling, quality control, flavor selection and favorable retail display. The Company expects customers, either distributors who go into third party retail stores to sell the product they have purchased from us, or the direct retail customer that may service their own stores, as general good business practice to rotate the perishable products, make or obtain frequent delivery of products, replacement of damaged, old or substandard packages and deliver or have deliveries made directly to the refrigerated case. It is to the benefit of the distributor or retailer, as well as the Company, not to have spoiled, out dated, or substandard product on the shelf. However, due to the perishable nature of the product, the Company’s distributors and retailers have no right to return any product to the Company.

## MARKETING

Lifeway continues to promote the verifiable nutritional characteristics, purity and good taste of its kefir and kefir-based products. Lifeway primarily advertises its products through local radio stations, which advertisements are directed to both users and non-users of cultured milk products of all kinds. In addition, through newspaper and magazine advertising, Lifeway provides educational information on its products and appeals to the common perception that the products may be of particular health benefit, including promoting digestion, and continues to educate the public on the possible health benefits which could be derived from the use of kefir and kefir-based products.

In addition to local radio stations, newspapers and magazines, Lifeway promotes further exposure of its products through the internet (via our website, social media and blogs), catalog advertising and promotion, store demonstrations throughout the United States, and participation in various trade shows. Lifeway also sponsors several

different sporting events in the Chicago metropolitan area as an additional marketing tool.

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## COMPETITION

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

In connection with the certain Stockholders' Agreement, as amended, between Lifeway, Danone Foods, Inc. and other parties, as well as certain other transactions between the two foregoing companies described elsewhere in this report, the parties agreed that they would not compete with each other during the term of the Stockholders' Agreement with respect to certain yogurt, cheese and kefir products. The term of the non-compete obligation expired on December 31, 2010. The remaining provisions of the Stockholders' Agreement are in full force and effect.

## SUPPLIERS

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

## MAJOR CUSTOMERS

Lifeway distributes its products to numerous accounts throughout the United States. Concentrations of credit with regard to trade accounts receivable and sales are limited due to the fact that Lifeway's customers are spread across different geographic areas. However, customers are concentrated in the retail food industry, for example, Trader Joe's and United Natural Foods. In 2013, two customers represented approximately 27% of sales and reflected sales in various regions of the United States outside the Chicago metropolitan area.

## TRANSACTIONS WITH GROUPE DANONE SA

All share amounts and prices in this subsection are historical and have not been adjusted for the stock splits which occurred in the first quarter of 2004 and the second quarter of 2006. On October 1, 1999, Lifeway and certain members of the Smolyansky family sold shares of restricted common stock to Danone at \$10.00 per share. Later in 1999, Danone purchased additional shares of common stock from certain individuals, including shares purchased in transactions with certain Company affiliates, including Lifeway's founder Michael Smolyansky, Val Nikolenko, Vice President of Production and Pol Sikar, a director, and his affiliates. As a result of these transactions, Danone became the beneficial owner of approximately 20% of the outstanding common stock of Lifeway. Pursuant to the terms and conditions of the transaction, Lifeway granted certain limited rights to Danone, which include a right to nominate one director, anti-dilutive rights relating to future offerings and limited registration rights. In addition, as described above, Lifeway and Danone are parties to a Stockholders' Agreement dated October 1, 1999, as amended through extensions of certain provisions pursuant to which the parties agreed, among other things, that they would not compete with each other with respect to certain kefir products. The terms of the non-compete obligation expired on December 31, 2010. The Stockholders' Agreement also provides that Danone may not own more than 20% of the outstanding common stock of Lifeway as a result of direct or indirect acquisition of shares during the standstill period, which expired on December 31, 2010. Danone's interest as of December 31, 2013 was approximately 21.1% due to reductions in Lifeway's shares outstanding, primarily due to share repurchases by Lifeway. The remaining provisions of the Stockholders' Agreement are in full force and effect.



## PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS

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

Mark/Reg. No.	Goods/Services	Date of Registration	Expiration of Registration	Comments
ProBug Design 1, Reg. No. 3266378	dairy-based beverages; dairy- based food beverages; kefir; soy- based food beverage used as milk substitute	July 17, 2007	July 17, 2017	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.
ProBug Design 2, Reg. No. 3263130	dairy-based beverages; dairy- based food beverages; kefir; soy- based food beverage used as milk substitute	July 10, 2007	July 10, 2017	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.
Penelope ProBug Design, Reg. No. 3408792	dairy-based beverages; dairy- based food beverages; kefir; soy- based food beverage used as milk substitute	April 8, 2008	April 8, 2018	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.

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BA3APHBIII (a Stylized presentation of “bazarny” in Cyrillic characters), Reg. No. 3590660	cultured milk products, excluding ice cream, ice milk and frozen yogurt; cheeses and cottage cheese	March 17, 2009	March 17, 2019	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
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BAMBINO, Reg. No. 2770522	cheeses, cottage cheeses and other dairy products, excluding ice cream, ice milk, and frozen yogurt	October 7, 2003	October 7, 2023	A Renewal application was timely filed May 13, 2013. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.
BAZARNY, Reg. No. 3597883	cultured milk products, excluding ice cream, ice milk and frozen yogurt; cheeses and cottage cheese	March 31, 2009	March 31, 2019	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
BIO KEFIR, Reg. No. 3886709	yogurt, cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and frozen yogurt	December 7, 2010	December 7, 2020	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
CHANGING THE WORLD, ONE MOUTHFUL AT A TIME. (Stylized), Reg. No. 3541999	fruit juices	December 2, 2008	December 2, 2018	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
FRUIT JUICE (Stylized), Reg. No. 3413276	fruit juices	April 15, 2008	April 15, 2018	Registration is renewable at the time of expiration

Fruit Juice Logo, Reg. No. 3432421	fruit juices	May 20, 2008	May 20, 2018	provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.  Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
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GOO-BERRY PIE, Reg. No. 3405134	dairy-based beverages; dairy- based food beverages; kefir; soy-based food beverages used as a milk substitute	April 1, 2008	April 1, 2018	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.
HELIOS NUTRITION, Reg. No. 2283716	health foods, functional foods and medical foods, namely, dairy products excluding ice cream, ice milk and frozen yogurt	October 5, 1999	October 5, 2019	Registration was timely renewed on April 2, 2010. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date or the six-month grace period following the sixth anniversary date.
KOROVKA, Reg. No. 2504027	dairy-based spread	November 6, 2001	November 6, 2021	Registration was timely renewed on November 6, 2011. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.
KPECTBRHCKNN (a Stylized presentation of “krestyanskiy” in Cyrillic characters-means “peasant”), Reg. No. 2187363	cheeses, cottage cheeses and other milk products excluding ice cream, ice milk and frozen yogurt	September 8, 1998	September 8, 2018	Registration was timely renewed on August 23, 2008. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.

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Reg. No. 2135974	kefir, yogurt, cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and frozen yogurt	February 10, 1998	February 10, 2018	Registration was timely renewed on May 23, 2008. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.
LA FRUTA, Reg. No. 2937061	cultured milk products, excluding ice cream, ice milk and frozen yogurt	March 29, 2005	March 29, 2015	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.

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LIFEWAY, Reg. No. 1571136	cheese and kefir	December 12, 1989	December 12, 2019	Registration was timely renewed on December 12, 2009. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.
ORANGE CREAMY CRAWLER, Reg. No. 3263128	dairy-based beverages; dairy- based food beverages; kefir; soy- based food beverage used as milk substitute	July 10, 2007	July 10, 2017	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.
PHYTOBOOST, Reg. No. 3982487	dairy-based beverages; dairy- based food beverages; kefir; soy-based food beverage used as a milk substitute	June 21, 2011	June 21, 2021	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
PLAYGROUP PACK, Reg. No. 3634999	fruit juices	June 9, 2009	June 9, 2019	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
PRIDE OF MAIN STREET, MN Reg. No. 12947	dairy product	November 9, 1987	November 9, 2017	Only for the State of Minnesota, not in US – Registration was renewed

in 2007. Registration is  
renewable for ten years.

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PRO2O, Reg. No. 4226923	dairy-based beverages; dairy-based food beverages; kefir; soy-based food beverage used as a milk substitute beverages, namely, water and fruit and vegetable juices and fruit juices flavored with tea	October 16, 2012	October 16, 2022	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
PROBUGS, Reg. No. 3263129	dairy-based beverages; dairy- based food beverages; kefir; soy-based food beverage used as milk substitute	July 10, 2007	July 10, 2017	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.
SOYTREAT, Reg. No. 3530754	soy-based food beverage intended for use as cultured milk substitute	November 11, 2008	November 11, 2018	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
STARFRUIT, Reg. No. 3513252	franchise services, namely, offering	October 7, 2008	October 7, 2018	Registration is renewable at the time of expiration provided mandatory documents are filed with

	technical and business management assistance in the establishment and operation of restaurants			the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
STARFRUIT, Reg. No. 3454746	restaurant services	June 24, 2008	June 24, 2018	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.



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STARFRUIT (Stylized), Reg. No. 3879939	kefir	November 23, 2010	November 23, 2020	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.
SUBLIME SLIME LIME, Reg. No. 3263134	dairy-based beverages; dairy-based food beverages; kefir; soy-based food beverage used as milk substitute	July 10, 2007	July 10, 2017	An Affidavit of Continued Use was timely filed between the fifth and sixth anniversaries of the registration date. Registration is renewable between the ninth and tenth anniversaries of the registration date or the six-month grace period following the registration expiration date.
SWEET KISS, Reg. No. 2135975	cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and frozen yogurt	February 10, 1998	February 10, 2018	Registration was timely renewed on May 23, 2008. Registration is renewable for ten year periods or during the six-month grace period following the registration expiration date.
TODDLER TASTEBUD TRAINING (Stylized), Reg. No. 3542008	fruit juices	December 2, 2008	December 2, 2018	Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.

fruit juices

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TRAINING WHEELS  
FOR HEALTHY  
EATING (Stylized),  
Reg. No. 3412314

April 15,  
2008

April 15,  
2018

Registration is renewable at the time of expiration provided mandatory documents are filed with the USPTO between the fifth and sixth anniversaries of the registration date or the six-month grace period following the sixth anniversary date.

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

## REGULATION

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

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

## RESEARCH AND DEVELOPMENT

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

Lifeway conducts primarily all of its research internally, but at times will employ the services of an outside testing facility. During 2012 and 2013, the amount Lifeway expended for research and new product development was not material to the financial position of Lifeway and no amount was customer supported.

## EMPLOYEES

Lifeway currently employs approximately 350 employees, all of whom are full-time employees. Substantially all of these employees are engaged in the manufacturing of the Company's products. None of Lifeway's employees are covered by collective bargaining agreements. The Company only has distributor relationships with third party distributors. No distributors are considered to be employees. Company-owned vehicles are used by Company employees for local same day deliveries only and revenue is recognized on the date of delivery to the end retail customers. Drivers of those vehicles are employees of the Company and all payroll, withholdings, and income taxes are accounted for in the same manner.

## ITEM 1A. RISK FACTORS.

Not applicable.

## ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

## ITEM 2. PROPERTIES.

On May 16, 1988, Lifeway purchased an approximately 26,000 square foot parcel of real property, including an approximately 8,500 square foot one-story brick building in good condition, located at 7625 N. Austin Avenue, Skokie, Illinois. Lifeway uses this facility for manufacturing and storage and has no plans to improve or renovate this property. Lifeway is the only occupant of this property and presently holds fee simple title subject to a mortgage which secures the property as collateral for certain loans to Lifeway from The Private Bank & Trust as discussed in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation (the "Loans"). 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. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

On October 16, 1996, Lifeway purchased a 110,000 square foot commercially-zoned parcel of real property, including an approximately 50,000 square foot one-story brick building in good condition, located at 6431 Oakton Avenue, Morton Grove, Illinois. This property is used as Lifeway's corporate headquarters and main manufacturing facility. This property has been improved every year since the time of purchase by the addition of custom-built refrigerated storage space and the addition of various machinery and equipment used to manufacture, package and store Lifeway's products. Lifeway is the only occupant of this property and presently holds fee simple title subject to a mortgage which secures the property as collateral for the Loans discussed above. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

In June 2005, the Company purchased a 100,000 square foot distribution and warehousing facility that is equipped with 40,000 square feet of refrigeration. The facility, located at 6101 Gross Point Road in Niles, Illinois, approximately 50,000 square foot building, less than a mile away. The additional space at the Company's main plant is being used to expand production capacity for the Company's kefir and other probiotic products. Lifeway is the only occupant of this property and presently holds fee simple title subject to a mortgage which secures the property as collateral for the Loans discussed above. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

Included in the purchase of Pride of Main Street Dairy on August 3, 2006, Lifeway acquired an approximately 35,000 square foot commercially-zoned parcel of real estate located at 214 Main Street S. Sauk Centre, Minnesota, including a 16,000 square foot two-story brick building used for production, and a 5,600 square foot storage facility. This property is used as the main headquarters and main production facility for Pride of Main Street Dairy. The building was built in the 1920's with an addition in 1990. The facility is being used to produce all of the Pride of Main Street Dairy products, and approximately 70% of the Helios Nutrition Organic Kefir, with the remaining 30% being produced in Lifeway's main production facility in Morton Grove, Illinois. Lifeway is the only occupant of this property and presently holds fee simple title subject to negative mortgage pledge as part of the collateral package for the Loans discussed above. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

On February 6, 2009, in connection with the Company's acquisition of Fresh Made, Inc., Lifeway also acquired 1.135 acres of land in Philadelphia. This facility is used to store raw materials and finished goods. Lifeway is the only occupant of this property and presently holds fee simple title subject to a negative mortgage pledge as part of the collateral package for the Loans discussed above. The value of this property may be subject to real estate market forces that typically affect industrial real estate in the area immediately surrounding the property.

On July 2, 2013 the Company, through its wholly-owned subsidiary Lifeway Wisconsin, consummated the purchase of Golden Guernsey's dairy manufacturing, bottling and distribution plant in a 170,000 square foot facility in Waukesha, Wisconsin. Lifeway is the only occupant of this property and presently holds fee simple title subject to negative mortgage pledge as part of the collateral package for the Loans discussed above.

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

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

### ITEM 3. LEGAL PROCEEDINGS.

Lifeway is not party to any material pending legal proceedings. Lifeway is from time to time engaged in litigation matters arising in the ordinary course of business none of which presently is expected to have a material adverse effect on its business results or operations.

### ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable.



PART II

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

MARKET INFORMATION

Lifeway’s Common Stock, no par value, the only class of common equity of Lifeway, is traded on The Nasdaq Global Market under the symbol “LWAY.” Trading commenced on March 29, 1988.

The high and low sales prices for Lifeway’s Common Stock for the quarterly periods within the two most recent fiscal years, as reported by The Nasdaq Global Market, is set forth in the following table:

	Low Bid	High Bid
First Qtr. 2012	\$ 8.81	\$ 9.91
Second Qtr. 2012	\$ 8.03	\$ 10.40
Third Qtr. 2012	\$ 9.10	\$ 11.10
Fourth Qtr. 2012	\$ 7.90	\$ 9.88
First Qtr. 2013	\$ 8.39	\$ 14.00
Second Qtr. 2013	\$ 10.65	\$ 18.38
Third Qtr. 2013	\$ 12.50	\$ 19.99
Fourth Qtr. 2013	\$ 12.85	\$ 17.20

As of March 10, 2014, there were approximately 90 holders of record of Lifeway’s Common Stock. The Company has no information regarding beneficial owners whose shares are held in street name.

DIVIDENDS

Lifeway declared a cash dividend of \$0.08 per share during the fiscal year ended December 31, 2013 and a cash dividend of \$0.07 per share during the fiscal year ended December 31, 2012. We intend to pay regular annual distributions to our common shareholders, the amount of which may change from time to time. Future distributions will be declared and paid at the discretion of our Board of Directors, and will depend upon cash generated by operating activities, our financial condition, capital requirements, and such other factors as our Board of Directors deem relevant.

SALES OF UNREGISTERED SECURITIES

None.

PURCHASES OF THE COMPANY’S SECURITIES

None.

EQUITY COMPENSATION PLAN INFORMATION

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





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

Results of Operations

Comparison of Quarter Ended December 31, 2013 to Quarter Ended December 31, 2012

The following analysis should be read in conjunction with the audited financial statements of the Company and related notes included elsewhere in this annual report and the financial statements and Management's Discussion and Analysis contained in our quarterly reports on Form 10-Q, for the fiscal quarters ended March 31, 2013, June 30, 2013, and September 30, 2013.

Total consolidated gross sales increased by \$6,059,052 (approximately 26%) to \$28,936,073 during the three-month period ended December 31, 2013 from \$22,877,021 during the same three-month period in 2012. This increase is primarily attributable to increased sales and awareness of the Company's flagship line, Kefir, as well as ProBugs® Organic Kefir for kids and BioKefir™.

Total consolidated net sales increased by \$5,485,743 (approximately 26%) to \$26,266,697 during the three-month period ended December 31, 2013 from \$20,780,954 during the same three-month period in 2012. Net sales are recorded as gross sales less promotional activities such as slotting fees paid, couponing, spoilage and promotional allowances as well as early payment terms given to customers.

Cost of goods sold as a percentage of net sales, excluding depreciation expense, were approximately 80% during the fourth quarter of 2013, compared to approximately 65% during the same period in 2012. The increase was primarily attributable the increased cost of conventional and organic milk, the Company's largest raw material. The total cost of milk was approximately 30% higher during the fourth quarter 2013 when compared to the same period in 2012.

Operating expenses as a percentage of net sales were approximately 20% during the fourth quarter of 2013, compared to approximately 23% during the same period in 2012. This was primarily attributable to a decrease in selling expenses, which decreased by \$201,476 (approximately 6%) to \$3,004,421 during the fourth quarter of 2013, from \$3,205,897 during the same period in 2012.

The company reported a loss in operations of \$388,832 during the fourth quarter of 2013, a decrease of \$2,157,051 from income from operations of 1,768,219 during the same period in 2012.

Provision for income tax was a benefit of \$392,053 for the fourth quarter of 2013 compared to a provision for income tax of \$721,860, or a 40% effective tax rate for same period last year.

Total net loss was \$469,208 or \$0.02 per diluted share for the three-month period ended December 31, 2013 compared to net income of \$1,073,502 or \$0.07 per diluted share in the same period in 2012. Net loss includes an approximate \$305,000 loss on disposition of assets due to the closing of a non-performing Starfruit store location. This is viewed as a one time, non-cash expense.

Comparison of Year Ended December 31, 2013 to Year Ended December 31, 2012

Total consolidated gross sales increased by \$19,212,087 (approximately 21%) to \$108,966,094 during the twelve-month period ended December 31, 2013 from \$89,754,007 during the same twelve-month period in 2012. This increase is primarily attributable to increased sales and awareness of the Company's flagship line, Kefir, as well as ProBugs® Organic Kefir for kids and BioKefir™.

Total consolidated net sales increased by \$16,172,877 (approximately 20%) to \$97,524,142 during the twelve-month period ended December 31, 2013 from \$81,351,265 during the same twelve month period in 2012. Net sales are recorded as gross sales less promotional activities such as slotting fees paid, couponing, spoilage and promotional allowances as well as early payment terms given to customers.

Cost of goods sold as a percentage of net sales, excluding depreciation expense, were approximately 70% during the twelve-month period ended December 31, 2013, compared to approximately 65% during the same period in 2012. The increase was primarily attributable to the cost of conventional and organic milk, the Company's largest raw material. The total cost of milk was approximately 25% higher during the twelve-month period ended December 31, 2013 when compared to the same period in 2012.

Operating expenses as a percentage of net sales were approximately 20% during the twelve-month period ended December 31, 2013 compared to approximately 22% during the same period in 2012. Selling expenses increased by \$592,401 (approximately 6%) to \$11,296,381 from 10,703,980 during the twelve-month period ended December 31, 2013 when compared to the same period in 2012.

Total operating income decreased by \$813,399 (approximately 9%) to \$8,031,312 during the twelve-month period ended December 31, 2013, from \$8,844,711 during the same period in 2012.

Provision for income taxes was 2,866,875 or a 37% effective tax rate, for the twelve-month period ended December 31, 2013 compared with \$3,205,076 or a 36% effective tax rate, during the same period in 2012. Income taxes are discussed in Note 10 of the Notes to Consolidated Financial Statements.

Total net income was \$4,990,298 or \$0.31 per share for the twelve-month period ended December 31, 2013 compared to \$5,619,798 or \$0.34 per share in the same period in 2012.

## Liquidity and Capital Resources

### Sources and Uses of Cash

Net cash provided by operating activities was \$5,841,128 during the twelve-months ended December 31, 2013 compared to net cash provided by operating activities of \$6,627,684 in the same period in 2012. This decrease is primarily attributable to the decrease in refundable income taxes of \$886,607 in 2013.

Net cash used in investing activities was \$7,862,973 during the twelve-months ended December 31, 2013 compared to net cash used in investing activities of \$1,555,914 in the same period in 2012. This increase is primarily due to an increase in purchases of property and equipment of \$7,051,169 compared to 2012.

The Company had a net increase of cash and cash equivalents of \$1,020,382 during the twelve month period ended December 31, 2013 compared to a net decrease in cash and cash equivalents of \$1,171,079 during the same period in 2012. The Company had cash and cash equivalents of \$3,306,608 as of December 31, 2013 compared to cash and cash equivalents of \$2,286,226 as of December 31, 2012.

### Assets and Liabilities

Total assets were \$63,673,801 as of December 31, 2013, which is an increase of \$10,167,175 when compared to December 31, 2012. This is primarily due to \$20,824,448 of net property and equipment as of December 31, 2013, which is an increase of \$5,837,672, when compared to December 31, 2012.

Total current liabilities were \$8,882,241 as of December 31, 2013, which is an increase of \$2,672,547 when compared to December 31, 2012. This is primarily due to a \$2,466,454 increase in accounts payable.

Notes payable increased by \$4,043,067 as of December 31, 2013, when compared to December 31, 2012. The balance of the notes payable as of December 31, 2013 was \$8,999,012.

Total stockholder's equity was \$42,949,122 as of December 31, 2013, which is an increase of \$3,636,653 when compared to December 31, 2012. This is primarily due the increase in retained earnings of \$3,682,437 when compared to December 31, 2012.

We previously held significant portions of our assets in investment securities. All of our marketable securities are classified as available-for-sale on our balance sheet. All of these securities are stated there on at market value as of the end of the applicable period. Gains and losses on the portfolio are determined by the specific identification method.

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

#### Off-Balance Sheet Arrangements

We do not have any off-balance sheet financing arrangements.

#### Critical Accounting Policies

Lifeway's analysis and discussion of its financial condition and results of operations are based upon its consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). The preparation of financial statements in accordance with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. US GAAP provides the framework from which to make these estimates, assumptions and disclosures. Lifeway chooses accounting policies within US GAAP that management believes are appropriate to accurately and fairly report Lifeway's operating results and financial position in a consistent manner. Management regularly assesses these policies in light of current and forecasted economic conditions and has discussed the development and selection of critical accounting policies with its audit committee of the Board of Directors. For further information concerning accounting policies, refer to Note 2 — Nature of Business and Significant Accounting Policies in the notes to the consolidated financial statements.

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

Not applicable.

#### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

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

LIFEWAY FOODS, INC. AND SUBSIDIARIES  
CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2013 AND 2012

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders  
Lifeway Foods, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Lifeway Foods, Inc. and Subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lifeway Foods, Inc. and Subsidiaries at December 31, 2013 and 2012, and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Lifeway Foods, Inc. and Subsidiaries' internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992 and our report dated April 2, 2014 expressed an adverse opinion thereon.

/s/ Plante & Moran, PLLC  
Chicago, Illinois  
April 2, 2014

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders  
Lifeway Foods, Inc. and Subsidiaries

We have audited Lifeway Foods, Inc. and Subsidiaries' (the Company) internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992. Management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. Management has identified pervasive material weaknesses in controls including an inadequate process for the valuation of inventory, an inadequate process to develop accurate financial statements including a lack of segregation of duties, and inadequate design and existence of entity level controls. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2013 financial statements, and this report does not affect our report dated April 2, 2014 on those financial statements.

In our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, Lifeway Foods, Inc. and Subsidiaries has not maintained effective internal control over financial reporting as of December 31, 2013, based on the COSO criteria in 1992.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Lifeway Foods, Inc. and Subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and our report dated April 2, 2014 expressed an unqualified opinion thereon.

/s/ Plante & Moran, PLLC  
Chicago, Illinois  
April 2, 2014



LIFEWAY FOODS, INC. AND SUBSIDIARIES  
 Consolidated Statements of Financial Condition  
 December 31, 2013 and 2012

	December 31 2013	2012
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$3,306,608	\$2,286,226
Investments	2,516,380	1,869,888
Certificates of deposits in financial institutions	15,373	450,000
Inventories	6,899,008	5,939,186
Accounts receivable, net of allowance for doubtful accounts and discounts of \$1,050,000 and \$970,000	10,444,839	8,723,737
Prepaid expenses and other current assets	128,323	97,138
Other receivables	103,272	8,825
Deferred income taxes	322,071	234,687
Refundable income taxes	1,014,947	84,828
Total current assets	24,750,821	19,694,515
Property and equipment, net	20,824,448	14,986,776
Intangible assets		
Goodwill and other non amortizable brand assets	14,068,091	14,068,091
Other intangible assets, net of accumulated amortization of \$4,555,559 and \$3,842,756 at December 31, 2013 and 2012, respectively	3,750,441	4,463,244
Total intangible assets	17,818,532	18,531,335
Other Assets		
Long-term accounts receivable net of current portion	280,000	294,000
Total assets	\$63,673,801	\$53,506,626
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Current maturities of notes payable	\$875,002	\$542,981
Accounts payable	6,723,179	4,256,725
Accrued expenses	1,284,060	1,155,677
Accrued income taxes	0	254,311
Total current liabilities	8,882,241	6,209,694
Notes payable	8,999,012	4,955,945
Deferred income taxes	2,843,426	3,028,518
Total liabilities	20,724,679	14,194,157
Stockholders' equity		

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Common stock, no par value; 40,000,000 shares authorized; 17,273,776 shares issued; 16,346,017 shares outstanding at December 31, 2013; 17,273,776 shares issued; 16,346,017 shares outstanding at December 31, 2012	6,509,267		6,509,267
Paid-in-capital	2,032,516		2,032,516
Treasury stock, at cost	(8,187,682	)	(8,187,682
Retained earnings	42,587,214		38,904,777
Accumulated other comprehensive income (loss), net of taxes	7,807		53,591
Total stockholders' equity	42,949,122		39,312,469
Total liabilities and stockholders' equity	\$63,673,801		\$53,506,626

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LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Income and Comprehensive Income  
December 31, 2013 and 2012

	(Unaudited) Years Ended December 31, 2013		2012	
	2013		2012	
Sales	\$ 108,966,094		\$ 89,754,007	
Less: discounts and allowances	(11,441,952 )		(8,402,742 )	
Net sales	97,524,142	97,524,142	81,351,265	81,351,265
Cost of goods sold		68,274,674		53,098,191
Depreciation expense		1,626,575		1,629,594
Total cost of goods sold		69,901,249		54,727,785
Gross profit		27,622,893		26,623,480
Selling expenses		11,296,381		10,703,980
General and administrative		7,582,397		6,319,972
Amortization expense		712,803		754,817
Total operating expenses		19,591,581		17,778,769
Income from operations		8,031,312		8,844,711
Other income (expense):				
Interest and dividend income		116,380		85,383
Rental income		11,727		12,285
Interest expense		(203,365 )		(177,622 )
Gain (loss) on sale of investments, net reclassified from OCI		195,500		71,286
Loss on disposition of assets		(304,958 )		
Other income (expense)		10,577		(11,169 )
Total other income (expense)		(174,139 )		(19,837 )
Income before provision for income taxes		7,857,173		8,824,874
Provision for income taxes		2,866,875		3,205,076
Net income		\$ 4,990,298		\$ 5,619,798
Basic and diluted earnings per common share		0.31		0.34
Weighted average number of shares outstanding		16,346,017		16,373,224

COMPREHENSIVE INCOME

Net income	\$ 4,990,298	\$ 5,619,798
Other comprehensive income (loss), net of tax:		
Unrealized gains (losses) on investments (net of tax)	64,674	102,816
Less reclassification adjustment for (gains) losses included in net income (net of taxes)	(110,458 )	(40,277 )
Comprehensive income	\$ 4,944,514	\$ 5,682,337

LIFEWAY FOODS, INC. AND SUBSIDIARIES  
 Consolidated Statements of Changes in Stockholders' Equity  
 For the Years Ended December 31, 2013 and 2012

	Common Stock, No Par Value		# of Shares of	Treasury Stock	Common Stock	Paid In Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Total
	40,000,000 Shares Authorized	# of Shares								
Balances at December 31, 2011	17,273,776	16,409,317	864,459	\$6,509,267	\$2,032,516	\$(7,606,974)	\$34,431,296	\$(8,948)	\$35,000,000	
Redemption of stock	—	(63,300)	63,300	—	—	(580,708)	—	—	(580,708)	
Other comprehensive income (loss): Unrealized gains on securities, net of taxes	—	—	—	—	—	—	—	62,539	62,539	
Net income for the year ended December 31, 2012	—	—	—	—	—	—	5,619,798	—	5,619,798	
Dividends (\$.07) per share	—	—	—	—	—	—	(1,146,317)	—	(1,146,317)	
Balances at December 31, 2012	17,273,776	16,346,017	927,759	\$6,509,267	\$2,032,516	\$(8,187,682)	\$38,904,777	\$53,591	\$39,000,000	
Redemption of stock	—	—	—	—	—	—	—	—	—	
Other comprehensive income (loss): Unrealized gains on securities, net	—	—	—	—	—	—	—	(45,784)	(45,784)	

of taxes

Net income for  
the year ended  
December 31,  
2013

—	—	—	—	—	—	—	4,990,298	—	4,
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Dividends  
(\$ .08) per share

—	—	—	—	—	—	—	(1,307,861 )	—	(1
---	---	---	---	---	---	---	--------------	---	----

Balances at  
December 31,  
2013

17,273,776	16,346,017	927,759	\$6,509,267	\$2,032,516	\$(8,187,682)	\$42,587,214	\$7,807	\$42
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LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
For the Years Ended December 31, 2013 and 2012

	December 31, 2013		2012	
Cash flows from operating activities:				
Net income	\$4,990,298		\$5,619,798	
Adjustments to reconcile net income to net cash flows from operating activities:				
Depreciation and amortization	2,339,378		2,384,411	
Loss (gain) on sale of investments, net	(195,500)	)	(71,286)	)
Deferred income taxes	(238,804)	)	(434,896)	)
Bad Debt Expense	32,604		435,344	
Loss (Gain) on sale of equipment	304,958		11,169	
(Increase) decrease in operating assets:				
Accounts receivable	(1,741,759)	)	(1,213,253)	)
Other receivables	(94,447)	)	215,379	
Inventories	(959,822)	)	(984,711)	)
Refundable income taxes	(930,119)	)	(43,512)	)
Prepaid expenses and other current assets	(6,185)	)	(17,508)	)
Increase (decrease) in operating liabilities:				
Accounts payable	2,466,454		(129,514)	)
Accrued expenses	128,383		601,952	
Income taxes payable	(254,311)	)	254,311	
Net cash provided by operating activities	5,841,128		6,627,684	
Cash flows from investing activities:				
Purchases of investments	(3,518,781)	)	(1,452,672)	)
Proceeds from sale of investments	3,001,016		1,475,730	
Investments in certificates of deposits	0		(150,255)	)
Redemption of certificates of deposits	423,997		0	
Purchases of property and equipment	(8,479,886)	)	(1,428,717)	)
Proceeds from sale of equipment	710,681		0	
Net cash (used in) provided by investing activities	(7,862,973)	)	(1,555,914)	)
Cash flows from financing activities:				
Checks written in excess of bank balances	0		(592,040)	)
Purchases of treasury stock	0		(580,708)	)
Dividends Paid	(1,307,861)	)	(1,146,317)	)
Net proceeds from debt issuance	4,975,000		250,000	
Repayment of notes payable	(624,912)	)	(1,831,626)	)
Net cash provided (used in) financing activities	3,042,227		(3,900,691)	)
Net (decrease) increase in cash and cash equivalents	1,020,382		1,171,079	
Cash and cash equivalents at the beginning of the period	2,286,226		1,115,150	

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Cash and cash equivalents at the end of the period	\$3,306,608	\$2,286,226
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## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

### Note 1 – NATURE OF BUSINESS

Lifeway Foods, Inc. (the “Company” or “Lifeway”) 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 a vegetable-based seasoning under the name “Golden Zesta.” The Company currently distributes its products throughout the Chicago Metropolitan area and various cities on the East Coast through local food stores. In addition, products are sold throughout the United States by distributors. The Company also distributes some of its products in London.

### 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, Helios Nutrition, Ltd., Pride of Main Street, L.L.C., Starfruit, L.L.C., Fresh Made, Inc. and Starfruit Franchisor, L.L.C., Lifeway First Juice, Inc. (IL), First Juice, Inc. (DE) and Lifeway Wisconsin, Inc. Lifeway Wisconsin, Inc. was created to facilitate the operation of a production facility in Wisconsin. All significant intercompany accounts and transactions have been eliminated.

#### Use of estimates

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

#### Revenue Recognition

Sales 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. Discounts and allowances are reported as a reduction of gross sales unless the allowance is attributable to an identifiable benefit separable from the purchase of the product, the value of which can be reasonably estimated, which would be charged to the appropriate expense account.

#### Customer Concentration

Sales are predominately to companies in the retail food industry, located within the United States of America. Two major customers accounted for approximately 35 percent and 31 percent of gross sales for the years ended December 31, 2013 and 2012, respectively. These customers accounted for approximately 25 percent and 30 percent of accounts receivable as of December 31, 2013 and December 31, 2012, respectively.

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

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. Balances expected to be paid beyond one year are classified as long-term.

Accounts receivable are recorded at invoice amounts, and reduced to their estimated net realizable value by recognition of an allowance for doubtful accounts and anticipated discounts. The Company's estimate of the allowances for doubtful accounts and anticipated discounts are based upon historical experience, its evaluation of the current status and contract terms 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

Purchased property and equipment are recorded at cost. 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

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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

December 31, 2013 and 2012

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

## Intangible assets acquired in business combinations

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 identifiable 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 per 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 are the result of temporary differences that arise 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.

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 returns are the 2010, 2011 and 2012 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.

## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

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

## Treasury stock

Treasury stock is recorded using the cost method.

## Advertising and promotional costs

The Company expenses advertising costs as incurred. For the years ended December 31, 2013 and 2012 total advertising expenses were \$ 2,685,691 and \$2,679,798, respectively.

## 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 years ended December 31, 2013 and 2012, diluted and basic earnings per share were the same, as the effect of dilutive securities options outstanding was not significant.

## Correction of Prior Year Amounts

Management has revised the consolidated statement of income and comprehensive income for the year ended December 31, 2012, to correct an immaterial matter. During 2012 salaries and wages related to costs of production of inventory were not presented as part of cost of goods sold at December 31, 2012 and were erroneously included as selling expenses in our previously issued financial statements. This revision resulted in an \$802,727 increase in cost of goods sold and a corresponding decrease in the selling expenses. There was no impact on previously reported net income, consolidated balance sheets or consolidated statement of cash flows.

## Note 3 – INTANGIBLE ASSETS

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

	December 31, 2013		December 31, 2012	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Recipes	\$ 43,600	\$ 43,600	\$ 43,600	\$ 43,600
Customer lists and other customer related intangibles	4,504,200	2,474,790	4,504,200	2,025,736
Lease acquisition	87,200	87,200	87,200	87,200
Customer relationship	985,000	596,785	985,000	526,701
Trade names	2,248,000	1,028,334	2,248,000	878,469
Formula	438,000	324,850	438,000	281,050
	\$ 8,306,000	\$ 4,555,559	\$ 8,306,000	\$ 3,842,756

Amortization expense is expected to be approximately the following for the 12 months ending December 31:

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2014	\$	712,803
2015		712,803
2016		694,553
2017		669,003
2018		629,409
Thereafter		331,870
	\$	3,750,441

Amortization expense during the years ended December 31, 2013 and 2012 was \$712,803 and \$754,817, respectively.



## LIFEWAY FOODS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

December 31, 2013 and 2012

## Note 4 – INVESTMENTS

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

December 31, 2013	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities	\$ 1,006,169	\$ 98,213	\$ (32,181)	\$ 1,072,201
Mutual Funds	54,847	1,994	0	56,841
Preferred Securities	464,585	12,960	(15,449)	462,096
Corporate Bonds	973,333	1,329	(49,420)	925,242
Total	\$ 2,498,934	\$ 114,496	\$ (97,050)	\$ 2,516,380

December 31, 2012	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Equities	\$ 639,974	\$ 90,875	\$ (5,190)	\$ 725,659
Corporate Bonds	1,135,064	16,212	(7,047)	1,144,229
Total	\$ 1,775,038	\$ 107,087	\$ (12,237)	\$ 1,869,888

Proceeds from the sale of investments were \$3,001,016 and \$1,475,730 for the years ended December 31, 2013 and 2012, respectively.

Gross gains of \$248,223 and \$88,713 and gross losses of \$52,723 and \$17,427 were realized on these sales during the years ended December 31, 2013 and 2012, 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 December 31, 2013 and 2012:

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2013						
Equities	\$ 213,222	\$ (32,180)	\$ 0	\$ 0	\$ 213,222	\$ (32,180)
Mutual Funds	0	0	0	0	0	0
Preferred Securities	224,125	(15,449)	0	0	224,125	(15,449)
Corporate Bonds	615,986	(42,827)	96,726	(6,593)	712,712	(49,420)
	\$ 1,053,333	\$ (90,456)	\$ 96,726	\$ (6,593)	\$ 1,150,059	\$ (97,049)

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2012						
Equities	\$ 63,620	\$ (3,745)	\$ 21,910	\$ (1,445)	\$ 85,530	\$ (5,190)

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Corporate Bonds	301,229	(2,721)	193,930	(4,326)	495,159	(7,047)
	\$ 364,849	\$ (6,466)	\$ 215,840	\$ (5,771)	\$ 580,689	\$ (12,237)

Equities, Mutual Funds, Preferred Securities, and Corporate Bonds - The Company's investments in equity securities, mutual funds, preferred securities, and corporate bonds consist of investments in common stock, preferred stock and debt securities of companies in various industries. As of December 31, 2013, there were three corporate bond securities that had unrealized losses greater than twelve months. 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 did not consider any material investments to be other-than-temporarily impaired at December 31, 2013.

## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

## Note 5 – INVENTORIES

Inventories consist of the following:

	December 31,	
	2013	2012
Finished goods	\$ 3,027,900	\$ 2,462,548
Production supplies	2,690,097	2,599,668
Raw materials	1,181,011	876,970
Total inventories	\$ 6,899,008	\$ 5,939,186

## Note 6 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	December 31,	
	2013	2012
Land	\$ 1,856,370	\$ 1,178,160
Buildings and improvements	14,587,022	11,904,919
Machinery and equipment	19,633,164	15,185,204
Vehicles	1,244,560	1,346,078
Office equipment	433,679	411,773
Construction in process	177,519	612,468
	37,932,314	30,638,602
Less accumulated depreciation	17,107,866	15,651,826
Total property and equipment	\$ 20,824,448	\$ 14,986,776

Lifeway completed the purchase of Golden Guernsey's assets on July 2, 2013. The cost was approximately \$7.4 million and none of the purchased assets have been placed in service.

Depreciation expense during the years ended December 31, 2013 and 2012 was \$1,626,575 and \$1,629,594, respectively.

## Note 7 – ACCRUED EXPENSES

Accrued expenses consist of the following:

	December 31,	
	2013	2012
Accrued payroll and payroll taxes	\$ 477,312	\$ 356,280
Accrued property tax	306,608	302,573
Other	500,140	496,824
	\$ 1,284,060	\$ 1,155,677



## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

## Note 8 – NOTES PAYABLE

Notes payable consist of the following:

	December 31, 2013	2012
Note payable to Private Bank in monthly installments of \$42,222, plus variable interest rate, currently at 2.6677%, with a balloon payment for the remaining balance. Collateralized by substantially all assets of the Company. In May 2013, the Company refinanced this note under similar terms which extended the maturity date to May 31, 2018.	\$ 4,858,889	\$ 5,365,556
Line of credit with Private Bank at variable interest rate, currently at 3.25%. The agreement has been extended with terms allowing borrowings up to \$5 million. Collateralized by substantially all assets of the Company and matures on May 31, 2014.	0	0
Note payable to Private Bank in monthly installments of \$27,778, plus variable interest rate, currently at 2.6677% with a balloon payment for the remaining balance, maturing on May 31, 2019, collateralized by substantially all assets of the Company	4,916,667	0
Notes payable to Ford Credit Corp. payable in monthly installments of \$1,778.23 at 5.99%, due July 2015, secured by transportation equipment.	32,124	50,871
Note payable to Fletcher Jones of Chicago, Ltd LLC in monthly installments of \$1,768.57 at 6.653%, due May 24, 2017, secured by transportation equipment.	66,334	82,499
Total notes payable	9,874,014	5,498,926
Less current maturities	875,002	542,981
Total long-term portion	\$ 8,999,012	\$ 4,955,945

In accordance with the Private Bank agreements referenced above, the Company is subject to minimum fixed charged ratio and tangible net worth thresholds.

Maturities of notes payables are as follows:

For the Period Ended December 31,

2014	\$ 875,002
2015	870,787
2016	859,875
2017	849,084

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2018		3,165,558
Thereafter		3,253,708
Total	\$	9,874,014

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## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

## Note 9 – COMMITMENTS AND CONTINGENCIES

The Company leases three stores for its Starfruit subsidiary. Total expense for these leases was approximately \$347,164, and \$379,348 for the years ended December 31, 2013 and 2012, respectively. The Company is also responsible for additional rent equal to real estate taxes and other operating expenses. Future annual minimum base rental payments for the leases as of December 31, 2013 are approximately as follows:

2014	\$	44,138
2015		45,461
2016		46,825
2017		48,229
2018		49,676
Total	\$	234,329

## Note 10 – PROVISION FOR INCOME TAXES

The provision for income taxes consists of the following:

	For the Years Ended December 31,	
	2013	2012
Current:		
Federal	\$ 2,551,505	\$ 2,757,332
State and local	554,174	882,640
Total current	3,105,679	3,639,972
Deferred	(238,804)	(434,896)
Provision for income taxes	\$ 2,866,875	\$ 3,205,076

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

	For the Years Ended December 31,			
	2013		2012	
	Amount	Percentage	Amount	Percentage
Federal income tax expense computed at the statutory rate	\$ 2,666,223	34.0%	\$ 3,000,457	34.0%
State and local tax expense, net U.S. domestic manufacturers' deduction & other permanent differences	744,974	9.5%	838,363	9.5%
	(455,442)	(5.8)%	(427,525)	(4.9)%
Change in tax estimate	(88,880)	(1.1)%	(206,219)	(2.2)%
Provision for income taxes	\$ 2,866,875	36.6%	\$ 3,205,076	36.4%





## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

## Note 10 – PROVISION FOR INCOME TAXES - Continued

Amounts for deferred tax assets and liabilities are as follows:

	December 31, 2013	2012
Non-current deferred tax assets (liabilities) arising from:		
Temporary differences -		
Accumulated depreciation and amortization from purchase accounting adjustments	\$ (2,896,058)	\$ (3,164,716)
Capital loss carry-forwards	52,632	136,198
Total non-current net deferred tax liabilities	(2,843,426)	(3,028,518)
Current deferred tax assets arising from:		
Unrealized losses (gain) on investments	(7,589)	(41,260)
Inventory	307,910	265,072
Allowance for doubtful accounts and discounts	21,750	10,875
Total current deferred tax assets	322,071	234,687
Net deferred tax liability	\$ (2,521,355)	\$ (2,793,831)

## Note 11 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes are as follows:

	For the Years Ended December 31,	
	2013	2012
Interest	\$ 205,739	\$ 191,277
Income taxes	\$ 4,362,991	\$ 3,413,687



LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

Note 12 – FAIR VALUE MEASUREMENTS

Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 820, Fair Value Measurements and Disclosures, provides the framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under FASB ASC 820 are described as follows:

Level 1. Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2. Inputs to the valuation methodology include the following:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in inactive markets;
- Inputs other than quoted prices that are observable for the asset or liability;
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.

Level 3. Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used as of December 31, 2013 and 2012.

The majority of the Company's short-term investments are classified within Level 1 or Level 2 of the fair value hierarchy. The Company's valuation of its Level 1 investments, which include mutual funds, is based on quoted market prices in active markets for identical securities. The Company's valuation of its Level 2 investments, which include certificates of deposits, is based on other observable inputs, specifically a valuation model which utilized vendor pricing for similar securities.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Company believes the valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.



## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

## Note 12 – FAIR VALUE MEASUREMENTS – Continued

The following table sets forth by level, within the fair value hierarchy, the Company's financial assets at fair value for the years ended December 31, 2013 and December 31, 2012, respectively. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

	Assets and Liabilities at Fair Value as of December 31, 2013			
	Level 1	Level 2	Level 3	Total
Cash	\$ 3,306,608	\$ 0	\$ 0	\$ 3,306,608
Certificate of Deposits	0	15,378	0	15,378
Mutual Funds	56,841	0	0	56,841
Stocks	1,072,201	0	0	1,072,201
Preferred Securities	0	462,096	0	462,096
Corporate Bonds	0	925,242	0	925,242
Notes Payable	0	9,874,014	0	9,874,014

	Assets and Liabilities as Fair Value as of December 31, 2012			
	Level 1	Level 2	Level 3	Total
Cash	\$ 2,286,226	\$ 0	\$ 0	\$ 2,286,226
Certificate of Deposits	0	439,982	0	439,982
Stocks	725,670	0	0	725,670
Corporate Bonds	0	1,144,229	0	1,144,229
Notes Payable	0	5,498,926	0	5,498,926

The Company's financial assets and liabilities also include accounts receivable, other receivables and, accounts payable for which carrying value approximates fair value. All such assets are valued using level 2 inputs.

## Note 13 – LITIGATION

The Company is named a party to lawsuits in the normal course of business. In the opinion of management, the resolution of these lawsuits will not have a material adverse effect on the Company's consolidated financial position or results of operations.

## Note 14 – RECENT ACCOUNTING PRONOUNCEMENTS

In February 2013, the Financial Accounting Standards Board ("FASB") amended the disclosure requirements regarding the reporting of amounts reclassified out of accumulated other comprehensive income. The amendment does not change the current requirement for reporting net income or other comprehensive income, but requires additional

disclosures about items reclassified out of accumulated other comprehensive income, and the income statement line items impacted by the reclassifications. We adopted this standard effective January 1, 2013. Other than the additional disclosure requirements, the adoption of this standard did not have a material impact on our unaudited Consolidated Financial Statements.

In July 2013, the FASB issued an Accounting Standards Update (“ASU”) related to the presentation of unrecognized tax benefits. The update requires presentation of an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset for a net operating loss carryforward or a tax credit carryforward in the statement of financial position. The guidance does not apply to the extent that a net operating loss carryforward or tax credit carryforward at the reporting date is not available under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position. The guidance is effective for fiscal years (and interim periods within those years) beginning after December 15, 2013. We do not expect the adoption of this standard to have a material impact on our Consolidated Financial Statements.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

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

As of 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 were not effective at the reasonable assurance level as of December 31, 2013 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 weakness described below. As a result, we performed additional analysis and other post-closing procedures to ensure our consolidated financial statements were prepared in accordance with generally accepted accounting principles. Accordingly, management believes the consolidated financial statements included in this Form 10-K fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented.

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is identified in Exchange Act Rules 13a-15(f). Internal control over financial reporting is a process designed by, or under the supervision of, our principal executive officer and principal financial and accounting officer, and effected by the Board of Directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Our control over financial reporting includes those policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of our assets;

provide reasonable assurance that our transactions are recorded as necessary to permit preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipts and expenditures of the company are being made only in accordance with

authorizations of our management and our directors; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on our financial statements.

Internal control over financial reporting has inherent limitations which may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or because the level of compliance with related policies or procedures may deteriorate.



Management evaluated the effectiveness of our internal control over financial reporting as of December 31, 2013. In making the assessment, management used the framework in “Internal Control –Integrated Framework” promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the “COSO” criteria. Based on that assessment, our principal executive officer and principal financial and accounting officer concluded that our internal control over financial reporting was not effective as of December 31, 2013 because pervasive material weaknesses existed in our internal control over financial reporting. Specifically, we had material weaknesses arising from a lack of segregation of duties in financial reporting, a fragmented financial statement preparation process with various levels of input and control resulting from the use of external consultants for the processing and preparation of our financial statements, inadequate systems used to identify, record and review period end activity and calculations of inventory and inadequate entity level controls.

As a result, we performed additional analysis and other post-closing procedures to ensure our consolidated financial statements were prepared in accordance with generally accepted accounting principles. Accordingly, management believes the consolidated financial statements included in this Form 10-K fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented. The effectiveness of our internal control over financial reporting as of December 31, 2013 has been audited by Plante & Moran, PLLC, an independent registered public accounting firm, as stated in their report which appears herein.

#### Remediation of Material Weakness

The Company is beginning the process to identify and engage an outside consultant to assist us in developing a plan of remediation with respect to the material weaknesses identified above and to assist us in improving the design and operations of our internal controls over financial reporting generally.

Management is committed to continuous improvement of the Company’s internal control processes. Under the direction of the Audit Committee, management will continue to review and make changes it deems necessary to the overall design of the Company’s internal control over financial reporting, including implementing further improvements in policies and procedures and taking additional measures to address any control deficiencies.

#### Conclusion

We believe that with the assistance of an expert we can implement measures to remediate the material weaknesses we have identified and will continue to strengthen our internal controls over financial reporting. We are committed to continually improving our internal control processes and will diligently and vigorously review our financial reporting controls and procedures. As we continue to evaluate and work to improve our internal controls over financial reporting, we may determine that additional measures are necessary to address control deficiencies. Moreover, we may decide to modify certain of the remediation measures we implement as we continue to evaluate and work to improve our internal controls over financial reporting.

#### Changes in Internal Control over Financial Reporting

Except as discussed above there were no changes in our internal control over financial reporting that occurred during the fourth quarter of 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### ITEM 9B. OTHER INFORMATION.

None.



PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

DIRECTORS AND EXECUTIVE OFFICERS.

LUDMILA SMOLYANSKY, 63, was appointed as a Director by the Board to fill a vacancy created by an increase of the maximum number of Directors up to seven and unanimously elected as the Chairperson of the Board in November 2002. For more than 20 years, Mrs. Smolyansky has been the operator of several independent delicatessen, gourmet food distributorship businesses and imported food distributorships. In 2002, prior to the commencement of her tenure as a Director, she was hired by the Company as its General Manager. Mrs. Smolyansky devotes as much time as necessary to the business of the Company and currently holds no other directorships in any other reporting company. Mrs. Smolyansky is the mother of Julie Smolyansky (the President, Chief Executive Officer, and a Director of the Company) and Edward P. Smolyansky (the Chief Operating Officer, Treasurer, Chief Financial and Accounting Officer and Secretary of the Company). Mrs. Smolyansky brings many years of food industry experience to the Board.

JULIE SMOLYANSKY, 38, was appointed as a Director, and elected President, CEO, CFO and Treasurer of the Company by the Board of Directors to fill the vacancies in those positions created by the death of her father, Michael Smolyansky, in June 2002. She is a graduate with a Bachelor's degree from the University of Illinois at Chicago. Prior to her appointment, Ms. Smolyansky spent six years as the Company's Director of Sales and Marketing. She devotes as much time as necessary to the business of the Company and currently holds no other directorships in any other reporting company. Ms. Smolyansky is the daughter of Ludmila Smolyansky, the Chairperson of the Board. In 2004, Ms. Smolyansky resigned as CFO and Treasurer and Edward Smolyansky, Ms. Smolyansky's brother, was appointed to such positions. Ms. Smolyansky brings historical and operational expertise and experience to the Board.

POL SIKAR, 65, has been a Director of the Company since its inception in February 1986. He is a graduate with a Master's degree from the Odessa State Institute of Civil Engineering in Russia. For more than 13 years, he has been President and a major shareholder of Montrose Glass & Mirror Co., a company providing glass and mirror products to the wholesale and retail trade in the greater Chicago area. Mr. Sikar devotes as much time as necessary to the business of the Company. Mr. Sikar holds no other directorships in any other reporting company. Mr. Sikar has been a Director since inception and brings a historical perspective to the Board.

RENZO BERNARDI, 61, has been a Director of the Company since 1994. Mr. Bernardi is the president and founder of Renzo & Sons, Inc., a Dairy and Food Service Company which has been in business since 1969 (formerly, Renzo-Milk Distribution Systems). He has over 30 years of experience in the dairy distribution industry. Mr. Bernardi is a graduate of Instituto Teonico E Commerciale of Macomer, Sardinia. Mr. Bernardi devotes as much time as necessary to the business of the Company. Mr. Bernardi holds no other directorships in any other reporting company. Mr. Bernardi brings deep industry experience to the Board.

GUSTAVO CARLOS VALLE, 49, has been a Director of the Company since June 19, 2009. He is an Argentine citizen and was appointed President and CEO of the Dannon Company, Inc. effective April 1, 2009. Mr. Valle joined Danone Argentina in 1996 as Vice President Finance where he became CEO of Danone Waters Argentina in 2002. Two years later, he was appointed CEO of Danone Brazil. Mr. Valle graduated in Economics from Buenos Aires University in Argentina. Mr. Valle holds no other directorships in any other reporting company. Mr. Valle has been designated by DS Waters, L.P. (as the related successor to The Dannon Company, Inc.) to be its representative to the Board in accordance with the terms of that certain Stockholder's Agreement, as amended, between the Company and Dannon. Mr. Valle brings deep industry experience to the Board.

PAUL LEE, 39, was elected as a Director of the Company to fill a vacancy on the Board of Directors created by the resignation of Eugene Katz in July 2012. Mr. Lee joined Lightbank Inc. as a Partner in February 2011. Previously,

Mr. Lee was Managing Director and Group Head for Digital Ventures at Playboy Enterprises, and was a founding member and Senior Vice President at the Peacock Equity Fund. Mr. Lee brings financial and strategic experience to the Company's Board of Directors.

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JASON SCHER, 39, was elected as a Director of the Company to fill a vacancy on the Board of Directors in July 2012. Mr. Scher is the Chief Operating Officer of Vosges Haut-Chocolat. Mr. Scher previously served as principal in Khoury Construction and RP3 Development. His strong leadership has been instrumental in laying a foundation for an entrepreneurial growing business. Mr. Scher also brings financial and strategic experience to the Company's Board of Directors.

EDWARD P. SMOLYANSKY, 34, was appointed as Chief Financial and Accounting Officer and Treasurer of Lifeway in November 2004. He was also appointed Chief Operating Officer and Secretary in 2012. He had served as the Controller of the Company from June 2002 until such time. He received his baccalaureate degree in finance from Loyola University of Chicago in December 2001. Edward P. Smolyansky is the brother of Company President and CEO Julie Smolyansky and the son of Lifeway's Chairperson of the Board, Ludmila Smolyansky.

#### KEY EMPLOYEES.

VALERIY NIKOLENKO, 68, Vice President of Operations, has been VP of Operations for 17 years with Lifeway.

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

Section 16(a) of the Securities and Exchange Act of 1934 requires the Company's Officers and Directors, and persons who own more than 10% of a registered class of the Company's equity securities, to file reports of ownership and changes in ownership with the Securities and Exchange Commission ("SEC"). Based on the Company's review of the copies of such forms received by it, or written representations from certain reporting persons, the Company believes that none of its directors, executive officers or persons who beneficially own more than 10% of the Company's Common Stock failed to comply with Section 16(a) reporting requirements in fiscal year ended December 31, 2013, except for Ms. Julie Smolyansky who failed to timely file two Form 4s regarding three transactions and Edward Smolyansky who failed to timely file two Form 4s regarding three transactions.

#### FAMILY RELATIONSHIPS

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

#### CODE OF ETHICS

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

#### CORPORATE GOVERNANCE

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

The Company's Audit Committee consists of Mr. Sikar, Mr. Bernardi and Mr. Lee, each of whom has an understanding of finance and accounting and is able to read and understand fundamental financial statements. Audit

Committee members are appointed by the full Board. The functions of the Audit Committee are to review the Company's internal controls, accounting policies and financial reporting practices; to review the financial statements, the arrangements for and scope of the independent audit, as well as the results of the audit engagement; to review the services and fees of the independent auditors, including pre-approval of non-audit services and the auditors' independence; and to recommend to the Board of Directors for its approval and for ratification by the shareholders the engagement of the independent auditors to serve the following year in examining the accounts of the Company. Board of Directors has examined the qualifications of Mr. Lee and determined Mr. Lee to be an "audit committee financial expert," as defined in Item 407(d)(5)(ii) of Regulation S-K promulgated by the SEC.

## ITEM 11. EXECUTIVE COMPENSATION.

Summary Compensation Table as of December 31, 2012 and December 31, 2013

Name	Year	Salary	Bonus	All other Comp.	Total
Julie Smolyansky, CEO and President(1)	2013	\$ 900,000	\$ 115,000	\$ 44,500	\$ 1,059,500
	2012	\$ 890,903	\$ 125,000	\$ 14,280 (5)	\$ 1,030,183
Edward P. Smolyansky, CFO, Chief Accounting Officer, Treasurer, Chief Operating Officer and Secretary (2)	2013	\$ 1,000,000	\$ 150,000	\$ 38,500	\$ 1,188,500
	2012	\$ 928,403	\$ 150,000	\$ 31,280 (6)	\$ 1,109,683
Valeriy Nikolenko, Vice President of Operations and Secretary (4)(8)	2013	\$ 200,000	\$ 50,000	\$ 32,000	\$ 282,000
	2012	\$ 153,800	\$ 60,000	\$ 29,210 (7)	\$ 243,010

## NOTES TO SUMMARY COMPENSATION TABLE

- (1) The Board appointed Julie Smolyansky as the CEO, CFO, President and Treasurer of the Company on June 10, 2002. From September 21, 1998 until such appointments, she had been Director of Sales and Marketing of the Company. Since November 2004, Ms. Smolyansky has served solely as CEO and President.
- (2) The Board appointed Edward Smolyansky as the CFO, Chief Accounting Officer and Treasurer of the Company in November 2004.
- (3) The Company approves, on an annual basis, the payment to Ludmila Smolyansky of salary and bonus as other compensation for continuing advisory services to the Company and in light of her extensive experience. Ludmila Smolyansky devotes as much time as necessary to the business of the Company.
- (4) The Board appointed Valeriy Nikolenko as the Vice President of Operations and Secretary of the Company in December 1993.
- (5) Represents (i) the Company's portion of the matching contributions to the Company's 401(k) plan on behalf of the following named executive officer, Julie Smolyansky: \$17,500 for 2013; (ii) \$12,000 for health insurance premiums; and (iii) \$15,000 related to personal usage of automobiles leased by the Company, which includes lease payments, insurance premiums and fuel.
- (6) Represents (i) the Company's portion of the matching contributions to the Company's 401(k) plan on behalf of the following named executive officer, Edward Smolyansky: \$17,500 for 2013; (ii) \$6,000 for health insurance premiums; and (iii) \$15,000 related to personal usage of automobiles leased by the Company, which includes lease payments, insurance premiums and fuel.
- (7) Represents (i) the Company's portion of the matching contributions to the Company's 401(k) plan on behalf of the following named executive officer, Val Nikolenko: \$10,000 for 2013; (ii) \$12,000 for health insurance

premiums; and (iii) \$10,000 related to personal usage of automobiles leased by the Company, which includes lease payments, insurance premiums and fuel.



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

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

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

On June 9, 1995, the Company filed a registration statement on Form S-8 with the Securities and Exchange Commission in connection with the “Lifeway Foods, Inc. Consulting and Services Compensation Plan” (the “Plan”) covering 1,200,000, as adjusted, shares of its Common Stock. The Plan was adopted by the Company on June 5, 1995. Pursuant to such Plan, the Company may issue common stock or options to purchase common stock to certain consultants, service providers, and employees of the Company. There were a total of approximately 940,000 shares eligible for issuance under the Plan at December 31, 2012. The option price, number of shares, grant date, and vesting terms of awards granted under the Plan are determined at the discretion of the Company’s Board of Directors. On March 18, 2014 the Company filed a post-effective amendment to the Form S-8 to withdraw and remove from registration the shares of Common Stock registered that remained unissued and unsold as of March 18, 2014.

#### Outstanding Equity Awards At December 31, 2013

As of December 31, 2013, there were no stock options outstanding or exercisable and no unvested stock awards.

There are no agreements with the named executive officers that provide for payments in connection with resignation, retirement, termination of employment or change in control other than the Employment Agreement described above.

#### Director Compensation as of December 31, 2013

Name	Fees Earned or Paid in Cash	All Other Compensation	Total
Ludmila Smolyansky	\$ 408,000(1)	\$ 14,200(2)	\$ 422,300
Pol Sikar	\$ 7,500	—	\$ 7,500
Renzo Bernardi	\$ 7,500	—	\$ 7,500
Gustavo Carlos Valle	—	—	—
Eugene Katz	\$ —	—	\$ —
Paul Lee	\$ 4,500	—	\$ 4,500
Jason Sher	4,500	—	4,500

(1) Of the Fees Paid in Cash, \$408,000 represents the annual fees paid to Ms. Smolyansky for her services as a consultant to the Company. Ms. Smolyansky did not receive any additional retainer fees or other meeting attendance fees in her capacity as a director.

(2)

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Represents (i) the Company's portion of the matching contributions to the Company's 401(k) plan on behalf of Ludmila Smolyansky: \$8,200 for 2013; and (ii) \$6,000 for health insurance premiums.

During 2013, each outside (non-employee) director other than Ms. Ludmila Smolyansky was compensated at the rate of \$1,500 per non-annual meeting attended. No employee director (Julie Smolyansky) nor any Director serving as the nominee of Danone (Gustavo Carlos Valle) was compensated as a Director during 2013.

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

The following table sets forth certain information known to the Company regarding the beneficial ownership of the Company's Common Stock, the Company's only outstanding class of securities, as of March 28, 2014 by (a) each shareholder known by the Company to be the beneficial owner of more than five percent of the Company's Common Stock, (b) each of the Company's directors, (c) each of the Company's executive officers named in the Summary Compensation Table above and (d) all executive officers and directors of the Company as a group. The shareholders listed below have sole voting and investment power except as noted.

Name and Address of Beneficial Owner(1)	Amount and Nature of Beneficial Ownership	Percent of Class(2)
Ludmila Smolyansky(3,6)	7,371,584	45.1%
Julie Smolyansky(3,7)	517,265	3.2%
Edward Smolyansky(3)	294,738	1.8%
Pol Sikar(3)	3,000	*
Renzo Bernardi(3)	14,900	*
Gustavo Carlos Valle (3,4)	0	*
Paul Lee(3)	0	*
Jason Scher(3)	0	*
Val Nikolenko	0	*
All Directors and Officers of the Company as a Group (Seven persons in total)	8,201,487	50.2%
Danone Foods, Inc.	3,454,756	21.1%
Mario J. Gabelli(5)	831,805	5.1%

\*Less than .01%.

NOTES TO BENEFICIAL OWNERSHIP TABLE

- (1) With the exception of Gustavo Carlos Valle and Danone Foods, Inc., the address for all Directors and shareholders listed in this table is 6431 Oakton St., Morton Grove, IL 60053. The address of Gustavo Carlos Valle and Danone Foods, Inc. is 100 Hillside Avenue, White Plains, NY 10603-2861.
- (2) Based upon 16,346,017 shares of Common Stock outstanding as of March 28, 2014.
- (3) A director or officer of the Company.
- (4) Mr. Valle is also an officer of the Dannon Company, Inc., which is an affiliate of Danone Foods, Inc.
- (5) Mr. Gabelli directly or indirectly controls or acts as the chief investment officer of Gabelli funds, LLC, GAMCO Asset Management, Inc. and Teton Advisors, Inc. The 831,805 shares of the Company's common stock that Mr. Gabelli may be deemed to

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beneficially own, include (i) 5,500 shares held directly by Mr. Gabelli, (ii) 326 shares held by Gabelli Funds, LLC, (iii) 286,305 shares held by GAMCO Asset Management, Inc., and (iv) 213,000 shares held by Teton Advisors, Inc.

- (6) Includes 7,369,584 shares held by the Ludmila Smolyansky Trust 2/1/05, of which Ms. Smolyansky is the trustee.
- (7) Includes 5,000 shares held by Ms. Smolyansky on behalf of minor children.

## Equity Compensation Plan Information

Plan category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	0	\$0	940,000
Equity compensation plans not approved by security holders	0	\$0	—
Total	0	\$0	—

\*All of Lifeway's equity compensation plans have been approved by its shareholders. The only Securities remaining available for issuance are under the Plan the terms of which are described in the narratives following the Summary Compensation Table above.

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

## Related Transactions

We have determined that there are no related party transactions in excess of the lesser \$120,000 or 1% of the average of the Company's total assets for each of 2012 and 2013, since the beginning of 2010 or currently proposed, involving the Company.

## Director Independence

In evaluating director independence, the Company has adopted the definition set forth in Rule 4200 of the NASDAQ Marketplace Rules. The Company's board of directors, taking into consideration the relationships described in the Certain Relationships and Related Transactions section above, has determined that of the Company's current directors, Pol Sikar, Renzo Bernardi, Paul Lee and Jason Scher were independent of management.

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



ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

AUDIT FEES

In 2013 and 2012, Plante & Moran, PLLC, billed Lifeway approximately \$345,895 and \$324,081, respectively, for professional services rendered for the audit of Lifeway's annual financial statements and review of financial statements included in Lifeway's Forms 10-Q or services that are normally provided in connection with statutory and regulatory filings or engagements in 2012 and 2013.

AUDIT-RELATED FEES

None.

TAX FEES

No professional services were rendered by Plante & Moran, PLLC to Lifeway regarding tax advice, tax compliance and tax planning during 2012 and 2013.

ALL OTHER FEES

No other fees were billed to Lifeway by Plante & Moran, PLLC during 2012 and 2013 other than those described in this report.

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

AUDIT COMMITTEE PRE-APPROVAL POLICIES AND PROCEDURES

The Lifeway Audit Committee (the "Committee"), comprised of Messrs. Sikar, Bernardi, and Katz, pre-approved Plante & Moran, PLLC as the Company's independent auditor for the year-ended December 31, 2013 and has adopted the following guidelines regarding the engagement of the Company's independent auditor to perform services for the Company. Mr. Katz thereafter declined to stand for re-election. Mr. Lee was subsequently elected and appointed to fill Mr. Katz' vacancy on the Company's Board of Directors and the Committee.

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

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

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

auditor pursuant to this pre-approval process.

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

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

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.

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

EXHIBITS

- 3.1 Amended and Restated Bylaws (incorporated by reference to Exhibit No. 3.5 of Lifeway's Current Report on Form 8-K dated and filed on December 10, 2002 (File No. 000-17363)).
- 3.2 Articles of Incorporation, as amended and currently in effect.
- 4.1 Revolving Note dated February 6, 2009 (incorporated by reference to Exhibit 10.2 on Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009 (File No. 000-17363)).
- 4.2 Term Note dated February 6, 2009 (incorporated by reference to Exhibit 10.3 on Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009 (File No. 000-17363)).
- 4.3 Promissory Note dated September 4, 2013 (incorporated by reference to Exhibit 4.1 of Lifeway's Current Report on Form 8-K dated September 4, 2013 and filed on September 20, 2013 (File No. 000-17363)).
- 10.1 Lifeway Foods, Inc. Consulting and Services Compensation Plan, dated June 5, 1995 (incorporated by reference to Lifeway's Registration Statement on Form S-8, (File No. 333-93306)).
- 10.2 Stock Purchase Agreement dated October 1, 1999 by and among Danone Foods, Inc., Lifeway Foods, Inc., Michael Smolyansky and certain other parties (incorporated by reference to Exhibit 10.10 of Lifeway's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999 (File No. 000-17363)).
- 10.3 Stockholders' Agreement dated October 1, 1999 by and among Danone Foods, Inc., Lifeway Foods, Inc., Michael Smolyansky and certain other parties (incorporated by reference to Exhibit 10.11 of Lifeway's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999 (File No. 000-17363)).
- 10.4 Letter Agreement dated December 24, 1999 (amending original Stockholders' Agreement with Danone Foods, Inc.) (incorporated by reference to Exhibit 10.12 of Lifeway's Current Report on Form 8-K dated December 24, 1999, and filed January 12, 2000 (File No. 000-17363)).
- 10.5 Employment Agreement, dated September 12, 2002, between Lifeway Foods, Inc. and Julie Smolyansky (incorporated by reference to Exhibit 10.14 of Amendment

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No. 2 filed April 30, 2003 to Lifeway's Quarterly Report on Form 10- QSB/A for the quarter ended September 30, 2002 (File No. 000-17363)).

- 10.6 Loan and Security Agreement dated February 6, 2009 by and among Lifeway Foods, Inc., Fresh Made, Inc., LFI Enterprises, Inc., Helios Nutrition Limited, Pride Main Street Dairy, LLC and Starfruit, LLC and The Private Bank and Trust Company (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009 (File No. 000- 17363)).
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- 10.8 Second Modification Agreement dated November 12, 2009 by and among The PrivateBank and Trust Company, Lifeway Foods, Inc., Fresh Made, Inc., Helios Nutrition Limited, Pride of Main Street Dairy, LLC and Starfruit, LLC (incorporated by reference to Exhibit 10.16 of Lifeway's Annual Report on Form 10-K dated December 31, 2009 and filed on March 31, 2010 (File No. 000- 17363)).

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- 10.9 Third Modification Agreement dated February 6, 2010 by and among The PrivateBank and Trust Company, Lifeway Foods, Inc., Fresh Made, Inc., Helios Nutrition Limited, Pride of Main Street Dairy, LLC and Starfruit, LLC (incorporated by reference to Exhibit 10.17 of Lifeway's Annual Report on Form 10-K dated December 31, 2009 and filed on March 31, 2010 (File No. 000-17363)).
- 10.10 Fourth Modification Agreement dated March 31, 2011 by and among The PrivateBank and Trust Company, Lifeway Foods, Inc., Fresh Made, Inc., Helios Nutrition Limited, Pride of Main Street Dairy, LLC and Starfruit, LLC (incorporated by reference to Exhibit 10.10 of Lifeway's Annual Report on Form 10-K dated December 31, 2010 and filed on March 31, 2011 (File No. 000-17363)).
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- 10.13 Seventh Modification to Loan and Security Agreement dated as of May 14, 2013, by and among The PrivateBank and Trust Company, Lifeway Foods, Inc., Fresh Made, Inc., Helios Nutrition Limited, Pride of Main Street Dairy, LLC, and Starfruit, LLC (incorporated by reference to Exhibit 10.1 of Lifeway's Quarterly Report on Form 10-Q dated March 31, 2013 and filed on May 15, 2013 (File No. 000-17363)).
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- 10.16 Mortgage, Security Agreement, Assignment of Rents and Leases and Fixture Filing dated as of September 4, 2013, by and between Lifeway Foods, Inc. and The PrivateBank and Trust Company (incorporated by reference to Exhibit 10.1 of Lifeway's Current Report on Form 8-K dated September 4, 2013 and filed on September 20, 2013 (File No. 000-17363)).
- 10.17 Amendment to Mortgage, Security Agreement, Assignment of Rents and Leases and Fixture Filing dated as of September 4, 2013, by and between Lifeway Foods, Inc. and The PrivateBank and Trust Company (incorporated by reference to Exhibit 10.5 of Lifeway's Quarterly Report on Form 10-Q dated September 30, 2013 and filed on

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November 14, 2013 (File No. 000-17363)).

- 10.18 Assignment of Rents and Leases dated as of September 4, 2013 executed by Lifeway Wisconsin, Inc. to and for the benefit of The PrivateBank and Trust Company (incorporated by reference to Exhibit 10.2 of Lifeway's Current Report on Form 8-K dated September 4, 2013 and filed on September 20, 2013 (File No. 000-17363)).
- 10.19 Environmental Indemnity Agreement dated as of September 4, 2013, executed by Lifeway Foods, Inc., Helios Nutrition Limited, Pride of Main Street Dairy, LLC, Starfruit, LLC and Lifeway Wisconsin, Inc. to and for the benefit of The PrivateBank and Trust Company. (incorporated by reference to Exhibit 10.3 of Lifeway's Current Report on Form 8-K dated September 4, 2013 and filed on September 20, 2013 (File No. 000-17363)).

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- 21 List of Subsidiaries of the Registrant
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Julie Smolyansky
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Edward P. Smolyansky
- 32.1 Section 1350 Certification of Julie Smolyansky
- 32.2 Section 1350 Certification of Edward P. Smolyansky
- 101 Interactive Data Files



SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LIFEWAY FOODS, INC.

Date: April 1, 2014

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

Date: April 1, 2014

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

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

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

Date: April 1, 2014

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

Date: April 1, 2014

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

Date: April 1, 2014

/s/ Pol Sikar  
Pol Sikar  
Director

Date:

Gustavo Carlos Valle  
Director

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Date: April 1, 2014

/s/ Renzo Bernardi  
Renzo Bernardi  
Director

Date: April 1, 2014

/s/ Paul Lee  
Paul Lee  
Director

Date: April 1, 2014

/s/ Jason Scher  
Jason Scher  
Director

INDEX OF EXHIBITS

- 3.1 Amended and Restated Bylaws (incorporated by reference to Exhibit No. 3.5 of Lifeway's Current Report on Form 8-K dated and filed on December 10, 2002 (File No. 000-17363)).
- 3.2 Articles of Incorporation, as amended and currently in effect.
- 4.1 Revolving Note dated February 6, 2009 (incorporated by reference to Exhibit 10.2 on Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009 (File No. 000- 17363)).
- 4.2 Term Note dated February 6, 2009 (incorporated by reference to Exhibit 10.3 on Lifeway's Current Report on Form 8-K dated February 6, 2009 and filed on February 13, 2009 (File No. 000-17363)).
- 4.3 Promissory Note dated September 4, 2013 (incorporated by reference to Exhibit 4.1 of Lifeway's Current Report on Form 8-K dated September 4, 2013 and filed on September 20, 2013 (File No. 000-17363)).
- 10.1 Lifeway Foods, Inc. Consulting and Services Compensation Plan, dated June 5, 1995 (incorporated by reference to Lifeway's Registration Statement on Form S-8, (File No. 333-93306)).
- 10.2 Stock Purchase Agreement dated October 1, 1999 by and among Danone Foods, Inc., Lifeway Foods, Inc., Michael Smolyansky and certain other parties (incorporated by reference to Exhibit 10.10 of Lifeway's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999 (File No. 000-17363)).
- 10.3 Stockholders' Agreement dated October 1, 1999 by and among Danone Foods, Inc., Lifeway Foods, Inc., Michael Smolyansky and certain other parties (incorporated by reference to Exhibit 10.11 of Lifeway's Current Report on Form 8-K dated October 1, 1999, and filed October 12, 1999 (File No. 000-17363)).
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