

LIFEWAY FOODS INC
Form 10-Q
November 10, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark
One)

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

For the quarterly period ended: September 30, 2016

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

For the transition period from _____ to _____

Commission File Number: 000-17363

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

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

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

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

Indicate by check mark whether the registrant (1) 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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 Exchange Act).
Yes No

As of November 1, 2016, 16,140,633 shares of the registrant's common stock, no par value, were outstanding.

LIFEWAY FOODS, INC.

Table of Contents

PART I – FINANCIAL INFORMATION

| | | |
|---------|--|----|
| Item 1. | Financial Statements (Unaudited). | 3 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations. | 19 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk. | 24 |
| Item 4. | Controls and Procedures. | 24 |

PART II – OTHER INFORMATION

| | | |
|-----------|--|----|
| Item 1. | Legal Proceedings. | 27 |
| Item 1 A. | Risk Factors. | 27 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds. | 27 |
| Item 3. | Defaults Upon Senior Securities. | 27 |
| Item 4. | Mine Safety Disclosure. | 27 |
| Item 5. | Other Information. | 28 |
| Item 6. | Exhibits. | 29 |
| | Signatures. | 30 |
| | Index of Exhibits. | 31 |

ITEM 1. FINANCIAL STATEMENTS.

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

September 30, 2016 and December 31, 2015

(In thousands)

| | September 30, 2016 (Unaudited) | December 31, 2015 |
|--|---|-------------------------|
| Current assets | | |
| Cash and cash equivalents | \$ 9,164 | \$ 5,646 |
| Investments, at fair value | — | 2,216 |
| Certificates of deposits in financial institutions | — | 513 |
| Inventories | 9,186 | 7,664 |
| Accounts receivable, net of allowance for doubtful accounts and discounts & allowances of \$1,800 at September 30, 2016 and December 31, 2015 | 10,426 | 9,604 |
| Prepaid expenses and other current assets | 550 | 201 |
| Deferred income taxes | 509 | 556 |
| Refundable income taxes | 521 | 449 |
| Total current assets | 30,356 | 26,849 |
| Property and equipment, net | 21,603 | 21,375 |
| Intangible assets | | |
| Goodwill & indefinite-lived intangibles | 14,068 | 14,068 |
| Other intangible assets, net | 1,815 | 2,344 |
| Total intangible assets | 15,883 | 16,412 |
| Other Assets | 368 | 282 |
| Total assets | \$ 68,210 | \$ 64,918 |
| Current liabilities | | |
| Current maturities of notes payable | \$ 840 | \$ 840 |
| Accounts payable | 8,762 | 8,393 |
| Accrued expenses | 2,002 | 1,538 |
| Accrued income taxes | 267 | 52 |
| Total current liabilities | 11,871 | 10,823 |
| Notes payable | 6,489 | 7,119 |
| Deferred income taxes | 2,162 | 1,719 |
| Total liabilities | 20,522 | 19,661 |
| Stockholders' equity | | |
| Common stock, no par value; 40,000 shares authorized; 17,274, shares issued; 16,141 and 16,210 shares outstanding at September 30, 2016 and December 31, 2015 respectively | 6,509 | 6,509 |
| Paid-in-capital | 2,133 | 2,033 |

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

| | | |
|---|-----------|-----------|
| Treasury stock, at cost | (10,468) | (9,730) |
| Retained earnings | 49,514 | 46,516 |
| Accumulated other comprehensive income (loss), net of taxes | — | (71) |
| Total stockholders' equity | 47,688 | 45,257 |
| | | |
| Total liabilities and stockholders' equity | \$ 68,210 | \$ 64,918 |

See accompanying notes to consolidated financial statements

- 3 -

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Consolidated Statements of Income (Loss) and Comprehensive Income (Loss)

For the Three Months and Nine Months ended September 30, 2016 and 2015

(Unaudited)

(In thousands, except per share data)

| | Three Months | | Nine Months Ended | |
|---|--------------------------------|-------------------|-----------------------|-------------------|
| | Ended September 30, 2016 | (Revised) 2015 | September 30, 2016 | (Revised) 2015 |
| Net sales | \$29,990 | \$ 29,599 | \$93,691 | \$ 89,042 |
| Cost of goods sold | 21,478 | 20,049 | 65,480 | 63,916 |
| Depreciation expense | 533 | 614 | 1,797 | 1,809 |
| Total cost of goods sold | 22,011 | 20,663 | 67,277 | 65,725 |
| Gross profit | 7,979 | 8,936 | 26,414 | 23,317 |
| Selling expenses | 4,306 | 2,706 | 10,733 | 8,626 |
| General and administrative | 3,308 | 3,998 | 10,300 | 10,643 |
| Amortization expense | 176 | 179 | 529 | 537 |
| Total operating expenses | 7,790 | 6,883 | 21,562 | 19,806 |
| Income from operations | 189 | 2,053 | 4,852 | 3,511 |
| Other income (expense): | | | | |
| Interest expense | (56) | (55) | (161) | (179) |
| Gain / (Loss) on sale of investments, net reclassified from OCI | 12 | 1 | (15) | (21) |
| Impairment of investments | — | (205) | — | (385) |
| (Loss) / Gain on sale of property and equipment | (156) | — | (307) | 243 |
| Other income (expense), net | 28 | 26 | 105 | 173 |
| Total other income (expense) | (172) | (233) | (378) | (169) |
| Income before provision for income taxes | 17 | 1,820 | 4,474 | 3,342 |
| Provision for income taxes | 81 | 927 | 1,476 | 1,697 |
| Net income (loss) | \$(64) | \$ 893 | \$2,998 | \$ 1,645 |
| Basic earnings (loss) per common share | \$(0.00) | \$ 0.05 | \$0.19 | \$ 0.10 |
| Diluted earnings (loss) per common share | \$(0.00) | \$ 0.05 | \$0.19 | \$ 0.10 |
| Weighted average number of shares outstanding – Basic | 16,141 | 16,346 | 16,159 | 16,346 |
| Weighted average number of shares outstanding – Diluted | 16,161 | 16,346 | 16,181 | 16,346 |

COMPREHENSIVE INCOME (LOSS)

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

| | | | | |
|--|---------|--------|---------|----------|
| Net income (loss) | \$(64) | \$ 893 | \$2,998 | \$ 1,645 |
| Other comprehensive income (loss), net of tax: | | | | |
| Unrealized gains (losses) on investments, net of taxes | 6 | (183) | 62 | (247) |
| Reclassifications to earnings: | | | | |
| Other than temporary impairment of investments, net of taxes | | | | |
| Realized (gains) losses on investments, net of taxes | (8) | 124 | 9 | 247 |
| Comprehensive income (loss) | \$(66) | \$ 834 | \$3,069 | \$ 1,645 |

See accompanying notes to consolidated financial statements

- 4 -

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Stockholders' Equity
For the Nine Months Ended September 30, 2016 and 2015
(Unaudited)
(In thousands)

| | Common Stock | | | | Paid In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss), Net of Tax | Total Stockholders' Equity |
|---|------------------|---------|-----------------------|------------|--------------------|----------------------|--|----------------------------------|
| | Issued Shares | \$ | In treasury Shares | \$ | | | | |
| Balances at January 1, 2015 | 17,274 | \$6,509 | (928) | \$(8,188) | \$2,033 | \$44,544 | \$ (198) | \$ 44,700 |
| Other comprehensive income | — | — | — | — | — | — | — | — |
| Net income for the nine months ended September 30, 2015 | — | — | — | — | — | 1,645 | — | 1,645 |
| Balances at September 30, 2015 | 17,274 | \$6,509 | (928) | \$(8,188) | \$2,033 | \$46,189 | \$ (198) | \$ 46,345 |
| Balances at January 1, 2016 | 17,274 | \$6,509 | (1,064) | \$(9,730) | \$2,033 | \$46,516 | \$ (71) | \$ 45,257 |
| Other comprehensive income | — | — | — | — | — | — | 71 | 71 |
| Treasury stock purchased | — | — | (69) | (738) | — | — | — | (738) |
| Stock based compensation | — | — | — | — | 100 | — | — | 100 |
| Net income for the nine months ended September 30, 2016 | — | — | — | — | — | 2,998 | — | 2,998 |
| Balances at September 30, 2016 | 17,274 | \$6,509 | (1,133) | \$(10,468) | \$2,133 | \$49,514 | \$ — | \$ 47,688 |

See accompanying notes to consolidated financial statements

- 5 -

LIFEWAY FOODS, INC. AND SUBSIDIARIES
 Consolidated Statements of Cash Flows
 For the Nine Months Ended September 30, 2016 and 2015
 (Unaudited)
 (In thousands)

| | | |
|---|---------|---------|
| <u>Cash flows from operating activities:</u> | 2016 | 2015 |
| Net income | \$2,998 | \$1,645 |
| Adjustments to reconcile net income to operating cash flow: | | |
| Depreciation and amortization | 2,326 | 2,346 |
| Loss on sale of investments, net | 15 | 21 |
| Impairment of investments | — | 385 |
| Deferred income taxes | 444 | (472) |
| Reserve for inventory obsolescence | 89 | — |
| Stock based compensation | 100 | — |
| Loss (Gain) on sale of property and equipment | 307 | (243) |
| (Increase) decrease in operating assets: | | |
| Accounts receivable | (823) | (540) |
| Inventories | (1,611) | (1,118) |
| Refundable income taxes | (72) | 1,011 |
| Prepaid expenses and other current assets | (310) | 252 |
| Increase (decrease) in operating liabilities: | | |
| Accounts payable | 370 | (396) |
| Accrued expenses | 465 | 1,038 |
| Accrued income taxes | 215 | 449 |
| Net cash provided by operating activities | 4,513 | 4,378 |
| <u>Cash flows from investing activities:</u> | | |
| Purchases of investments | (559) | (1,369) |
| Proceeds from sale of investments | 2,751 | 1,230 |
| Redemption of certificates of deposits | 513 | 250 |
| Investments in certificates of deposit | — | (635) |
| Purchases of property and equipment | (2,481) | (1,619) |
| Proceeds from sale of property and equipment | 149 | 343 |
| Net cash provided by (used in) investing activities | 373 | (1,800) |
| <u>Cash flows from financing activities:</u> | | |
| Purchase of treasury stock | (738) | — |
| Repayment of notes payable | (630) | (827) |
| Net cash used in financing activities | (1,368) | (827) |
| Net increase in cash and cash equivalents | 3,518 | 1,751 |
| Cash and cash equivalents at the beginning of the period | 5,646 | 3,260 |
| Cash and cash equivalents at the end of the period | \$9,164 | \$5,011 |
| Supplemental cash flow information: | | |
| Cash paid for income taxes, net of refunds | \$886 | \$795 |
| Cash paid for interest | \$162 | \$178 |

See accompanying notes to consolidated financial statements

- 6 -

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

September 30, 2016 and December 31, 2015

(Unaudited)

(In thousands, except per share data)

Note 1 – Basis of Presentation

Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information, and do not include all of the information and disclosures required for complete, audited financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation, have been included. For further information, refer to the consolidated financial statements and disclosures included in the consolidated financial statements included in the Company's Annual Report on Form 10-K as of and for the year ended December 31, 2015. Certain amounts in prior-year financial statements were reclassified to conform to the current-year presentation. The results for the period are not necessarily indicative of the results to be expected for other interim periods or the full year.

New presentation format. In prior periods, the Company presented gross sales, discounts and promotional allowances and net sales as distinct financial statement captions in our statements of income (loss) and comprehensive income (loss). During the second quarter of 2016, the Company concluded that it was appropriate to simply present net sales. All prior periods have been conformed to the new presentation.

Corrections of errors and revisions of prior period financial statements

During the third quarter of fiscal 2016, the Company recorded adjustments to properly classify indirect manufacturing overhead costs related to certain production facilities within our manufacturing platform as an element of Cost of Goods Sold in our Statements of Income (Loss) and Comprehensive Income (Loss). In prior periods these costs were incorrectly classified in General and Administrative expenses.

Additionally, in the first and second quarter of 2015, certain executive compensation was classified in Selling expenses that more appropriately should be classified as General and Administrative expenses. We previously corrected these classification errors in our first and second quarter 2016 filings on Form 10-Q with the SEC.

Collectively, these adjustments had the following impact on our Consolidated Statements of Income (Loss) and Comprehensive Income (Loss):

| | (Unaudited) Three Months Ended March 31, 2016 | | | (Unaudited) Six Months Ended June 30, 2016 | | |
|--------------------|---|------------|---------------|--|------------|---------------|
| | As Previously Reported | Adjustment | As Revised | As Previously Reported | Adjustment | As Revised |
| Net Sales | \$32,570 | \$ — | \$32,570 | \$63,701 | \$ — | \$63,701 |
| Cost of Goods Sold | 23,351 | 519 | 23,870 | 44,290 | 976 | 45,266 |
| Gross Profit | 9,219 | (519) | 8,700 | 19,411 | (976) | 18,435 |
| Selling expenses | 2,964 | — | 2,964 | 6,427 | — | 6,427 |

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

| | | | | | | |
|--------------------------|---------|--------|---------|---------|--------|---------|
| General & administrative | 4,465 | (519) | 3,946 | 7,968 | (976) | 6,992 |
| Amortization | 176 | — | 176 | 353 | — | 353 |
| Operating expenses | 7,605 | (519) | 7,086 | 14,748 | (976) | 13,772 |
| Income from Operations | \$1,614 | \$ — | \$1,614 | \$4,663 | \$ — | \$4,663 |

- 7 -

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

| | (Unaudited) Three Months Ended March 31, 2015 | | | (Unaudited) Six Months Ended June 30, 2015 | | |
|--------------------------|---|------------|---------------|--|------------|---------------|
| | As Previously Reported (a) | Adjustment | As Revised | As Previously Reported (a) | Adjustment | As Revised |
| Net Sales | \$29,622 | \$ — | \$29,622 | \$59,443 | \$ — | \$59,443 |
| Cost of Goods Sold | 21,239 | 458 | 21,697 | 44,044 | 1,017 | 45,061 |
| Gross Profit | 8,383 | (458) | 7,925 | 15,399 | (1,017) | 14,382 |
| Selling expenses | 3,302 | — | 3,302 | 5,920 | — | 5,920 |
| General & administrative | 3,492 | (458) | 3,034 | 7,662 | (1,017) | 6,645 |
| Amortization | 179 | — | 179 | 358 | — | 358 |
| Operating expenses | 6,973 | (458) | 6,515 | 13,940 | (1,017) | 12,923 |
| Income from Operations | \$1,410 | \$ — | \$1,410 | \$1,459 | \$ — | \$1,459 |

(a) As previously reported in our first and second quarter 2016 Form 10Q filings.

| | (Unaudited) Nine Months Ended September 30, 2015 | | | (Unaudited) Twelve Months Ended December 31, 2015 | | |
|--------------------------|--|------------|---------------|---|------------|---------------|
| | As Previously Reported (b) | Adjustment | As Revised | As Previously Reported (b) | Adjustment | As Revised |
| Net Sales | \$89,042 | \$ — | \$89,042 | \$118,587 | \$ — | \$118,587 |
| Cost of Goods Sold | 64,588 | 1,137 | 65,725 | 86,986 | 1,556 | 88,542 |
| Gross Profit | 24,454 | (1,137) | 23,317 | 31,601 | (1,556) | 30,045 |
| Selling expenses | 9,486 | (860) | 8,626 | 12,752 | (860) | 11,892 |
| General & administrative | 10,920 | (277) | 10,643 | 13,730 | (696) | 13,034 |
| Amortization | 537 | — | 537 | 716 | — | 716 |
| Operating expenses | 20,943 | (1,137) | 19,806 | 27,198 | (1,556) | 25,642 |
| Income from Operations | \$3,511 | \$ — | \$3,511 | \$4,403 | \$ — | \$4,403 |

(b) Includes the reclassification of certain executive compensation from Selling to General and administrative expenses.

Further, these adjustments had no impact on the measurement of Income before provision for incomes taxes, Net income (loss), Basic and diluted earnings (loss) per common share or any element of the Consolidated Balance Sheets or Statements of Cash Flows for any of the respective periods. The Company determined these adjustments to be immaterial, individually and in the aggregate, to our previously filed consolidated financial statements.

Principles of consolidation

Our Consolidated Financial Statements include the accounts of Lifeway Foods, Inc. and all its wholly owned subsidiaries (collectively "Lifeway" or the "Company"). All significant intercompany accounts and transactions have been eliminated.

- 8 -

Note 2 – Significant Accounting Policies

Use of estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP 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 consolidated 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 reserve for promotional allowances, the fair value of investment securities, the valuation of goodwill and intangible assets, and deferred income taxes.

Revenue Recognition

The Company records sales when 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 costs are included in cost of sales.

The Company routinely offers sales allowances and discounts to our customers and consumers. These programs include rebates, in-store display and demo allowances, allowances for non-salable product, coupons and other trade promotional activities. These allowances are considered reductions in the price of our products and thus are recorded as reductions to gross sales. Some of these incentives are recorded by estimating incentive costs based on our historical experience and expected levels of performance of the trade promotion. We maintain a reserve for the estimated allowances incurred but unpaid. Differences between estimated and actual allowances are normally insignificant and are recognized in income in the period such differences are determined. Product returns have historically not been material.

Bulk cream is a by-product of the Company's fluid milk manufacturing process. The Company does not use bulk cream in any of its end products, but rather disposes of it through sales to other companies. Bulk cream by-product sales are included in net sales.

Advertising and promotional costs

The Company expenses advertising costs as incurred. For the nine months ended September 30, 2016 and 2015 total advertising expenses were \$5,418 and \$4,145 respectively. For the three months ended September 30, 2016 and 2015 total advertising expenses were \$2,665 and \$1,324 respectively.

Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board ("FASB") issued new guidance to address the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows, such as debt prepayment or debt extinguishment costs, contingent consideration payments made after an acquisition, proceeds from the settlement of insurance claims, and other topics. The new guidance will be effective for fiscal years beginning on or after December 15, 2017 and interim periods within those years. Early adoption of the guidance is permitted. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In March 2016, the FASB issued new guidance regarding certain aspects of the accounting for employee share-based payment transactions including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance will be effective for fiscal years beginning on or after December 15, 2016 and interim periods within those years. Early adoption of the guidance

is permitted. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

- 9 -

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

In February 2016, the FASB issued new guidance regarding leases. The guidance requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize on the balance sheet a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The new guidance is effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those years. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In January, 2016, the FASB issued new guidance regarding the recognition and measurement of financial assets and liabilities. The new guidance modifies how entities measure equity investments and present changes in the fair value of certain financial liabilities. Under the new guidance, entities will have to measure equity investments that do not result in consolidation and are not accounted under the equity method at fair value and recognize any changes in fair value in net income unless certain conditions exist. The new guidance will be effective for fiscal years beginning on or after December 15, 2017 and interim periods within those years. Other than for recognition and measurement, early adoption of the guidance is permitted. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In November 2015, the FASB issued new guidance regarding the balance sheet classification of deferred income taxes. This new guidance requires that all deferred tax assets and liabilities, along with any related valuation allowance, be classified as noncurrent on the balance sheet. Previous guidance required deferred tax assets and liabilities to be separated into current and noncurrent amounts on the balance sheet. The guidance is effective for fiscal years beginning on or after December 15, 2016, and interim periods within those years. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In July 2015, the FASB issued new accounting guidance for measuring inventory. The core principal of the guidance is that an entity should measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance does not apply to inventory that is being measured using the Last-In, First-Out (LIFO) or the retail inventory method. The guidance is effective for financial statements issued for annual and interim periods beginning after December 15, 2016 on a prospective basis. Early adoption is permitted. Management is currently evaluating the impact this will have on the consolidated financial statements.

In May 2014, the FASB issued new guidance regarding revenue recognition. Additional revenue recognition guidance clarifications have been issued subsequent to May 2014. Collectively the new revenue recognition guidance supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, including most industry-specific requirements. The new guidance establishes a five-step revenue recognition process in which an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The new guidance also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. The Company is required to adopt the new guidance not later than January 1, 2018. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements and the method of retrospective application, either full or modified.

Note 3 – Intangible Assets

Goodwill & indefinite-lived intangible assets consists of the following:

| | September 30, 2016 | December 31, 2015 |
|---|-----------------------|----------------------|
| Goodwill | \$ 10,368 | \$ 10,368 |
| Brand names | 3,700 | 3,700 |
| Goodwill & indefinite lived intangible assets | \$ 14,068 | \$ 14,068 |

- 10 -

Other intangible assets, net consists of the following:

| | September 30, 2016 | December 31, 2015 |
|---|-----------------------|----------------------|
| Recipes | \$ 44 | \$ 44 |
| Customer lists and other customer related intangibles | 4,529 | 4,529 |
| Customer relationship | 985 | 985 |
| Trade names | 2,248 | 2,248 |
| Formula | 438 | 438 |
| | 8,244 | 8,244 |
| Accumulated amortization | (6,429) | (5,900) |
| Intangible assets, net | \$ 1,815 | \$ 2,344 |

Note 4 – Investments

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

| September 30, 2016 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|-----------------------|------|---------------------|----------------------|---------------|
| Common stocks & ETF's | \$ — | \$ — | \$ — | — |
| Mutual Funds | — | — | — | — |
| Preferred Securities | — | — | — | — |
| Corporate Bonds | — | — | — | — |
| Total | \$ — | \$ — | \$ — | — |

| December 31, 2015 | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|-----------------------|---------|---------------------|----------------------|---------------|
| Common stocks & ETF's | \$690 | \$ 17 | \$ (94) | \$613 |
| Mutual Funds | 27 | — | (1) | 26 |
| Preferred Securities | 98 | 6 | — | 104 |
| Corporate Bonds | 1,518 | 43 | (88) | 1,473 |
| Total | \$2,333 | \$ 66 | \$ (183) | \$2,216 |

Gross gains of \$185 and \$14 and gross losses of \$200 and \$35 were realized on these sales during the nine months ended September 30, 2016 and 2015, respectively. Gross gains of \$120 and \$1 and gross losses of \$108 and \$0 were realized on these sales during the three months ended September 30, 2016 and 2015 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 September 30, 2016 and December 31, 2015:

- 11 -

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

| September 30, 2016 | Less Than 12 Months | | 12 Months or Greater | | Total | |
|-----------------------|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Common stocks & ETF's | \$ — | \$ — | \$ — | \$ — | \$ — | \$ — |
| Mutual Funds | — | — | — | — | — | — |
| Preferred Securities | — | — | — | — | — | — |
| Corporate Bonds | — | — | — | — | — | — |
| | \$ — | \$ — | \$ — | \$ — | \$ — | \$ — |

| December 31, 2015 | Less Than 12 Months | | 12 Months or Greater | | Total | |
|-----------------------|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Common stocks & ETF's | \$225 | \$ (72) | \$152 | \$ (22) | \$377 | \$ (94) |
| Mutual Funds | 26 | (1) | — | — | 26 | (1) |
| Preferred Securities | — | — | — | — | — | — |
| Corporate Bonds | 370 | (32) | 479 | (56) | 849 | (88) |
| | \$621 | \$ (105) | \$631 | \$ (78) | \$1,252 | \$ (183) |

The Company's investments in equity securities, mutual funds, preferred securities, and corporate bonds consisted of investments in common stock, preferred stock, structured notes and other debt securities of companies in various industries. The Company recorded other-than-temporary impairment losses related to certain structured notes of \$0 and \$385 during the nine months ended September 30, 2016 and 2015 respectively. The structured notes allow the issuer to settle at an amount less than par in certain circumstances. In reaching a conclusion to record these other-than-temporary impairment losses, the Company evaluated the near-term prospects of the issuers and determined it was probable the issuers would have the ability to settle the bonds for an amount less than par value at maturity.

Note 5 – Inventories

Inventories consist of the following:

| | September 30, 2016 | December 31, 2015 |
|---------------------|--------------------|-------------------|
| Finished goods | \$ 3,357 | \$ 2,946 |
| Production supplies | 3,168 | 2,636 |
| Raw materials | 2,661 | 2,082 |
| Total inventories | \$ 9,186 | \$ 7,664 |

Note 6 – Property and Equipment

Property and equipment consist of the following:

| | September 30, 2016 | December 31, 2015 |
|------------------------------|--------------------------|-------------------------|
| Land | \$ 1,747 | \$ 1,807 |
| Buildings and improvements | 16,387 | 16,387 |
| Machinery and equipment | 22,533 | 22,907 |
| Vehicles | 848 | 1,298 |
| Office equipment | 709 | 709 |
| Construction in process | 1,765 | 311 |
| | 43,989 | 43,419 |
| Accumulated depreciation | (22,386) | (22,044) |
| Total property and equipment | \$ 21,603 | \$ 21,375 |

Note 7 – Accrued Expenses

Accrued expenses consist of the following:

| | September 30, 2016 | December 31, 2015 |
|-----------------------------------|--------------------------|-------------------------|
| Accrued payroll and payroll taxes | \$ 1,462 | \$ 859 |
| Accrued property tax | 297 | 377 |
| Other | 243 | 302 |
| Total accrued expenses | \$ 2,002 | \$ 1,538 |

Note 8 – Notes Payable

| | September 30, 2016 | December 31, 2015 |
|---|--------------------------|----------------------|
| Variable rate bank notes due May 31, 2018. Principal and interest payable monthly with a balloon payment due at maturity. | \$ 3,465 | \$ 3,846 |
| Variable rate bank notes due May 31, 2019. Principal and interest payable monthly with a balloon payment due at maturity. | 3,864 | 4,113 |
| Total notes payable | 7,329 | 7,959 |
| Less current maturities | 840 | 840 |
| Total long-term portion | \$ 6,489 | \$ 7,119 |

The variable rate bank notes are subject to interest at the prime rate or at the LIBOR rate plus 2.5% and are collateralized by substantially all of the assets of the Company. In addition, under the terms of the related agreements, the Company is subject to minimum fixed charged ratio and tangible net worth thresholds, which among other things may limit the Company's ability to pay dividends or repurchase shares of its common stock. The Company was in compliance with these financial covenants at September 30, 2016. Further, under the agreements the Company is required to deliver its annual and quarterly financial statements and related SEC filings within specified timeframes. At the time of filing this Form 10-Q the Company was in compliance with these requirements.

In addition, the Company has a \$5 million revolving credit facility. Borrowings under the facility are subject to interest at the prime rate or LIBOR plus 2.5%. As of September 30, 2016 and December 31, 2015 there were no borrowings under the facility. The facility expires in July 2017.

Note 9 – Commitments and contingencies

Lease obligations -The Company leases corporate office space and three stores for its Lifeway Kefir Shop subsidiary. Total rent expense for these leases was \$171 and \$93 for the nine months ended September 30, 2016 and 2015, respectively. The Company is also responsible for additional rent equal to real estate taxes and other operating expenses.

Litigation -The Company is engaged in various legal actions, claims and proceedings arising in the normal course of business, including commercial disputes, product liabilities, intellectual property matters and employment-related matters resulting from the Company's business activities.

The Company records accruals for outstanding legal matters when it believes it is probable that a loss will be incurred and the amount of such loss can be reasonably estimated. The Company evaluates, on a periodic basis, developments in legal matters that could affect the amount of any accrual and developments that would make a loss contingency both probable and reasonably estimable. If a loss contingency is not both probable and estimable, the Company does not establish an accrued liability. Currently, none of the Company's accruals for outstanding legal matters are material individually or in the aggregate to the Company's financial position and it is management's opinion that the ultimate resolution of these outstanding legal matters will not have a material adverse effect on our business, financial condition, results of operation, or cash flows. However, if the Company ultimately is required to make payments in connection with an adverse outcome, it is possible that it could have a material adverse effect on the Company's business, financial condition, results of operations or cash flows.

The Company's contingencies are subject to substantial uncertainties, including for each such contingency the following, among other factors: (i) the procedural status of the case; (ii) whether the case has or may be certified as a class action suit; (iii) the outcome of preliminary motions; (iv) the impact of discovery; (v) whether there are significant factual issues to be determined or resolved; (vi) whether the proceedings involve a large number of parties and/or parties and claims in multiple jurisdictions or jurisdictions in which the relevant laws are complex or unclear; (vii) the extent of potential damages, which are often unspecified or indeterminate; and (viii) the status of settlement discussions, if any, and the settlement posture of the parties. Consequently, the Company cannot predict with any reasonable certainty the timing or outcome of such contingencies, and the Company is unable to estimate a possible loss or range of loss.

Note 10 – Income taxes

For each interim period, the Company estimates the effective tax rate (ETR) expected to be applicable for the full year and applies that rate to income before provision for income taxes for the period. Additionally, the Company records discrete income tax items such as enacted tax rate changes and completed tax audits in the period in which they occur.

The effective tax rate for the three months ended September 30, 2016 exceeded 100% compared to an ETR of 50.9% for the three months ended September 30, 2015. The ETR for the three-month period ended September 30, 2016 reflects a change in the estimated U.S. manufacturing deduction and the relatively small amount of income before provision for income taxes. The ETR for the three-month period ended September 30, 2015 reflects certain operating expenses that were not fully deductible for federal income tax purposes.

The effective tax rate for the nine months ended September 30, 2016 was 33.0% compared to an ETR of 50.8% for the nine months ended September 30, 2015. During the nine months ended September 30, 2016 we recorded an income tax benefit of \$265 as a result of the favorable settlement of uncertain tax positions, which reduced the ETR

by 5.9%. During the nine months ended September 30, 2015 we incurred certain operating expenses that were not fully deductible for federal income tax purposes, which increased the ETR by 8.1%.

- 14 -

Note 11 – Fair Value Measurements

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.

The following is a description of the valuation methodologies used for assets measured at fair value on a recurring basis. There have been no changes in the methodologies used as of September 30, 2016 and December 31, 2015.

The majority of the Company's fair value measurements for investments are classified within Level 1 or Level 2 of the fair value hierarchy. The Company's Level 1 fair value measurements, which include mutual funds and common stock, is based on quoted market prices in active markets for identical securities. The Company's Level 2 fair value measurements, which include corporate bonds and preferred securities, is based on quoted prices in inactive markets for identical or similar assets. The company's level 3 fair value measurements which include other than temporarily impaired bonds are based on the present value of the estimated proceeds expected to be received at maturity of the bond. Those bonds were reclassified to level 3 from level 2 during 2015.

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.

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

The following table sets forth by level, within the fair value hierarchy, the Company's financial assets measured at fair value on a recurring basis as of September 30, 2016 and December 31, 2015. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

| | Assets at Fair Value as of September 30, 2016 | | | |
|-----------------------|---|---------|---------|-------|
| | Level 1 | Level 2 | Level 3 | Total |
| | Mutual Funds | \$— | \$— | \$— |
| Common Stocks & ETF's | — | — | — | — |
| Preferred Securities | — | — | — | — |
| Corporate Bonds | — | — | — | — |

| | Assets at Fair Value as of December 31, 2015 | | | |
|-----------------------|--|---------|---------|-------|
| | Level 1 | Level 2 | Level 3 | Total |
| | Mutual Funds | \$26 | \$— | \$— |
| Common Stocks & ETF's | 613 | — | — | 613 |
| Preferred Securities | — | 104 | — | 104 |
| Corporate Bonds | — | 1,149 | 324 | 1,473 |

The Company's financial assets and liabilities which are not carried at fair value on a recurring basis include cash and cash equivalents, certificates of deposit, accounts receivable, other receivables, accounts payable, accrued expenses and notes payable for which carrying value approximates fair value.

Note 12 – Stock-based and Other Compensation

In December 2015, Lifeway shareholders approved the 2015 Omnibus Incentive Plan, which authorized the issuance of an aggregate of 3.5 million shares to satisfy awards of stock options, stock appreciation rights, unrestricted stock, restricted stock, restricted stock units, performance shares and performance units. The Company has not established a pace for the frequency of awards under the Omnibus Incentive Plan, and may choose to suspend the issuance of new awards in the future and may grant additional awards at any time including issuing special grants of restricted stock, restricted stock units and stock options to attract and retain new and existing executives.

Pursuant to the Omnibus Incentive Plan, Lifeway granted 26 stock options to certain key employees of the company effective January 1, 2016 and 24 stock options on July 1, 2016 (the "2016 options"). The 2016 options generally vest over a three-year period, on a relatively accelerated basis. The accelerated vesting reflects the landmark nature of the awards and the relative tenure of individual participants.

For the three and nine months ended September 30, 2016 total pre-tax stock-based compensation expense recognized in the consolidated statements of income (loss) and comprehensive income (loss) was \$58 and \$100, respectively. For the three and nine months ended September 30, 2016 tax-related benefits of \$22 and \$37 were also recognized.

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

The following table summarizes stock option activity during the nine months ended September 30, 2016:

| | Options | Weighted average exercise price | Weighted average remaining contractual life | Aggregate intrinsic value |
|-----------------------------------|---------|---------------------------------|---|---------------------------|
| Outstanding at December 31, 2015 | — | | | \$ |
| Granted | 50 | \$ 10.37 | | |
| Exercised | — | \$ — | | |
| Terminated | — | \$ — | | |
| Outstanding at September 30, 2016 | 50 | \$ 10.37 | 9.50 | \$ 329 |
| Exercisable at September 30, 2016 | 7 | \$ 9.57 | 9.75 | \$ 50 |

We measure the fair value of stock options using the Black-Scholes option pricing model. The expected term of options granted was based on the weighted average time of vesting and the end of the contractual term. We utilized this simplified method as we do not have sufficient historical exercise data to provide a reasonable basis upon which to estimate the expected term.

The following assumptions were used for the grants in 2016:

| | Three Months Ended September 30, 2016 |
|-------------------------|---------------------------------------|
| Risk free interest rate | 1.00 - 1.11% |
| Expected dividend yield | 0.27% |
| Expected volatility | 38.96 - 39.94% |
| Expected term | 5.03 - 5.88 |

We expense stock options on a straight-line basis over the service period. As of September 30, 2016, the total remaining unearned compensation related to non-vested stock options was \$94, which will be amortized over the weighted-average remaining service period of 1.15 years.

In March 2016 Lifeway established an incentive-based compensation program for certain senior executives (the "participants"). The incentive compensation is based on the achievement of certain sales and EBITDA performance levels versus respective targets in 2016. Under the program, collectively the participants may earn cash and equity-based incentive compensation in amounts ranging from \$0 to \$4,000 during 2016 depending on the performance levels compared to the respective targets. The participants' achievement of equity-based compensation during the balance of 2016 is not considered to be probable. At September 30, 2016 bonuses of \$1,280 had been earned under the program, including \$200 of equity-based awards.

The company has a defined contribution plan which is available to substantially all full-time employees. Under the terms of the plan the company matches employee contributions under a prescribed formula. For the nine months ended September 30, 2016 and 2015 total contribution expense recognized in the consolidated statements of income (loss) and comprehensive income (loss) was \$255 and \$200 respectively. For the three months ended September 30, 2016 and 2015 total contribution expense recognized in the consolidated statements of income (loss) and comprehensive income (loss) was \$82 and \$53 respectively.

Note 13 – Segments, Products and Customers

The Company manufactures probiotic, cultured, functional dairy health food products. The Company's primary product is kefir, a dairy beverage similar to but distinct from yogurt, in several flavors and in several package configurations. In addition to the drinkable products, Lifeway manufactures "Lifeway Farmer Cheese," a line of various farmer cheeses.

The Company has determined that it has one reportable segment based on how the Company's chief operating decision maker manages the business and in a manner consistent with the internal reporting provided to the chief operating decision maker. The chief operating decision maker, who is responsible for allocating resources and assessing company performance, has been identified collectively as the Chief Financial Officer, the Chief Operating Officer, the Chief Executive Officer and Chairman of the board of directors. Substantially all of the consolidated revenues of the Company relate to the sale of fermented dairy products which are produced using the same processes and materials and are sold to consumers through a network of distributors and retailers in the United States.

Net sales of products by category were as follows:

| | Nine months ended September 30, | | Three months ended September 30, | |
|--|---------------------------------------|----------|--|----------|
| | 2016 | 2015 | 2016 | 2015 |
| Cream and Drinkable Kefir other than ProBugs | \$80,135 | \$76,723 | \$25,533 | \$25,902 |
| Pro Bugs | 4,962 | 5,999 | 1,606 | 1,702 |
| Lifeway Farmer Cheese | 7,579 | 5,125 | 2,479 | 1,661 |
| Frozen Kefir | 1,015 | 1,195 | 372 | 334 |
| Net Sales | \$93,691 | \$89,042 | \$29,990 | \$29,599 |

Significant Customers -- Sales are predominately to companies in the retail food industry, located within the United States. Two major customers accounted for approximately 23% and 22% of net sales for the nine months ended September 30, 2016 and 2015, respectively and 22% and 20% of net sales for the three months ended September 30, 2016 and 2015 respectively.

Note 14 – Related party transactions

The Company obtains consulting services from the Chairman of its board of directors. Fees earned by the Chairman are included in general and administrative expense in the accompanying consolidated statements of income (loss) and comprehensive income (loss) and were \$787 and \$727 during the nine months ended September 30, 2016 and 2015 respectively, and \$248 and \$340 during the three months ended September 30, 2016 and 2015 respectively.

Beginning in 2016 the Company is also a party to a royalty agreement with the Chairman of its board of directors under which the Company pays the Chairman a royalty based on the sale of certain Lifeway product, not to exceed \$50 in any fiscal month. Royalties of \$450 and \$150 were earned by the Chairman during the nine months and three months ended September 30, 2016 respectively and were included in selling expenses in the accompanying consolidated statements of income (loss) and comprehensive income (loss).

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in this Form 10-Q is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements, the accompanying notes, and the MD&A included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 (the "Form 10-K"). Unless otherwise specified, any description of "our", "we", and "us" in this MD&A refer to Lifeway Foods, Inc. and subsidiaries.

Cautionary Statement Regarding Forward-Looking Statements

In addition to historical information, this quarterly report contains "forward looking" statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements reflect our current expectations of the future and at the same time are subject to risks, uncertainties and assumptions that are difficult to predict.

In some cases, these statements may be identified by the use of words such as "may", "will", "could", "expect", "anticipate", "intend", "believe", "estimate", "plan", "predict", and similar terms or terminology, or the negative of such terms or other comparable terminology. Although we believe the expectations expressed in these forward-looking statements are based on reasonable assumptions within the bound of our knowledge of our business, our actual results could differ materially from those discussed in these statements. Factors that could contribute to such differences include, but are not limited to, those discussed in the "Risk Factors" section of the Form 10-K. We undertake no obligation to update publicly any forward-looking statements for any reason even if new information becomes available or other events occur in the future.

Comparison of the three-month period ended September 30, 2016 to the three-month period ended September 30, 2015

Results of Operations

| | Three months ended | | Change | |
|---|-----------------------|-------------------|-----------|---------|
| | September 30, 2016 | (Revised) 2015 | \$ | % |
| Net sales | \$29,990 | \$ 29,599 | \$391 | 1.3 % |
| Cost of goods sold | \$21,478 | \$ 20,049 | \$1,429 | |
| Depreciation expense | 533 | 614 | (81) | |
| Total cost of goods sold | \$22,011 | \$ 20,663 | \$(1,348) | (6.5 %) |
| Gross profit | \$7,979 | \$ 8,936 | \$(957) | (10.7%) |
| Gross Profit % to net sales | 26.6 % | 30.2 % | | |
| Selling expenses | \$4,306 | \$ 2,706 | \$(1,600) | (59.1%) |
| Selling expenses % to net sales | 14.4 % | 9.1 % | | |
| General & administrative expenses | \$3,308 | \$ 3,998 | \$690 | 17.3 % |
| General & administrative % to net sales | 11.0 % | 13.5 % | | |
| Amortization expense | \$176 | \$ 179 | \$3 | 1.7 % |
| Total operating expenses | \$7,790 | \$ 6,883 | \$(907) | (13.2%) |
| Total operating expense % to net sales | 26.0 % | 23.3 % | | |
| Income from operations | \$189 | \$ 2,053 | \$(1,864) | (90.8%) |
| Income from operations % to net sales | 0.6 % | 6.9 % | | |

Net Sales

Net sales increased by \$391 or 1.3% to \$29,990. The increase in net sales was driven by volume gains in organic and private label sales and the introduction of new items, partially offset by increased trade spending and relatively flat cream sales.

Gross Profit

Gross profit as a percent of net sales declined to 26.6% during the three-month period ended September 30, 2016 from 30.2% during the same three-month period in 2015. The lower gross profit percent reflects increased trade promotion and unfavorable mix.

Selling Expenses

Selling expenses increased by \$1,600 or 59.1% to \$4,306 during the three-month period ended September 30, 2016 from \$2,706 during the same period in 2015, reflecting an increase in advertising costs and higher salaries and royalty expense. During the third quarter of 2016, we ran a six week, broad-based advertising campaign advancing the Lifeway brand. The campaign had an Olympics theme and featured our brand ambassador Carli Lloyd. Selling expenses as a percentage of sales were 14.4% for the three-month period ended September 30, 2016 compared to 9.1% for the same period in 2015.

General and administrative expenses

General and administrative expenses declined \$690 or 17.3% to \$3,308 during the three-month period ended September 30, 2016 from \$3,998 during the same period in 2015. The decline is primarily a result of lower professional fees partially offset by higher compensation driven by increased incentive compensation and headcount. We experienced elevated levels of legal and professional fees in the prior year related to our delayed SEC filings, additional audit fees and costs associated with remediation of our internal control environment.

Income from operations and net income

The company reported income from operations of \$189 during the three months ended September 30, 2016, compared to \$2,053 during the same period in 2015. Provision for income taxes was \$81 during three months ended September 30, 2016, compared to a provision for income taxes of \$927 during the same period in 2015. Our effective tax rate for the three months ended September 30, 2016 exceeded 100% compared to an effective tax rate of 50.9% in the same period last year. The effective tax rate for the three-month period ended September 30, 2016 reflects a change in the estimated U.S. manufacturing deduction and the relatively small amount of income before provision for income taxes. Income taxes are discussed in Note 10 in the Notes to the Consolidated Financial Statements

We reported a net loss of \$64 or \$0.00 per basic and diluted common share for the three-month period ended September 30, 2016 compared to net income of \$893 or \$0.05 per basic and diluted common share in the same period in 2015.

Edgar Filing: LIFEWAY FOODS INC - Form 10-Q

Comparison of the nine-month period ended September 30, 2016 to the nine-month period ended September 30, 2015

Results of Operations

| | Nine months ended | | Change | |
|---|-----------------------|-------------------|-----------|---------|
| | September 30, 2016 | (Revised) 2015 | \$ | % |
| Net sales | \$93,691 | \$ 89,042 | \$4,649 | 5.2 % |
| Cost of goods sold | \$65,480 | \$ 63,916 | \$1,564 | |
| Depreciation expense | 1,797 | 1,809 | (12) | |
| Total cost of goods sold | \$67,277 | \$ 65,725 | \$(1,552) | (2.4 %) |
| Gross profit | \$26,414 | \$ 23,317 | \$3,097 | 13.3 % |
| Gross Profit % to net sales | 28.2 % | 26.2 % | | |
| Selling expenses | \$10,733 | \$ 8,626 | \$(2,107) | (24.4%) |
| Selling expenses % to net sales | 11.5 % | 9.7 % | | |
| General & administrative expenses | \$10,300 | \$ 10,643 | \$343 | 3.2 % |
| General & administrative % to net sales | 11.0 % | 12.0 % | | |
| Amortization expense | \$529 | \$ 537 | \$8 | 1.5 % |
| Total operating expenses | \$21,562 | \$ 19,806 | \$(1,756) | (8.9 %) |
| Total operating expense % to net sales | 23.0 % | 22.2 % | | |
| Income from operations | \$4,852 | \$ 3,511 | \$1,341 | 38.2 % |
| Income from operations % to net sales | 5.2 % | 3.9 % | | |

Net Sales

Net sales increased by \$4,649 or 5.2% to \$93,691. The increase in net sales was driven by volume gains of our private label and organic products, the introduction of new items and lower trade spending, partially offset by lower sales of our ProBugs product.

Gross Profit

Gross profit as a percent of net sales increased to 28.2% during the nine-month period ended September 30, 2016 from 26.2% during the same period in 2015. The improvement in the gross profit percent reflects lower input costs, primarily milk prices and lower trade promotion, partially offset by unfavorable mix.

- 22 -

Selling Expenses

Selling expenses increased by \$2,107 or 24.4% to \$10,733 during the nine-month period ended September 30, 2016 from \$8,626 during the same period in 2015 reflecting increased advertising expenses and additional royalty expenses. During the nine month period ending September 30, 2016 we ran two advertising campaigns compared to only one campaign in the year ago period. The 2016 advertising campaigns consisted of a product-focused Pro Bugs campaign and a Lifeway brand-focused campaign. The 2015 advertising campaign was our first commercial campaign and ran during the week of the 2015 Golden Globe awards. Selling expenses as a percentage of sales were 11.5% for the nine-month period ended September 30, 2016 compared to 9.7% for the same period in 2015.

General and administrative expenses

General and administrative expenses declined \$343 or 3.2% to \$10,300 during the nine-month period ended September 30, 2016 from \$10,643 during the same period in 2015. The decrease reflects lower professional fees partially offset by higher compensation driven by increased headcount and incentive compensation. Professional fees, which consist primarily of legal and accounting fees declined due primarily to the elevated levels of fees in the prior year related to our delayed SEC filings, additional audit fees and costs associated with remediation of our internal control environment. Additionally, we have made a concerted effort to contain professional fees in 2016.

Income from operations and net income

The company reported income from operations of \$4,852 during the nine months ended September 30, 2016, compared to \$3,511 during the same period in 2015. Provision for income taxes was \$1,476, or a 33.0% effective rate during nine months ended September 30, 2016, compared to a provision for income taxes of \$1,697 or a 50.8% effective tax rate, during the same period in 2015. During the nine months ended September 30, 2016 we recognized an income tax benefit of \$265 as a result of the favorable settlement of uncertain tax positions, which reduced the effective tax rate by 5.9%. During the nine months ended September 30, 2015 we incurred certain operating expenses that were not fully deductible for federal income tax purposes, which increased the effective tax rate by 8.1%. Income taxes are discussed in Note 10 in the Notes to the Consolidated Financial Statements.

Net income was \$2,998 or \$0.19 per basic and diluted common share for the nine-month period ended September 30, 2016 compared to \$1,645 or \$0.10 per basic and diluted common share in the same period in 2015.

Liquidity and Capital Resources

Sources and Uses of Cash

We anticipate foreseeable liquidity and capital resource requirements to be met through operating cash flows; long term and short term borrowings, and cash and cash equivalents. We continue to explore potential acquisition opportunities in our industry in order to boost sales while leveraging our manufacturing and distribution capabilities.

Net cash provided by operating activities was \$4,513 during the nine months ended September 30, 2016 compared to net cash provided by operating activities of \$4,378 in the same period in 2015. The increase in cash provided by operating activities reflects higher profitability partially offset by increased inventory levels attributable to the expansion of our Waukesha production levels; increased receivable balances reflecting the year over year sales growth and the unfavorable timing of payments to suppliers and service providers in 2016.

Net cash provided by investing activities was \$373 during the nine -months ended September 30, 2016 compared to net cash used in investing activities of \$1,800 in the same period in 2015. The lower level of net cash used in investing activities reflects liquidity provided from our investments. During the third quarter of 2016, we liquidated

our investment portfolio to generate cash for general corporate purposes. Capital spending was \$2,481 during the nine-months ended September 30, 2016 compared to \$1,619 in the same period in 2015 reflecting our continuing investments in new productive equipment.

- 23 -

Net cash used in financing activities was \$1,368 during the nine-months ended September 30, 2016 compared to net cash used in financing activities of \$827 in the same period in 2015. We repurchased 69 shares of common stock at a cost of \$738 in the nine months ended September 30, 2016. There were no share repurchases in the same period in 2015. On September 24, 2015, the Company's Board of Directors authorized a stock repurchase program under which the Company may repurchase up to \$3,500 of common stock not to exceed an aggregate of 250 shares.

Approximately \$1,200 remained available under this authorized program as of September 30, 2016. The repurchase program has no expiration date and may be suspended or discontinued at any time.

The Company had a net increase in cash and cash equivalents of \$3,518 during the nine-month period ended September 30, 2016 compared to a net increase in cash and cash equivalents of \$1,751 in the same period in 2015.

At September 30, 2016, the Company had \$840 of current maturities of notes payable. The Company also has a \$5 million revolving credit facility with The Private Bank. This facility remained unused at September 30, 2016, is available for general corporate purposes and expires in July 2017.

The company is in compliance with the covenants contained in its loan agreements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

For information regarding our exposure to certain market risk, see Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in the Form 10-K. There have been no significant changes in our market risk exposures from the 2015 year-end.

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures

Our evaluation of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act was performed under the supervision and with the participation of our senior management, including our Chief Executive Officer and Chief Financial Officer. The purpose of disclosure controls and procedures is to ensure that information required to be disclosed in the reports 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 management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

As previously disclosed under "Item 9A—Controls and Procedures" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and under "Item 4 – Controls and Procedures" in our Quarterly Report on Form 10-Q/A for the three months ended March 31, 2016, we concluded that our internal control over financial reporting was not effective based on the material weaknesses identified. Based on those material weaknesses, which we view as an integral part of our disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the quarter ended September 30, 2016, our disclosure controls and procedures were not effective. Nevertheless, based on a number of factors, including the performance of additional procedures by management designed to ensure the reliability of our financial reporting, we believe that the consolidated financial statements in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial position, results of operations and cash flows for the periods presented in conformity with GAAP.

(b) Changes in Internal Control over Financial Reporting

Our remediation efforts were ongoing during the three months ended September 30, 2016. Remediation generally requires making changes to how controls are designed and implemented and then adhering to those changes for a sufficient period of time such that the effectiveness of those changes is demonstrated with an appropriate amount of

consistency. We have taken certain remediation steps to address the material weaknesses referenced above and to improve our control over financial reporting. If not remediated these deficiencies could result in material misstatements to our consolidated financial statements.

In addition to the actions previously disclosed under "Item 9A—Controls and Procedures" in our Form 10-K, our remediation initiatives summarized below, are intended to further address our specific material weaknesses and to continue to enhance our internal control over financial reporting.

- 24 -

Management's Remediation Initiatives

Our leadership team remains committed to achieving and maintaining a strong control environment, high ethical standards and financial reporting integrity. This commitment continues to be communicated to and reinforced with our employees.

We continue to foster awareness and understanding of standards and principles for accounting and financial reporting. This includes the implementation and clarification of specific accounting policies and procedures.

We continue to enhance the development, communication, and monitoring of processes and controls to ensure that appropriate account reconciliations and journal entry controls are performed, documented, and reviewed as part of our standardized procedures.

We continue to improve the planning, coordination, communication and discipline in our period-end closing and financial statement preparation process in order to increase both its effectiveness and efficiency.

The audit committee of our board of directors has maintained an elevated frequency and depth of its discussions with management regarding financial reporting and internal control matters.

During the three months ended March 31, 2016 we took the following actions to improve our internal controls over financial reporting:

We in-sourced our fixed asset system and related transaction processing from a third party service provider, enabling the transacting of fixed asset additions and depreciation journal entries earlier in our quarterly close process.

We consolidated our income tax accounting services and income tax return preparation under a single third party service provider. Consolidating these activities into a single service provider enhances our ability to close the books on timely and accurate basis.

During the three months ended June 30, 2016 we took the following actions to improve our internal controls over financial reporting:

We have increased the size and capabilities of our finance and accounting functions by establishing a new role that oversees financial planning and analysis. Our former corporate controller has begun transitioning into this new role. Also, in July 2016 we hired a new corporate controller with significant public accounting and financial reporting experience who has begun transitioning into his role.

We have implemented a management disclosure committee of representatives from our finance, accounting, and legal departments to enhance the review and operation of our disclosure controls and procedures. From time to time, we will supplement the committee with members from other areas of our management team and business, including our outsourced internal audit and investor relations functions.

We have centralized our payroll processing activities from three locations down to one. The centralization improves management's oversight and better segregates time and attendance activities from payroll processing activities.

We have updated and expanded our whistleblower policy and retained a new third-party service provider to manage the administrative aspects of our whistleblower hotline.

We have formalized our contract approval process. The formalized process establishes explicit levels of authority for contract approval and requires specific levels of review. The improved process includes a documented policy and enabling technology that will enhance governance over significant contracts.

During the three months ended September 30, 2016 we took the following actions to improve our internal controls over financial reporting:

o We continued to transition our controllership responsibilities to our recently hired corporate controller.

We implemented additional procedures in our inventory accounting process, including expanded analytical reviews over our priced-out physical inventory, expanded completeness testing of the priced out physical inventory, expanded reviews of the accuracy of our bill of materials (BOM's) and expanded analytical reviews of gross margin.

o Our management disclosure committee continued to meet formally and informally in tandem with our third quarter reporting process.

o During the third quarter, we also put additional formality into our disclosure controls by establishing a cascaded certification process. While our existing policies create a foundation for organizational transparency, our cascaded certification process goes a step further by requiring key managers to inform the certifying officers in a structured way of any accounting or reporting matters in their areas of responsibility that could be relevant to such filings.

There were no other material changes in our internal control over financial reporting that occurred during the three months ended September 30, 2016 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

We are a party to various lawsuits, proceedings, and other matters arising out of the conduct of our business. Currently, it is management's opinion that the ultimate resolution of these matters will not have a material adverse effect on our business, financial condition, results of operation, or cash flows.

ITEM 1A. RISK FACTORS.

There have been no material changes to the Risk Factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and our Quarterly Report on Form 10-Q/A for the fiscal quarter ended March 31, 2016.

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

Issuer Purchases of Equity Securities

| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of a publicly announced program (a) | Approximate Dollar Value of Shares that may yet be Purchased Under the Plans or Programs (\$ in thousands) |
|-----------------------|----------------------------------|------------------------------|--|--|
| 7/1/2016 to 7/31/2016 | — | \$ — | — | \$ 1,214 |
| 8/1/2016 to 8/30/2016 | — | \$ — | — | \$ 1,214 |
| 9/1/2016 to 9/30/2016 | — | \$ — | — | \$ 1,214 |
| Total | — | \$ — | — | \$ 1,214 |

During the fourth quarter of 2015, the company had a publicly announced share repurchase program. Under this (a) program, which was announced on September 24, 2015, the company's Board of Directors authorized the purchase of up to \$3.5 million of company stock. The program has no expiration date.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. MINE SAFETY DISCLOSURE.

Not applicable.

- 27 -

ITEM 5. OTHER INFORMATION.

Item 5.02 Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers.

(i) On November 7, 2016, the Board of Directors of Lifeway Foods, Inc. (the "Company") appointed Douglas A. Hass to serve as General Counsel and Assistant Corporate Secretary, effective November 7, 2016.

Douglas A. Hass, 40, has more than twenty years of legal, management, and operations experience, centered on technology-intensive businesses. He joined the Company as Legal Counsel in March 2016 having most recently served as an attorney at international law firm DLA Piper LLP (US) where he advised and represented a wide range of public and privately-held manufacturers and technology companies on labor and employment law, technology/new media issues, intellectual property and restrictive covenants, and associated corporate law and litigation issues. Prior to joining DLA Piper, Mr. Hass practiced law in Chicago, where he represented federal and state government and private-sector clients in a variety of labor and employment, corporate, and litigation matters. From 1998 until 2006, Mr. Hass was Chief Operations Officer at ImageStream, a multinational telecommunications and Internet networking equipment manufacturer. Prior to 1998, Mr. Hass was Vice President and Partner at Skye/net, a major Midwest-based Internet service provider. Mr. Hass also founded country music website Roughstock.com.

Mr. Hass has been named one of Illinois' "40 under 40 Attorneys to Watch" by Chicago Lawyer Magazine, selected from thousands of attorney and law professor nominees from across the state. He was also named a Rising Star by SuperLawyers for Illinois in labor and employment, has published more than a dozen articles in law journals and other publications, and has been a frequent invited speaker on a range of topics at legal and telecommunications industry conferences. He holds a Juris Doctor from Indiana University Maurer School of Law in Bloomington, Indiana.

Employment Agreements

On March 5, 2016, the Company entered into an employment agreement with Mr. Hass. Beginning in 2016, Mr. Hass began earning an annual base salary of \$315,000. Mr. Hass's base salary is subject to annual review by the Board. The employment agreement also allows for an annual incentive payment of ten percent (10%) of his base salary based on the satisfaction of certain pre-established performance goals established by the Board. Mr. Hass is also eligible for certain equity and other long-term incentive awards, in the sole discretion of the Board. The Company may terminate Mr. Hass's employment for any lawful reason.

The foregoing descriptions of Mr. Hass's employment agreement are qualified in their entirety by reference to the full text of Mr. Hass's employment agreement, which is attached hereto as Exhibit 10.1, and incorporated herein by reference.

Family Relationships

There is no family relationship between Mr. Hass and any director or executive officer of the Company.

Related Party Transactions

Mr. Hass has no direct or indirect material interest in any transaction required to be disclosed pursuant to Item 404(a) of Regulation S-K.

ITEM 6. EXHIBITS.

- 10.1 Employment Agreement dated March 5, 2016 with Douglas A. Hass
- 31.1 Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1* Press release dated November 9, 2016 reporting the Company's financial results for the nine months ended September 30, 2016.
- 101 Interactive Data Files.

* This exhibit is furnished and will not be deemed "filed."

SIGNATURES

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

LIFEWAY FOODS, INC.

Date: November 9, 2016 By: /s/ Julie Smolyansky
Julie Smolyansky
Chief Executive Officer, President, and Director
(Principal Executive Officer)

Date: November 9, 2016 By: /s/ John P. Waldron
John P. Waldron
Chief Financial Officer
(Principal Financial and Accounting Officer)

INDEX OF EXHIBITS

- 10.1 Employment Agreement dated March 5, 2016 with Douglas A. Hass

- 31.1 Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 31.2 Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- 99.1* Press release dated November 9, 2016 reporting the Company's financial results for the nine months ended September 30, 2016.

- 101 Interactive Data Files.

* This exhibit is furnished and will not be deemed "filed."