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LIFEWAY FOODS INC  
Form 10KSB/A  
April 26, 2004

U.S. Securities and Exchange Commission  
Washington, D.C. 20549

Form 10-KSB/A  
AMENDMENT NO. 1

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2003
- TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from: \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-17363

LIFEWAY FOODS, INC.

-----  
(Name of small business issuer in its charter)

Illinois

36-3442829

-----  
(State or other jurisdiction of  
incorporation or organization)

-----  
(IRS Employer Identification No.)

6431 West Oakton, Morton Grove, Illinois 60053

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(Address of principal executive offices) (Zip Code)

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

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

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

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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in this Amendment No. 1 to Annual Report on Form 10-KSB/A.

The issuer's revenues for its most recent fiscal year were: \$14,877,788

The aggregate market value of the voting and non-voting common equity held by non-affiliates (approximately 2,202,136 shares) computed by reference to the price at which the stock was sold as of March 12, 2004 (\$17.60 per share as quoted on the National Market System of the Nasdaq Stock Market) was:

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\$38,757,593.60

(APPLICABLE ONLY TO CORPORATE REGISTRANTS)

The number of shares outstanding of each of the issuer's classes of common equity, as of March 12, 2004 were: 8,436,888 shares of Common Stock.

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DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Notice of Annual Meeting and Proxy Statement, to be filed no later than April 29, 2004, for the Registrant's 2004 Annual Meeting of Shareholders, scheduled to be held June 12, 2004, are incorporated by reference in Part III.

Transitional Small Business Disclosure Format (check one): Yes [ ] No [X]

PART I

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

In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, readers of this document and any document incorporated by reference herein, are advised that this document and documents incorporated by reference into this document contain both statements of historical facts and forward looking statements. Forward looking statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those indicated by the forward looking statements.

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

### ITEM 1. DESCRIPTION OF BUSINESS.

#### EXPLANATORY NOTE REGARDING AMENDMENT

The subsection of this Item regarding transactions between Lifeway and Groupe Danone SA is being amended hereby to clarify certain details of the transactions and explain the potential impact to shareholders of the expiration on September 30, 2004 of certain agreements between Lifeway and Danone. Additionally, certain information regarding purchases of Lifeway shares by Danone from non-affiliate individuals was removed from this Item as it is not relevant and previously was disclosed in Schedule 13D and Schedule 13D/A filings made by Danone in 1999. Finally, minor revisions were made to the text.

#### BUSINESS DEVELOPMENT

Lifeway Foods, Inc. 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"; a line of various drinkable yogurts sold under the "La Fruta" and "Tuscan" brands; and "BasicsPlus," a dairy based immune-supporting dietary supplement beverage. The Company also produces several soy-based kefir beverages under the "SoyTreat" trademark. In addition to the drinkable products, Lifeway manufactures "Lifeway Farmer Cheese," a line of various farmer cheeses; and "Sweet Kiss," a fruit sugar-flavored spreadable cheese similar in consistency to cream cheese. The Company also manufactures and markets a vegetable-based seasoning under the "Golden Zesta" brand. In the Chicago metropolitan area, Lifeway distributes its products on its own trucks and via one distributor. Lifeway distributes its products primarily throughout the United States and to a limited but growing extent in Eastern Canada. All of Lifeway's products are manufactured at Company-owned facilities.

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### SUBSIDIARY CORPORATION

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

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

### BUSINESS OF ISSUER

#### PRODUCTS

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

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

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

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

LIFEWAY'S KEFIR. "Lifeway's Kefir" is a drinkable kefir product manufactured in eleven varieties--plain (regular and low-fat), raspberry, blueberry, strawberry, cherry, peach, banana-strawberry, cappuccino, chocolate and vanilla -- and sold in 32 ounce containers featuring color-coded caps and labels describing nutritional information. In March 1996, Lifeway began

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marketing its fat-free, low cholesterol kefir in six flavors--plain, raspberry, strawberry, strawberry-banana, peach and blueberry. The kefir product is currently marketed under the name "Lifeway's Kefir," and is typically sold by retailers from their dairy sections.

LIFEWAY'S ORGANIC SOYTREAT. "SoyTreat" is a soy alternative to dairy kefir and is made from organic soy milk, which is derived from non-genetically modified soybeans. SoyTreat can be consumed by those who desire the benefits of kefir, but are lactose intolerant or interested in a soy-based alternative to milk. SoyTreat also provides 6.25g of soy protein per serving, and features the United States Food and Drug Administration-approved health

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claim, "25g of soy protein a day as part of a diet low in saturated fat can help lower cholesterol and reduce the risk of heart disease." At present SoyTreat is manufactured in seven flavors: Strawberry, Apple, Peach, Coconut, Coffee Latte, English Toffee and Dulce de Leche.

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 four flavors: Plain, Raspberry, Strawberry and Peach. Lifeway Organic Kefir is sweetened with organic cane juice.

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

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

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

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.

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

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

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

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

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.

Lifeway intends to continue to develop new products, such as salad dressing and a frozen dessert product based on kefir and Farmer's Cheese. There is no assurance that such products or any other new products can be developed successfully or marketed profitably.

### DISTRIBUTION

With its ten company-owned trucks, Lifeway distributes its products directly and extensively in the State of Illinois, primarily in the Chicago metropolitan area, including major retail chains such as Jewel Food Stores, Dominick's Finer Foods, Treasure Island Food Marts, Whole Foods and independent retailers.

In addition to the State of Illinois, Lifeway's products are distributed to stores throughout the United States. Lifeway has verbal distribution arrangements with various distributors throughout the United States. These verbal

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distribution arrangements, in the opinion of Lifeway, allow management the necessary latitude to expand into new areas and markets and establish new relationships with distributors on an ongoing basis. Lifeway has not offered any exclusive territories to any distributors.

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

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

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### MARKETING

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

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

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

### COMPETITION

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

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

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by Lifeway as of December 24, 1999; and Danone agreed not to produce or sell any type of kefir-based products in the United States.

### SUPPLIERS

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

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### MAJOR CUSTOMERS

Lifeway distributes its products to numerous accounts throughout the U.S. Concentrations of credit with regard to trade accounts receivable and sales are limited due to the fact that Lifeway's customers are spread across different geographic areas. The customers are concentrated in the retail food industry. In 2003, Lifeway's largest customer represented approximately 9% of sales and reflects sales in various regions of the United States outside the Chicago, Illinois metropolitan area.

### TRANSACTIONS WITH GROUPE DANONE SA

All share amounts and prices in this subsection are historical and have not been adjusted for the stock split which occurred in the first quarter of 2004. On October 1, 1999, Lifeway sold 497,767 shares of restricted common stock to Danone at \$10.00 per share. Danone also concurrently purchased 150,000 outstanding shares of common stock from Lifeway's founder, and then controlling shareholder, President and CEO, Michael Smolyansky; his wife and current Chairperson of the Board, Ludmila Smolyansky; his daughter and current President and CEO, Julie Smolyansky; his son and current Controller, Edward Smolyansky on similar terms. Later in 1999, Danone purchased an additional 215,922 shares of common stock from certain individuals, including 52,262 shares purchased in transactions with certain Company affiliates, including Michael Smolyansky (38,362 shares), Val Nikolenko, Vice President of Production (3,900 shares) and Pol Sikar, a director, and his affiliates (10,000 shares).

As a result of these transactions, Danone became the beneficial owner of 20% of the outstanding common stock of Lifeway. Pursuant to the terms and conditions of the transaction, Lifeway granted certain limited rights to Danone, which include a right to nominate one director, anti-dilutive rights relating to future offerings and limited registration rights. Since November 1999, Thomas Kunz, president and CEO of Danone, has served on Lifeway's Board of Directors as Danone's nominee. In addition, as described above, Lifeway and Danone are parties to a Stockholders' Agreement dated October 1, 1999, pursuant to which the parties agreed that they would not compete with each other through September 30, 2004 with respect to certain yogurt, cheese and kefir products. The Stockholders' Agreement also provides that Danone may not own more than 20% of the outstanding common stock of Lifeway as a result of direct or indirect acquisition of shares. Danone's interest as of the date hereof is approximately 20.4% due to reductions in Lifeway's shares outstanding, primarily due to share repurchases. If the Stockholders' Agreement is not renewed on or before September 30, 2004, Danone would be able to sell its shares of Lifeway common. The ability of Danone to sell, or the prospect of Danone being able to sell should such restrictions lapse, such a large stake in Lifeway could have a negative effect on the Company's stock price.

Additionally, on December 24, 1999, Lifeway entered into a Support Agreement with Danone, the primary purpose of which was to allow Lifeway access to Danone's brokers and distributors in the United States. The Support Agreement provided for an initial term of three years and was renewable annually thereafter. On February 11, 2003, the term of the Support Agreement was extended through December 31, 2003. Lifeway and Danone did not renew the term of the Support Agreement after December 31, 2003 due to the expectation of the parties that this and other agreements between them would be discussed and possibly renegotiated pending their expiration on September 30, 2004.

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### PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS

All trademark registrations have been granted by the United States Patent and

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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.

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Mark	Use	Date of Registration	Expiration of Registration
Lifeway's	Cheese and kefir	December 12, 1989	December 12, 2007
Lifeway's (Canada)	Cheese and kefir	January 10, 1992	January 10, 2007
Golden Zesta	Dehydrated vegetable soup mix; and spices, seasonings, food additives for non-nutritional purposes for use as a flavoring	August 19, 1997	August 19, 2007
Sweet Kiss	Cheese, cottage cheese and other milk products, excluding ice cream, ice milk and frozen yogurt	February 10, 1998	February 10, 2007
Kwashenka	Kefir, yogurt, cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and	February 10, 1998	February 10, 2007

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frozen yogurt

Bambino	Cheeses, cottage cheeses and other milk products	October 7, 2003	October 7, 2013
KPECTBRHCKNN (A stylized presentation of "Krestyanskiy" in Cyrillic characters)	Cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and frozen yogurt	September 8, 1998	September 8, 2008

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PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS (CONTINUED)

Mark	Use	Date of Registration	Expiration of Registration
=====	=====	=====	=====
BasicsPlus	Dairy-based food beverages for use a dietary supplement	September 7, 1999	September 7, 2009
BA3APHBIII (A stylized presentation of "Bazarniy" in Cyrillic characters)	Pressed unripened cheese	July 25, 2000	June 25, 2010
SoyTreat	Soy-based food beverage intended for use as a cultured milk substitute	December 12, 2000	December 12, 2010
Garden Harmony	Unripened cheese-based spreads	March 20, 2001	March 20, 2011
Korovka	Dairy-based spread	November 6, 2001	November 6, 2011

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La Fruta	Cultured milk products, excluding ice cream, ice milk and frozen yogurt	Not applicable	Not applicable
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PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS (CONTINUED)

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

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

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

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.

In addition, Lifeway product that are exported to Canada are subject to strict quotas imposed by the Trade Control Policy Division of the Department of Foreign Affairs and International Trade of Canada. Lifeway believes that it currently is in compliance with all applicable Canadian regulations.

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### 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 2003, the amount Lifeway expended for research and new product development was not material to the financial position of Lifeway.

### EMPLOYEES

Lifeway currently employs approximately 55 employees, all of whom are full-time employees. Substantially all of those employees are engaged in the manufacturing process of Lifeway's kefir and kefir-based products. None of Lifeway's employees are covered by collective bargaining agreements.

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## PART II

### ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION.

#### EXPLANATORY NOTE REGARDING AMENDMENT

This Item is being amended and restated in its entirety to correct and clarify certain statements.

#### RESULTS OF OPERATIONS

The year ended December 31, 2003 was the second consecutive year of new highs for sales, net income and earnings per share. For the year ended December 31, 2003, sales were \$14,877,788, which is a \$2,665,552 (approximately 22%) increase from \$12,212,236 in 2002. We believe that approximately half of the 2003 increase in sales was attributable to a new customer as of June 2003, Sav-A-Lot, Ltd., which represented sales of a significant amount of 8 oz. bottles of Lifeway's LaFruta line. Save-A-Lot, the 13th largest grocery chain in the United States, operates more than 1000 Sav-A-Lot and Supervalu food stores nationwide. The portion of the increase in sales not attributable to the new relationship with Sav-A-Lot is primarily attributable to a nationwide increase in the sales of existing products which we believe occurred because of continued steady sales growth in the ethnic and natural foods markets. We also believe that Lifeway's sales growth potentially is indirectly related to growth experienced by its distributors. For example, United Natural Foods, Inc. ("United"), Lifeway's main distributor to natural and health food retailers experienced a \$200 million revenue increase in 2003, acquired two smaller distributors and expanded its customer list to include over 14,000 retailers across the United States. Distribution of Lifeway's products by United to its new as well as existing customers is believed to account for some of the increase in Lifeway's 2003 sales.

We believe, based on first quarter 2004 results as of March 22, 2004, that Lifeway is on target for approximately 15% sales growth for the first half of 2004 compared to the first six months of 2003. At present, we also are in the last stages of implementing our new shrink-sleeve packaging for our SoyTreat and Lifeway's Kefir product lines. Our transition to updated packaging should be completed during the third quarter of 2004, which we anticipate will contribute to increased sales through the end of the second half of 2004. At industry trade shows, we have observed significant interest and a positive reaction to our new shrink-sleeve packaging. Several newly labeled flavors of our SoyTreat product

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can already be seen on the store shelves in several regions, and several more flavors of our flagship product, kefir, are in the final stages of this packaging change.

Cost of goods sold as a percentage of sales was approximately 53% in 2003, compared to about 55% in 2002. Even though the price of milk, the largest component of our cost of goods sold, increased slightly during 2003 as compared to 2002, Lifeway was able to decrease its cost of goods sold as a percentage of sales through negotiated contracts with vendors and the purchase of other raw materials in bulk, thus reducing per item cost. We anticipate that we will be able to maintain our gross margins in 2004 even though the United States Department of Agriculture has reported that it expects the average price of milk to increase by 10-15% nationally in 2004. We anticipate being able to offset any milk price increase in 2004 as well as increased costs for the new packaging described above by selective increases in the prices of our products. While we have not previously increased our prices in response to an increased cost of milk, we do not expect that increased prices will have a negative impact on our sales or revenues. Nonetheless, the anticipated increase in milk prices and increased packaging costs present the largest risk to our gross margin in 2004.

Even though sales increased by approximately 22% in 2003, Lifeway's 2003 operating expenses as a percentage of sales ratio was similar to 2002. Our operating expenses increased during 2003 due to our investment in the design and implementation of our new shrink-sleeve packaging and due to the increased professional services costs resulting from the Sarbanes-Oxley Act of 2001, and the regulations promulgated pursuant thereto by the Securities and Exchange Commission and the Nasdaq Stock Market. Additionally, Lifeway's annual aggregate fuel costs, whether incurred directly or passed through to the Company by distributors and delivery providers, increased in 2003.

Inflation has not had any measurable impact on the Company's results of operations.

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### DISPOSITION OF REAL PROPERTY

In the first quarter of 2003, we finalized the disposition of one property, which resulted in a capital gain of approximately \$1.2 million. We took the opportunity presented by this disposition to sell certain impaired securities, recognize the losses at a time when the losses could be matched for federal tax purposes with all of the gain from the real estate disposition and furthering our ongoing program of transitioning our liquid securities into higher grade investments and thereby strengthening our balance sheet.

### MARKETABLE SECURITIES

A significant portion of our assets are held in marketable securities. The marketable securities are classified as available-for-sale on our balance sheet and thus are stated thereon at market value as of the end of the applicable period. Gains and losses on the portfolio are determined by the specific identification method.

During the course of 2003, and now in 2004, we have been and will continue to move away from higher-risk securities towards large cap value, higher dividend yielding and tax-advantaged equities. At the end of 2003, our investment portfolio was comprised of about 60% fixed income securities and around 40% equity investments. However, our investment portfolio presently consists of approximately 80% fixed income securities, and about 20% equity investments. Of the equity portion, 85% is invested in large cap value stocks, 10% in small cap growth stocks, and 5% in large cap growth stocks. We believe,

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given the current market conditions, this asset allocation strategy offers a positive risk-reward ratio for our Company.

### SOURCES AND USES OF CASH IN 2003 AND 2004

Net cash used in financing activities was \$30,707 in 2003, compared to \$1,068,077 in 2002. In 2003, the Company's use of cash in financing activities was limited to periodic payments of principal and interest made on the mortgage loan for Lifeway's headquarters and on the loans used to acquire some of its delivery trucks. In 2002, however, in addition to making the same mortgage and auto loan payments made in 2003, Lifeway also acquired 55,000 shares (110,000 shares when adjusted for the two-for-one stock split paid on March 8, 2004) of its common stock under a repurchase program and fully paid off two mortgage loans in advance of maturity.

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. We anticipate closing an acquisition in 2004 or early 2005. We expect that we will be able to use our available cash and cash equivalents as funding for an acquisition of this size. We are also exploring opportunities in Eastern Canada that will meet our desire to expand sales in that region.

### OTHER DEVELOPMENTS

As of March 22, 2004 we have realized approximately \$350,000 in capital gains resulting from the continuing rebalancing of the equity portion of our portfolio toward more lower-risk investments. The capital gains tax liability created by this realization will be offset by the capital loss carry forward as of December 31, 2003.

At present, management strongly believes that foreseeable increases in advertising and marketing costs, and professional services fees and potential personnel recruitment, hiring and employment expenses incurred as a result of compliance with the Sarbanes-Oxley Act and related SEC and Nasdaq regulations will continue to increase and may result in a negative impact to earnings sometime in the future. In addition, management is exploring options for additional production and storage space in light of increased sales of and demand for its products and the fact that its existing facilities are approaching the limits of their capacity.

If the aggregate market value of Lifeway's outstanding common stock (also known as the "public float") exceeds \$25 million in the final 60 days of 2004, Lifeway shall no longer file periodic reports under the SEC's regulations for "Small Business Issuers" and shall become subject to further SEC filing requirements. Additionally, if Lifeway's public float ever exceeds \$75 million, Lifeway would become subject to the SEC's "accelerated filer" requirements. Management anticipates either or both of these events would further increase the Company's professional service costs.

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Aside from the foregoing, management is not aware of any circumstances or trends, which would have a negative impact upon future sales or earnings. There have been no material fluctuations in the standard seasonal variations of Lifeway's business in 2003. The accompanying financial statements include all adjustments, which in the opinion of management are necessary in order to make the financial statements not misleading.

### CRITICAL ACCOUNTING POLICIES

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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.

### FORWARD-LOOKING STATEMENTS

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

- Changes in economic conditions, commodity prices;
- Shortages of and price increase for fuel, labor strikes or work stoppages, market acceptance of the Company's new products;
- Significant changes in the competitive environment;
- Changes in laws, regulations, and tax rates; and
- Management's ability to achieve reductions in cost and employment levels, to realize production efficiencies and to implement capital expenditures, all at of the levels and times planned by management.

### ITEM 8A. CONTROLS AND PROCEDURES

#### EXPLANATORY NOTE REGARDING AMENDMENT

This Item is being amended and restated in its entirety hereby to clarify the Chief Executive Officer's position as to internal control matters and to address the Company's intentions in this area for 2004.

The Chief Executive Officer (who serves as the principal executive and financial officer) conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures pursuant to Rule 13a-14 under the Securities Exchange Act of 1934 as of December 31, 2003. The Company has historically operated on strictly monitored cost constraints; with that perspective, the Chief Executive Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this annual report has been made known to her. However, based upon the Company's

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recent growth and improved cash position, as well as consultation with its auditors, management intends to implement additional procedures to improve internal controls

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in 2004. Specifically, an enhanced accounting software package has been identified which will permit enhanced data recording and internal reporting, additional on-site accounting staff and some changes to internal control procedures.

As of the date of this annual report, there have been no known significant changes in internal controls or in other factors that could significantly affect these controls subject to the date of such evaluation.

### PART III

#### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

##### EXPLANATORY NOTE REGARDING AMENDMENT

This Item is being amended and restated in its entirety to further clarify the information regarding fees paid to the Company's principal accountant and to set forth in detail information regarding the accountant pre-approval process of the Company's audit committee.

Gleeson, Sklar, Sawyers and Cumpata, LLP ("Gleeson") was Lifeway's principal accountant from January 1, 2003 through December 31, 2003.

##### AUDIT FEES

In 2002, Gleeson billed Lifeway approximately \$32,500 for professional services rendered for the audit of Lifeway's annual financial statements and review of financial statements included in Lifeway's Form 10-QSB for services that are normally provided in connection with statutory and regulatory filings or engagements in 2002.

In 2003, Gleeson billed Lifeway approximately \$41,500 for professional services rendered for the audit of Lifeway's annual financial statements and review of financial statements included in Lifeway's Form 10-QSB or services that are normally provided in connection with statutory and regulatory filings or engagements in 2003.

##### AUDIT-RELATED FEES

In 2002, Gleeson billed Lifeway approximately \$6,185 for assurance and related services that are reasonably related to the performance of the audit or review of Lifeway's financial statements.

In 2003, Gleeson billed Lifeway approximately \$4,701 for assurance and related services that are reasonably related to the performance of the audit or review of Lifeway's financial statements.

##### TAX FEES

No professional services were rendered by Gleeson to Lifeway regarding tax advice, tax compliance and tax planning.

##### ALL OTHER FEES

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No other fees were billed to Lifeway by Gleeson other than those described in this report.

No hours expended by Gleeson in its engagement to audit Lifeway's financial statements for the most recent fiscal year were attributable to work performed by persons other than Gleeson's full-time permanent employees.

### AUDIT COMMITTEE PRE-APPROVAL POLICIES AND PROCEDURES ADOPTED PURSUANT TO REGULATION S-X

The Lifeway Audit Committee (the "Committee"), comprised of Messrs. Rick D. Salm and Pol Sikar, pre-approved Gleeson as the Company's independent auditor for the year-ended December 31, 2004 and has adopted the following guidelines regarding the engagement of the Company's independent auditor to perform services for the Company:

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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, company 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 the Controller, Chief Financial Officer or Chief Executive Officer the authority to amend or modify the list of approved permissible non-audit services and fees. The Controller, Chief Financial Officer or Chief Executive Officer 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 Controller or 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.

SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunder duly authorized.

LIFEWAY FOODS, INC.

Date: April 20, 2004

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

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

Date: April 20, 2004

/s/ Julie Smolyansky  
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Julie Smolyansky, Chief Executive Officer,  
Chief Financial and Accounting Officer,  
President, Treasurer and Director

Date: April 20, 2004

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

Date: April 26, 2004

/s/ Pol Sikar  
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Pol Sikar, Director

Date: April 20, 2004

/s/ Rick D. Salm  
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Rick D. Salm, Director