

LIFEWAY FOODS INC  
Form 10-Q  
September 30, 2015

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

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(Mark  
One)

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

For the quarterly period ended: June 30, 2015

- 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

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

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Illinois  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

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

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

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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	Smaller reporting
<input type="radio"/>	<input checked="" type="radio"/>	filer <input type="radio"/>	company <input type="radio"/>

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 September 24, 2015, 16,346,017 shares of the registrant’s common stock, no par value, were outstanding.

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LIFEWAY FOODS, INC.

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1.	Financial Statements.	3
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations.	18
Item 3.	Quantitative and Qualitative Disclosures About Market Risk.	23
Item 4.	Controls and Procedures.	24

PART II – OTHER INFORMATION

Item 1.	Legal Proceedings.	25
Item 1 A.	Risk Factors.	25
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds.	25
Item 3.	Defaults Upon Senior Securities.	25
Item 4.	Mine Safety Disclosure.	25
Item 5.	Other Information.	25
Item 6.	Exhibits.	25
	Signatures.	26
	Index of Exhibits.	27

## ITEM 1. FINANCIAL STATEMENTS.

LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Financial Condition  
June 30, 2015 and December 31, 2014

	June 30, 2015 (Unaudited)	December 31, 2014
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 5,873,079	\$ 3,260,244
Investments, at fair value	2,849,752	2,779,140
Certificates of deposits in financial institutions	434,981	149,965
Inventories	6,289,816	5,814,219
Accounts receivable, net of allowance for doubtful accounts and discounts of \$2,100,000 and \$1,050,000 at June 30, 2015 and December 31, 2014, respectively	10,349,813	10,213,541
Prepaid expenses and other current assets	113,751	251,922
Other receivables	28,794	134,338
Deferred income taxes	451,198	408,340
Refundable income taxes	741,302	1,140,796
Total current assets	27,132,486	24,152,505
Property and equipment, net	21,974,931	21,892,395
Intangible assets		
Goodwill	14,068,091	14,068,091
Other intangible assets, net	2,701,925	3,059,764
Total intangible assets	16,770,016	17,127,855
Other Assets		
Long-term accounts receivable, net of current portion	267,458	251,683
Total assets	\$ 66,144,891	\$ 63,424,438
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Current maturities of notes payable	\$ 840,000	\$ 872,285
Accounts payable	5,725,222	5,586,755
Accrued expenses	4,702,762	2,066,076
Accrued income taxes	14,600	—
Total current liabilities	11,282,584	8,525,116

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Notes payable	7,539,328	8,124,515
Deferred income taxes	1,812,296	2,075,095
Total liabilities	20,634,208	18,724,726
Stockholders' equity		
Common stock, no par value; 40,000,000 shares authorized; 17,273,776 shares issued; 16,346,017 shares outstanding at June 30, 2015 and December 31, 2014	6,509,267	6,509,267
Paid-in-capital	2,032,516	2,032,516
Treasury stock, at cost	( 8,187,682)	( 8,187,682)
Retained earnings	45,296,249	44,543,618
Accumulated other comprehensive loss, net of taxes	( 139,667)	( 198,007)
Total stockholders' equity	45,510,683	44,699,712
Total liabilities and stockholders' equity	\$ 66,144,891	\$ 63,424,438

See accompanying notes to consolidated financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Income and Comprehensive Income  
For the Three Months and Six Months Ended June 30, 2015 and 2014  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Gross sales	\$ 36,291,842	\$ 32,594,048	\$ 69,394,925	\$ 64,655,195
Less: discounts and promotional allowances	(6,470,654)	(3,028,637)	(9,951,613)	(5,958,073)
Net sales	29,821,188	29,565,411	59,443,312	58,697,122
Cost of goods sold	22,201,129	21,432,624	42,849,096	43,114,535
Depreciation expense	604,531	627,878	1,195,158	1,411,238
Total cost of goods sold	22,805,660	22,060,502	44,044,254	44,525,773
Gross profit	7,015,528	7,504,909	15,399,058	14,171,349
Selling expenses	2,617,399	3,693,821	6,779,802	7,173,509
General and administrative	4,170,155	2,107,197	6,802,051	4,487,827
Amortization expense	178,920	178,919	357,839	357,839
Total operating expenses	6,966,474	5,979,937	13,939,692	12,019,175
Income from operations	49,054	1,524,972	1,459,366	2,152,174
Other income (expense):				
Interest and dividend income	35,739	35,227	61,218	63,925
Rental income	1,800	1,200	3,600	1,700
Interest expense	(58,429)	(66,724)	(123,770)	(132,293)
(Loss)/Gain on sale of investments, net reclassified from OCI	(16,844)	57,321	(21,937)	62,130
Gain on sale of property and equipment	207,083	(76,484)	243,083	(76,484)
Other income (expense), net	136	1,672	(98,796)	1,672
Total other income (expense)	169,485	(47,788)	63,398	(79,350)
Income before provision for income taxes	218,539	1,477,184	1,522,764	2,072,824
Provision for income taxes	119,626	807,768	770,133	1,106,229
Net income	\$ 98,913	\$ 669,416	\$ 752,631	\$ 966,595
Basic and diluted earnings per common share	\$ 0.01	\$ 0.04	\$ 0.05	\$ 0.06

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Weighted average number of common shares outstanding	16,346,017	16,346,017	16,346,017	16,346,017
<b>COMPREHENSIVE INCOME</b>				
Net income	\$ 98,913	\$ 669,416	\$ 752,631	\$ 966,595
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on investments (net of tax)	( 18,215)	63,111	(64,475)	71,155
Less reclassification adjustment for (gains) losses and other than temporary impairments included in net income (net of taxes)	10,435	( 34,393)	122,815	( 37,110)
Comprehensive income	\$ 91,133	\$ 698,134	\$ 810,971	\$ 1,000,640

See accompanying notes to consolidated financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Changes in Stockholders' Equity  
For the Six Months Ended June 30, 2015 and 2014  
(Unaudited)

	Common Stock				Paid In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Total Equity
	Issued		In treasury					
	Shares	\$	Shares	\$				
Balances at December 31, 2013	17,273,776	\$ 6,509,267	(927,759)	\$ (8,187,682)	\$ 2,032,516	\$ 42,587,214	\$ 7,807	\$ 42,949,122
Other comprehensive income	—	—	—	—	—	—	34,045	34,045
Net income for the six months ended June 30, 2014	—	—	—	—	—	966,595	—	966,595
Balances at June 30, 2014	17,273,776	\$ 6,509,267	(927,759)	\$ (8,187,682)	\$ 2,032,516	\$ 43,553,809	\$ 41,852	\$ 43,949,762
Balances at December 31, 2014	17,273,776	\$ 6,509,267	(927,759)	\$ (8,187,682)	\$ 2,032,516	\$ 44,543,618	\$ (198,007)	\$ 44,699,712
Other comprehensive income	—	—	—	—	—	—	58,340	58,340
Net income for the six months ended June 30, 2015	—	—	—	—	—	752,631	—	752,631
Balances at June 30, 2015	17,273,776	\$ 6,509,267	(927,759)	\$ (8,187,682)	\$ 2,032,516	\$ 45,296,249	\$ (139,667)	\$ 45,510,683

See accompanying notes to consolidated financial statements





LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
For the Six Months Ended June 30, 2015 and 2014  
(Unaudited)

	June 30,	
	2015	2014
Cash flows from operating activities:		
Net income	\$ 752,631	\$ 966,595
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	1,552,997	1,769,077
Loss (gain) on sale of investments, net	21,937	(62,130)
Impairment of investments	179,500	—
Deferred income taxes	(351,818)	(440,285)
Bad debt expense	250	156,049
Gain on sale of property and equipment	(243,083)	76,484
(Increase) decrease in operating assets:		
Accounts receivable	(166,829)	728,281
Other receivables	105,544	46,591
Inventories	(475,597)	88,467
Refundable income taxes	399,494	(562,986)
Prepaid expenses and other current assets	138,171	(28,125)
Increase (decrease) in operating liabilities:		
Accounts payable	138,467	(1,972,157)
Accrued expenses	2,636,686	1,336,163
Accrued income taxes	14,600	—
Net cash provided by operating activities	4,702,950	2,102,024
Cash flows from investing activities:		
Purchases of investments	(1,286,664)	(1,774,734)
Proceeds from sale of investments	1,133,647	1,419,362
Redemption of certificates of deposits	99,965	15,000
Investments in certificates of deposits	(384,981)	—
Purchases of property and equipment	(1,377,390)	(1,761,401)
Proceeds from sale of property and equipment	342,780	4,000
Net cash used in investing activities	(1,472,643)	(2,097,773)
Cash flows from financing activities:		
Repayment of notes payable	(617,472)	(441,221)
Net cash used in financing activities	(617,472)	(441,221)
Net (decrease) increase in cash and cash equivalents	2,612,835	(436,970)
Cash and cash equivalents at the beginning of the period	3,260,244	3,306,608
Cash and cash equivalents at the end of the period	\$ 5,873,079	\$ 2,869,638
	\$ 1,120,000	\$ 2,109,500

Supplemental cash flow information

Cash paid for income taxes

Cash paid for interest \$ 124,043 \$ 132,415

See accompanying notes to consolidated financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

Note 1 – NATURE OF BUSINESS

Lifeway Foods, Inc. (the “Company” or “Lifeway”), an Illinois corporation, commenced operations in February 1986, and was incorporated under the laws of the State of Illinois on May 19, 1986. The Company’s principal business activity is the manufacturing of probiotic, cultured, functional dairy health food products. Lifeway’s primary product is kefir, a dairy beverage similar to but distinct from yogurt, in several flavors and in several packages. In addition to kefir, Lifeway manufactures “Lifeway Farmer Cheese,” a line of various farmer cheeses. Lifeway distributes its products throughout the United States and in London, England. The Company manufactures all of its products distributed in the United States at Company-owned facilities. In the Chicago metropolitan area, Lifeway distributes its products on its own trucks and via distributors. The Company directly distributes its products in the Philadelphia and Tri State metropolitan areas using its own trucks. The Company distributes its products throughout the remainder of the United States via distributors. The Company’s products distributed in London are manufactured and shipped to stores by a third party co-packer. Products sold by the Company to distributors in the United States may be resold by such distributors within or outside of the United States, including in Mexico, Costa Rica and the Caribbean. The Company’s products are also manufactured and distributed in Canada by a third party co-packer.

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Corrections of prior period financial statements

As reported in the Company’s fiscal 2014 annual report on Form 10-K, the Company recorded out-of-period adjustments during fiscal 2014 to correct the accounting for certain errors related primarily to the provision for income taxes and an understatement of depreciation expense arising from assigning incorrect useful lives. The Company has revised its previously issued interim consolidated financial statements to correct for these matters. The adjustments decreased previously reported second quarter net income by approximately \$425,000.

There was no impact to quarterly cash flows in 2014 as the increase in net income was offset by the decrease in the non-cash reconciling items for depreciation expense and refundable income taxes. The Company does not believe that these adjustments are material to the results of operations, financial position or cash flows for any of its previously filed interim consolidated financial statements. Accordingly, the June 30, 2014 interim consolidated financial statements included herein have been revised to reflect the adjustments discussed above. The Company will also revise its 2014 third quarter financial statements prospectively within its 2015 third quarter interim consolidated Quarterly Report on Form 10-Q.

The net-of-tax effect of these adjustments decreases the Company’s previously reported 2014 earnings per common and diluted share by \$0.02 for the quarter ended March 31, 2014, \$0.03 for the quarter ended June 30, 2014 and increases the Company’s 2014 earnings per common and diluted share by \$0.05 for the quarter ended December 31, 2014.

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 for the year ended December 31, 2014.

Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Helios Nutrition, Ltd., Pride of Main Street, L.L.C., Starfruit, L.L.C., Fresh Made, Inc. and Starfruit Franchisor, L.L.C. and Lifeway Wisconsin, Inc. Lifeway Wisconsin, Inc. was created to facilitate the operation of a production facility in Wisconsin. All significant intercompany accounts and transactions have been eliminated.

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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 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 taxes.

Revenue Recognition

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

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 at the end of each period for the estimated allowances incurred but unpaid. Differences between estimated and actual allowances are normally insignificant and are recognized in earnings 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 gross sales.

Customer Concentration

Sales are predominately to companies in the retail food industry, located within the United States of America. Two major customers accounted for approximately 29% and 29% of gross sales for the six months ended June 30, 2015 and 2014, respectively. Two major customers accounted for approximately 27% and 29% of gross sales for the three months ended June 30, 2015 and 2014, respectively.

Cash and cash equivalents

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

Investments

All investment securities are classified as available-for-sale and are carried at fair value. Unrealized gains and losses on available-for-sale securities are reported as a separate component of stockholders' equity to the extent they are considered temporary in nature. Amortization, accretion, interest and dividends, realized gains and losses, and declines in fair value judged to be other-than-temporary on available-for-sale securities are recorded as a component

of other income. All of the Company's securities are subject to a periodic impairment evaluation. This evaluation depends on the specific facts and circumstances. Factors that we consider in determining whether an other-than-temporary decline in fair value has occurred include: the fair value of the security in relation to its carrying amount; the financial condition of the investee; and the intent and ability to retain the investment for a sufficient period of time to allow for possible recovery in the fair value of the investment.

- 8 -

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LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

Note 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

Accounts receivable

Credit terms are extended to customers in the normal course of business. The Company performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral. Balances expected to be collected beyond one year are classified as long-term.

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

Inventories

Inventories are stated at the lower of cost or market. Our products are valued using the first in, first out method. The costs of inventories include raw materials, direct labor and indirect production and overhead costs.

Property and equipment

Property and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the related assets. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred; significant renewals and betterments are capitalized.

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

Category	Years
Buildings and improvements	31 and 39
Machinery and equipment	5 – 12
Office equipment	5 – 7
Vehicles	5
Leasehold improvements	Shorter of expected useful life or lease term

Intangible assets acquired in business combinations

Intangible assets acquired in a business combination are recorded at their estimated fair values at the date of acquisition.

Goodwill represents the excess purchase price over the fair value of the net tangible and other identifiable intangible assets acquired. Goodwill is not amortized, but is reviewed for impairment at least annually. The Company amortizes



other intangible assets over their estimated useful lives, as disclosed in the table below.

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

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

LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements  
June 30, 2015 and December 31, 2014

(Unaudited)

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

Intangible assets are being amortized over the following useful lives:

Category	Years
Recipes	4
Trade names	8-15
Formula	10
Customer relationships	8-12

## Income taxes

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

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

The Company has analyzed filing positions in all of the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. Periods subject to examination for the Company's federal returns are the 2012, 2013 and 2014 tax years. The amount of unrecognized tax benefits that, if recognized, would impact the annual effective tax rate was not significant as of June 30, 2015 and December 31, 2014. The total amount of unrecognized tax benefits can change due to audit settlements, tax examination activities, statute expirations and the recognition and measurement criteria under accounting for uncertainty in income taxes.

## Treasury stock

Treasury stock is recorded using the cost method.

## Advertising and promotional costs

The Company expenses advertising costs as incurred. For the six months ended June 30, 2015 and 2014 total advertising expenses were \$2,741,835 and \$1,824,524 respectively. For the three months ended June 30, 2015 and 2014 total advertising expenses were \$867,297 and \$1,006,016 respectively.

## Earnings per common share

Earnings per common share were computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. For the three and six months ended June 30, 2015 and 2014 the weighted average number of shares outstanding used in the calculation of diluted and basic earnings per share were the same.

Segments

The Company has two separate operating segments, the sale of fermented dairy products and three retail locations in Illinois that sell the Company's fermented dairy products. The Company has determined reportable segments 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 performance of the operating segments, has been identified as the Chief Financial Officer and the board of directors that makes strategic decisions. 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 consumer retail food sellers through direct delivery and distributors in the United States.

- 10 -

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## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

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

## Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”), which supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, including most industry-specific requirements. ASU 2014-09 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. ASU 2014-09 also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. In August 2015 the FASB delayed the effective date for implementation of ASU 2014-09. Under the delayed effective date, the Company is required to adopt the new standard not later than January 1, 2018. Management is currently evaluating the impact the adoption of ASU 2014-09 will have on the Company’s consolidated financial position, results of operations or cash flows and the method of retrospective application, either full or modified.

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.

## Note 3 – INTANGIBLE ASSETS

Intangible assets, net consists of the following:

	June 30, 2015	As of December 31, 2014
Recipes	\$ 43,600	\$ 43,600
Customer lists and other customer related intangibles	4,529,200	4,529,200
Customer relationship	985,000	985,000
Trade names	2,248,000	2,248,000
Formula	438,000	438,000
Subtotal	8,243,800	8,243,800
Accumulated amortization	(5,541,875)	(5,184,036)
Intangible assets, net	\$ 2,701,925	\$ 3,059,764

## Note 4 – INVESTMENTS

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

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June 30, 2015	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Common Stocks & ETF's	\$ 1,027,735	\$ 22,941	\$ (66,129)	\$ 984,547
Mutual Funds	58,102	0	(4,916)	53,186
Preferred Securities	97,405	675	0	98,080
Corporate Bonds	1,887,218	9,885	(183,164)	1,713,939
Total	\$ 3,070,460	\$ 33,501	\$ (254,209)	\$ 2,849,752

- 11 -

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## LIFEWAY FOODS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

## Note 4 – INVESTMENTS – Continued

December 31, 2014	Cost	Unrealized Gains	Unrealized Losses	Fair Value
Common Stocks & ETF's	\$ 530,328	\$ 19,608	\$ (64,046)	\$ 485,890
Mutual Funds	445,337	0	(10,624)	434,713
Preferred Securities	180,120	195	(2,075)	178,240
Corporate Bonds	1,948,596	1,880	(270,179)	1,680,297
Total	\$ 3,104,381	\$ 21,683	\$ (346,924)	\$ 2,779,140

Proceeds from the sale of investments were \$1,133,647 and \$1,419,362 for the six months ended June 30, 2015 and 2014, respectively. Proceeds from the sale of investments were \$440,424 and \$864,753 for the three months ended June 30, 2015 and 2014, respectively.

Gross gains of \$13,047 and \$34,984 and gross losses of \$80,822 and \$151,472 were realized on these sales during the six months ended June 30, 2015 and 2014, respectively. Gross gains of \$7,545 and \$15,333 and gross losses of \$70,227 and \$136,629 were realized on these sales during the three months ended June 30, 2015 and 2014, respectively.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2015 and December 31, 2014:

June 30, 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	\$ 419,655	\$ (39,292)	\$ 157,897	\$ (26,837)	\$ 577,552	\$ (66,129)
Mutual Funds	47,858	(3,204)	5,328	(1,712)	53,186	(4,916)
Preferred Securities	0	0	0	0	0	0
Corporate Bonds	692,965	(61,201)	749,771	(121,963)	1,442,736	(183,164)
	\$ 1,160,478	\$ (103,697)	\$ 912,996	\$ (150,512)	\$ 2,073,474	\$ (254,209)

December 31, 2014	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	\$ 162,268	\$ (49,053)	\$ 141,417	\$ (14,993)	\$ 303,685	\$ (64,046)
Mutual Funds	434,713	(10,624)	0	0	434,713	(10,624)
Preferred Securities	80,640	(2,075)	0	0	80,640	(2,075)

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Corporate Bonds	1,056,140	(194,641)	497,277	(75,538)	1,553,417	(270,179)
	\$ 1,733,761	\$ (256,393)	\$ 638,694	\$ (90,531)	\$ 2,372,455	\$ (346,924)

The Company's investments in equity securities, mutual funds, preferred securities, and corporate bonds consist of investments in common stock, preferred stock, structured notes and other debt securities of companies in various industries. During the first quarter of 2015, the Company recorded other-than-temporary impairment losses of approximately \$180,000 with respect to three structured notes. The impairment loss is included in "other income (expense), net" in the accompanying consolidated statements of income and comprehensive income. The structured notes allow the issuer to settle at 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

- 12 -

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## LIFEWAY FOODS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

## Note 4 – INVESTMENTS – Continued

issuers would have the ability to settle the bonds for an amount less than par value at maturity. With respect to one other corporate bond with unrealized losses greater than 12 months, the Company evaluated the near-term prospects of the issuer in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company did not consider the investment to be other-than-temporarily impaired at June 30, 2015.

## Note 5 – INVENTORIES

Inventories consist of the following:

	June 30, 2015	December 31, 2014
Finished goods	\$ 1,820,587	\$ 2,373,476
Production supplies	2,565,425	2,069,742
Raw materials	1,903,804	1,371,001
Total inventories	\$ 6,289,816	\$ 5,814,219

## Note 6 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	June 30, 2015	December 31, 2014
Land	\$ 1,756,673	\$ 1,856,370
Buildings and improvements	16,417,110	15,125,803
Machinery and equipment	22,697,235	20,434,910
Vehicles	1,310,527	1,244,560
Office equipment	602,087	465,801
Construction in process	30,260	2,408,754
	42,813,892	41,536,198
Less accumulated depreciation	20,838,961	19,643,803
Total property and equipment	\$ 21,974,931	\$ 21,892,395

## Note 7 – ACCRUED EXPENSES

Accrued expenses consist of the following:

June 30, 2015	December 31, 2014
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Accrued payroll and payroll taxes	\$	1,201,895	\$	891,763
Accrued property tax		352,169		331,278
Other		3,148,698		843,035
	\$	4,702,762	\$	2,066,076

- 13 -

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LIFEWAY FOODS, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements  
June 30, 2015 and December 31, 2014

(Unaudited)

## Note 8 – NOTES PAYABLE

Notes payable consist of the following:

	June 30, 2015	December 31, 2014
Note payable to Private Bank in monthly installments of \$42,222, plus variable interest rate (currently 2.67%) with a balloon payment for the remaining balance. Collateralized by substantially all assets of the Company. Maturity date - May 31, 2018.	\$ 4,098,889	\$ 4,352,222
Note payable to Private Bank in monthly installments of \$27,778, plus variable interest rate (currently 2.67%) with a balloon payment for the remaining balance, maturing on May 31, 2019, collateralized by substantially all assets of the Company.	4,280,439	4,583,333
Notes payable to Ford Credit Corp. payable in monthly installments of \$1,778 at 5.99%, paid in March 2015.	—	12,198
Note payable to Fletcher Jones of Chicago, Ltd LLC in monthly installments of \$1,769 at 6.653%, paid in March 2015.	—	49,047
Total notes payable	8,379,328	8,996,800
Less current maturities	840,000	872,285
Total long-term portion	\$ 7,539,328	\$ 8,124,515

In accordance with the Private Bank agreements referenced above, the Company is subject to minimum fixed charged ratio and tangible net worth thresholds. The Company was in compliance with these financial covenants at June 30, 2015. Further, the Company is required to deliver its annual and quarterly consolidated financial statements and related SEC filings within specified timeframes. Due to the Company's delay in completing such filings the Company obtained waivers as further discussed in Note 14.

In addition, as of June 30, 2015 the Company had a \$5 million revolving credit facility with The Private Bank. Borrowings under the facility were subject to interest at the prime rate or LIBOR plus 2.5%. At June 30, 2015 there were no borrowings under the facility. The facility expires on July 31, 2016.

Maturities of notes payables are as follows:

For the 12 Months Ended June 30, 2016	\$ 840,000
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2017		840,000
2018		840,000
2019		2,912,233
2020		2,947,095
Total	\$	8,379,328

LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

Note 9 – COMMITMENTS AND CONTINGENCIES

The Company leases three stores for its Starfruit subsidiary. Total expense for these leases was \$134,733 and \$150,566 for the six months ended June 30, 2015 and 2014, respectively. The Company is also responsible for additional rent equal to real estate taxes and other operating expenses. Future annual minimum base rental payments for the leases as of June 30, 2015 are approximately as follows:

For the 12 months ending June 30,		
2016	\$	73,000
2017		75,000
2018		63,000
2019		29,000
Total	\$	240,000

Note 10 – PROVISION FOR INCOME TAXES

The effective tax rate for the three and six months ended June 30, 2015 was 54.7% and 50.6% respectively compared to 54.7% and 53.4% respectively for the three and six months ended March 31, 2014. The difference between the statutory and effective tax rate reflects certain operating expenses that are not fully deductible for federal income tax purposes.

Note 11 – FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

Following is a description of the valuation methodologies used for assets measured at fair value on a recurring basis. There have been no changes in the methodologies used as of June 30, 2015 and December 31, 2014.

- 15 -

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## LIFEWAY FOODS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

## Note 11 – FAIR VALUE MEASUREMENTS – Continued

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, is based on other observable inputs, specifically a valuation model which utilized vendor pricing for similar securities.

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

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 June 30, 2015 and December 31, 2014. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

	Assets and Liabilities at Fair Value as of June 30, 2015				Total
	Level 1	Level 2	Level 3		
Mutual Funds	\$ 53,186	\$ —	\$ —	\$ —	53,186
Common Stocks & ETF's	984,547	—	—	—	984,547
Preferred Securities	—	98,080	—	—	98,080
Corporate Bonds	—	1,629,219	84,720	—	1,713,939

	Assets and Liabilities at Fair Value as of December 31, 2014				Total
	Level 1	Level 2	Level 3		
Mutual Funds	\$ 434,713	\$ —	\$ —	\$ —	434,713
Common Stocks & ETF's	485,890	—	—	—	485,890
Preferred Securities	—	178,240	—	—	178,240
Corporate Bonds	—	1,680,297	—	—	1,680,297

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 and notes payable for which carrying value approximates fair value.

## Note 12 – LITIGATION

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

Note 13 – SEGMENTS AND PRODUCTS

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 packages. In addition to the drinkable products, Lifeway manufactures "Lifeway Farmer Cheese," a line of various farmer cheeses.

- 16 -

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## LIFEWAY FOODS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2015 and December 31, 2014

(Unaudited)

## Note 13 – SEGMENTS AND PRODUCTS – Continued

Net sales of products by category for the six months ended June 30 were as follows:

	Six months ended June 30,		Three months ended June 30,	
	2015	2014	2015	2014
Drinkable Kefir other than				
ProBugs	\$50,821,289	\$50,651,559	\$25,233,948	\$25,563,748
Pro Bugs	4,296,976	3,683,935	2,290,905	1,820,038
Lifeway Farmer Cheese	3,464,377	3,367,789	1,741,985	1,681,601
Frozen Kefir	860,670	993,839	554,350	500,024
Net Sales	\$59,443,312	\$58,697,122	\$29,821,188	\$29,565,411

The Company has two operating segments, the sale of fermented dairy products and three retail locations in Illinois that sell the Company's fermented dairy products. The Company has determined reportable segments 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 performance of the operating segments, has been identified as the Chief Financial Officer and the board of directors that makes strategic decisions. 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 consumer retail food sellers through direct delivery and distributors in the United States.

The Company has less than \$1 million in revenues attributable to its retail locations during the three and six months ended June 30, 2015 and 2014. The annual revenues attributable to the three retail locations are not material and accordingly the Company has not presented financial information separately for this operating segment. Substantially all of the consolidated revenues and assets of the Company are within the United States.

## Note 14 - SUBSEQUENT EVENTS

On April 6, 2015, May 14, 2015 and August 25, 2015 the Company received letters (the "Nasdaq Notices") from The NASDAQ Stock Market LLC ("Nasdaq") notifying the Company that because it had not yet filed with the SEC its Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "Form 10-K") and its Quarterly Reports on Form 10-Q for the fiscal quarters ended March 31, 2015 (the "First Quarter Form 10-Q") and June 30, 2015 (the "Second Quarter Form 10-Q"), the Company is not in compliance with the periodic filing requirements for continued listing set forth in Nasdaq Listing Rule 5250(c)(1). The Company filed the Form 10-K on August 14, 2015, the First Quarter Form 10-Q on September 29, 2015 and the Second Quarter Form 10-Q on September 30, 2015.

On August 11, 2015, The Private Bank agreed to extend the due date for the Company to deliver its Annual Report on Form 10-K for the fiscal year ended December 31, 2014 until August 14, 2015 as well as the due date for the Company to deliver its First Quarter Form 10-Q to September 30, 2015 and its Second Quarter Form 10-Q to October 15, 2015. On August 11, 2015, The Private Bank also extended the maturity date for the revolving credit facility



to July 31, 2016.

On September 24, 2015, the Company's Board of Directors authorized a stock repurchase program under which the Company may repurchase up to \$3,500,000 of the Company's common stock not to exceed an aggregate of 250,000 shares, in the open market or in privately negotiated transactions, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Securities Exchange Act of 1934, as amended. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon a variety of factors, including market conditions, regulatory requirements and other corporate considerations, as determined by management. The repurchase program may be suspended or discontinued at any time.

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

The following discussion of the financial condition and results of operations of Lifeway Foods, Inc. as of and for the three and six months ended June 30, 2015 should be read in conjunction with the unaudited consolidated financial statements and the notes to those statements that are included elsewhere in this report on Form 10-Q and the audited financial statements and Management's Discussion and Analysis contained in our Form 10-K for the year ended December 31, 2014 (the "Form 10-K"). In addition to historical information, the following discussion contains certain forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements relate to our future plans, objectives, expectations and intentions. These statements may be identified by the use of words such as "may", "will", "could", "expect", "anticipate", "intend", "believe", "estimate", "plan", "predict", and other 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 three month period ended June 30, 2015 to the three month period ended June 30, 2014

### Results of Operations

#### Net sales

The following table summarizes our net sales:

	Three months ended		Change	
	2015	2014	\$	%
Gross Sales	\$ 36,291,842	\$ 32,594,048	\$ 3,697,794	11.3%
Less: Discounts & promotional allowances	(6,470,654)	(3,028,637)	(3,442,017)	113.6%
Net Sales	\$ 29,821,188	\$ 29,565,411	\$ 255,777	0.9%
Discounts & promotional allowances % to gross sales	17.8%	9.3%		

Net sales increased by \$255,777 or 0.9% to \$29,821,188. The increase in net sales reflects a \$3,697,794 or 11.3% increase in gross sales reflecting higher volumes of drinkable Kefir offset by significantly higher discounts and promotional allowances given to customers.

## Cost of goods sold

The following table summarizes our cost of goods sold:

	Three months ended		Change	
	June 30,			
	2015	2014	\$	%
Purchases	\$ 13,815,824	\$ 14,714,737	\$ (898,913)	-6.1%
Testing	38,903	13,145	25,758	195.9%
Supplies	506,240	371,637	134,603	36.2%
Salaries production	3,089,472	2,221,464	868,008	39.1%
Contract work	36,977	97,543	(60,566)	-62.1%
Freight	3,519,854	2,970,266	549,588	18.5%
Delivery expense	135,587	78,229	57,358	73.3%
Labor and overhead	1,058,272	965,603	92,669	9.6%
Cost of Goods Sold, excluding depreciation	22,201,129	21,432,624	768,505	3.6%
Depreciation expense	604,531	627,878	(23,347)	-3.7%
Cost of Goods Sold	\$ 22,805,660	\$ 22,060,502	\$ 745,158	3.4%

Cost of Goods sold % to net sales

76.5%

74.6%

Cost of goods sold, excluding depreciation expense increased by \$768,505 or 3.6% to \$22,201,129 during the three-month period ended June 30, 2015 from \$21,432,624 during the same three-month period in 2014. Cost of goods sold, excluding depreciation expense as a percent of sales was 74.4% during the three-month period ended June 30, 2015 compared to 72.5% during the same three-month period in 2014. The overall increase in the cost of goods sold percent to net sales reflects the elevated level of promotional allowances and discounts given to customers.

Depreciation expense decreased by \$23,347 or about 3.7% to \$604,531 during the three-month period ended June 30, 2015 from \$627,878 during the same three-month period in 2014.

## Selling Expenses

The following table summarizes our selling expenses:

	Three months ended		Change	
	June 30,			
	2015	2014	\$	%
Salesperson commissions	\$ 779,752	\$ 799,104	\$ (19,352)	-2.4%
Advertising	867,297	1,006,016	(138,719)	-13.8%
Salaries	914,394	1,334,037	(419,643)	-31.5%
Promotions payable	42,851	131,552	(88,701)	-67.4
Travel	13,105	423,112	(410,007)	-96.9
Selling expense	\$ 2,617,399	\$ 3,693,821	\$ (1,076,422)	29.1%
% to net sales	8.8%	12.5%		

Selling expenses decreased by \$1,076,422 or 29.1% to \$2,617,399 during the three-month period ended June 30, 2015 from \$3,693,821 during the same period in 2014. Selling expenses as a percentage of sales were 8.8 % for the

three-month period ended June 30, 2015 compared to 12.5% for the same period in 2014. The decrease reflects the reassignment of Company personnel in 2015 from principally selling responsibilities to broader general management responsibilities and lower travel due to timing.

- 19 -

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## General and administrative expenses

The following table summarizes our general and administrative expenses:

	Three months ended June 30,		Change	
	2015	2014	\$	%
Salaries	\$ 1,746,732	\$ 798,812	\$ 947,920	118.7%
Rent	69,753	78,645	(8,892)	-11.3%
Equipment lease	1,740	2,026	(286)	-14.1%
Auto expense	54,388	33,851	20,537	60.7%
Office supplies	54,557	42,258	12,299	29.4%
Professional fees	1,372,920	623,068	749,852	120.3%
Telephone expense	42,972	29,368	13,604	46.3%
Facilities	561,425	192,388	369,037	191.8%
Tax	47,574	56,030	(8,456)	-15.1%
Miscellaneous	218,094	250,751	(32,657)	-13.0%
General & administrative expense	\$ 4,170,155	\$ 2,107,197	\$ 2,062,958	97.9%
% to net sales	14.0%	7.2%		

General and administrative expenses increased \$2,062,958 or 97.9% to \$4,170,155 during the three-month period ended June 30, 2015 from \$2,107,197 during the same period in 2014. The increase is primarily a result of increases in salaries, facilities expense and professional fees. Salaries increased \$947,920 or 118.7% to \$1,746,732 during the three-month period ended June 30, 2015 from \$798,812 during the same period in 2014. The increase reflects the reassignment of Company personnel in 2015 from principally selling responsibilities to broader general management responsibilities. Professional fees, which consists primarily of legal and accounting fees increased by \$749,852 or 120.3% to \$1,372,920 in the three-month period ended June 30, 2015 from \$623,068 during the same period in 2014. The higher professional fees are due to costs associated the company's delayed SEC filings. Expenses related to our facilities, increased by \$369,037 or 191.8% to \$561,425 in the three-month period ended June 30, 2015 from \$192,388 during the same period in 2014. The increase is primarily due to higher utility costs associated with the Wisconsin facility.

## Income from operations and net income

The company reported income from operations of \$49,054 during the second quarter of 2015, compared to \$1,524,972 during the same period in 2014. Provision for income taxes was \$119,626, or a 54.7% effective rate for the second quarter of 2015 compared to a provision for income taxes of \$807,768 or a 54.7% effective tax rate, during the same period in 2014. Income taxes are discussed in Note 10 to the Notes to the Consolidated Financial Statements.

Net income was \$98,913 or \$0.01 per basic and diluted common share for the three-month period ended June 30, 2015 compared to \$669,416 or \$0.04 per basic and diluted common share in the same period in 2014.

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Comparison of six month period ended June 30, 2015 to the six month period ended June 30, 2014

Results of Operations

Net sales

The following table summarizes our net sales:

	Six months ended June 30,		\$	Change	
	2015	2014			%
Gross Sales	\$69,394,925	\$64,655,195	\$4,739,730		7.3%
Less: Discounts & promotional allowances	(9,951,613 )	(5,958,073 )	(3,993,540 )		67.0%
Net Sales	\$59,443,312	\$58,697,122	\$746,190		1.3%
Discounts & promotional allowances % to gross sales	14.3%	9.2%			

Net sales increased by \$746,190 or 1.3% to \$59,443,312 during the six-month period ended June 30, 2015 from \$58,697,122 during the same period in 2014. The 1.3% increase reflects a \$4,739,730 or 7.3% increase in gross sales reflecting higher volumes of drinkable Kefir and the commencement of cream sales in the second quarter of 2014 offset by significantly higher discounts and promotional allowances in 2015.

Cost of goods sold

The following table summarizes our cost of goods sold:

	Six months ended June 30,		\$	Change	
	2015	2014			%
Purchases	\$ 25,696,896	\$ 30,188,857	\$ (4,491,961)		-14.9%
Testing	52,877	21,458	31,419		146.4%
Supplies	1,189,903	659,845	530,058		80.3%
Salaries production	5,828,244	4,368,422	1,459,822		33.4%
Contract work	70,997	121,659	(50,662)		-41.6%
Freight	6,728,610	5,796,599	932,011		16.1%
Delivery expense	242,821	161,452	81,369		50.4%
Outside services		1,581	(1,581)		-100.0%
Labor and overhead	3,038,746	1,794,662	1,244,084		69.3%
Cost of Goods Sold, excluding depreciation	42,849,096	43,114,535	(265,441)		-0.6%
Depreciation expense	1,195,158	1,411,238	(216,080)		-15.3%
Cost of Goods Sold	\$ 44,044,254	\$ 44,525,773	\$ (481,521)		-0.1%

Cost of Goods sold % to net sales

74.1% 75.9%

Cost of goods sold, excluding depreciation expense, declined by \$265,441 or 0.6% to \$42,849,096 during the six-month period ended June 30, 2015 from \$43,114,535 during the same period in 2014. Cost of goods sold,

excluding depreciation expense as a percent of sales was 72.1% during the six-month period ended June 30, 2015 compared to 73.5% during the same period in 2014. The overall improvement in the cost of goods sold percent to sales reflects

- 21 -

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lower costs of purchases of raw materials, primarily lower milk prices, offset somewhat by increased labor and overhead, production salaries and supplies. In April, 2014 the Company began processing raw milk and producing Kefir related packaging in its Waukesha, Wisconsin facility, contributing to increased labor and overhead, production salaries and supplies in the first quarter of 2015 compared to the first quarter of 2014.

Depreciation expense decreased by \$216,080 or about 15.3% to \$1,195,158 during the six-month period ended June 30, 2015 from \$1,411,238 during the same period in 2014. The decrease reflects a \$400,000 correction of depreciation expense related to periods prior to 2014 recognized in the first quarter of 2014 partially offset by increased depreciation expense associated with assets placed in service at the Lifeway Wisconsin location in 2015.

### Selling Expenses

The following table summarizes our selling expenses:

	Six months ended June 30,		Change	
	2015	2014	\$	%
Salesperson commissions	\$ 1,344,219	\$ 1,333,795	\$ 10,424	0.8%
Advertising	2,741,835	1,824,524	917,311	50.3%
Salaries	2,381,024	2,938,190	(557,166)	-19.0%
Promotions payable	90,730	204,433	(113,703)	-55.6%
Travel	221,994	872,567	(650,573)	-74.6%
Selling expense	\$ 6,779,802	\$ 7,173,509	\$ (393,707)	-5.5%
% to net sales	11.4%	12.2%		

Selling expenses decreased by \$393,707 or 5.5% to \$6,779,802 during the six-month period ended June 30, 2015 from \$7,173,509 during the same period in 2014. Selling expenses as a percentage of sales were 11.4 % for the six-month period ended June 30, 2015 compared to 12.2% for the same period in 2014. The decrease reflects lower travel due to timing, and lower salaries due to the reassignment of Company personnel in 2015 from principally selling responsibilities to broader general management responsibilities offset partially by increased advertising. During the first quarter of 2015 the company ran its first national TV commercial contributing to the increased advertising expense.

### General and administrative expenses

The following table summarizes our general and administrative expenses:

	Six months ended June 30,		Change	
	2015	2014	\$	%
Salaries	\$ 2,719,341	\$ 1,733,944	\$ 985,397	56.8%
Rent	134,734	150,567	(15,833)	-10.5%
Equipment lease	3,641	3,194	447	14.0%
Auto expense	75,589	49,276	26,313	53.4%
Office supplies	81,144	67,445	13,699	20.3%
Professional fees	2,250,878	1,366,936	883,942	64.7%
Permits and licenses	0	84,157	(84,157)	-100.0%
Telephone expense	81,242	56,892	24,350	42.8%
Facilities	1,041,963	386,763	655,200	169.4%



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Tax	123,612	88,374	35,238	39.9%
Miscellaneous	289,907	500,279	(210,372)	-42.1%
General & administrative expense				51.6%
	\$ 6,802,051	\$ 4,487,827	\$ 2,314,224	
% to net sales	11.4%	7.6%		

General and administrative expenses increased \$2,314,224 or 51.6% to \$6,802,051 during the six-month period ended June 30, 2015 from \$4,487,827 during the same period in 2014. The increase is primarily a result of increases

in salaries, professional fees and facilities expense. The higher salaries reflects the reassignment of Company personnel in 2015 from principally selling responsibilities to broader general management responsibilities.

Professional fees, which consists primarily of legal and accounting fees increased by \$883,942 or 64.7% to \$2,250,878 in the six-month period ended June 30, 2015 from \$1,366,936 during the same period in 2014. The higher professional fees are due to costs associated the company's delayed SEC filings. Expenses related to our facilities, increased by \$655,200 or 169.4% to \$1,041,963 in the six-month period ended June 30, 2015 from \$386,763 during the same period in 2014. The increase is primarily due to higher utility costs associated with the Wisconsin facility.

#### Income from operations and net income

The company reported income from operations of \$1,459,366 during the six months ended June 30, 2015, compared to \$2,152,174 during the same period in 2014. Provision for income taxes was \$770,133, or a 50.6% effective rate for six months ended June 30, 2015 compared to a provision for income taxes of \$1,106,229, or a 53.4% effective tax rate, during the same period in 2014. Income taxes are discussed in Note 10 to the Notes to the Consolidated Financial Statements.

Net income was \$752,631 or \$0.05 per basic and diluted common share for the six-month period ended June 30, 2015 compared to \$966,595 or \$0.06 per basic and diluted common share in the same period in 2014.

#### Liquidity and Capital Resources

##### Sources and Uses of Cash

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.

Net cash provided by operating activities was \$4,702,950 during the six-months ended June 30, 2015 compared to net cash provided by operating activities of \$2,102,024 in the same period in 2014. The increase is primarily attributable to the timing of payments to suppliers and service providers, lower income tax payments and the relatively higher level of accounts receivable collections in the 2014 period.

Net cash used in investing activities was \$1,472,643 during the six-months ended June 30, 2015 compared to net cash used in investing activities of \$2,097,773 in the same period in 2014. The improvement in net cash used in investing activities reflects lower purchases of property and equipment and the proceeds related to the sale of property and equipment during the 2015 period.

The Company had a net increase in cash and cash equivalents of \$2,612,835 during the six month period ended June 30, 2015 compared to a net decrease in cash and cash equivalents of \$436,970 in the same period in 2014.

At June 30, 2015, the Company had \$840,000 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 June 30, 2015 and is available for other general corporate purposes.

#### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We do not undertake any specific actions to diminish our exposure to interest rate risk and we are not a party to any interest rate risk management transactions. We do not purchase or hold any derivative financial instruments. Our foreign sales are not material. Accordingly, our currency rate risk is not currently material.

As of June 30, 2015, we had an outstanding balance under our bank term loans of approximately \$8.379 million, and we have the option to borrow an additional \$5 million from our line of credit. The term loans bear interest at variable rates. Based on the outstanding amount under such loans at June 30, 2015 of approximately \$8.379 million (which remains outstanding as of the time of this filing) a 1.0 percent increase in interest rates would result in additional annualized interest expense of approximately \$85,000. For a detailed discussion of our notes payable, including a discussion of the applicable interest rate, please refer to Note 8, Notes Payable under Part I, Item 1 in this Quarterly Report on Form 10-Q.

#### ITEM 4. CONTROLS AND PROCEDURES.

##### 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, 2014, 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 June 30, 2015, 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.

##### Management's Remediation Initiatives

We continue to make progress toward achieving the effectiveness of our disclosure controls and procedures. 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 believe that we have made significant improvements in our internal control over financial reporting and are committed to remediating our material weaknesses. Our Sarbanes Oxley compliance function is responsible for helping develop and monitor our short-term and long-term remediation plans. In addition, we have assigned owners to each material weakness to oversee the necessary remedial changes to the overall design of our internal control environment and to address the root causes of our material weaknesses.

In addition to the actions previously disclosed under "Item 9A—Controls and Procedures" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 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.

- Our leadership team remains committed to achieving and maintaining a strong control environment, high ethical standards and financial reporting integrity. This commitment will continue 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 redesign our period-end closing and financial statement preparation process in order to improve both its effectiveness and efficiency.

Collectively, these and other actions are improving the foundation of our internal control over financial reporting.

#### Changes in Internal Control over Financial Reporting

Except as discussed above there were no changes in our internal control over financial reporting that occurred during the second quarter of 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

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

ITEM 1A. RISK FACTORS.

There have been no material changes to the Risk Factors disclosed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. MINE SAFETY DISCLOSURE.

Not applicable.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

- 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.

101 Interactive Data Files.

- 25 -

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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: September 30, 2015

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

Date: September 30, 2015

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





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