



*(Address of principal executive offices) (Zip Code)*

**(847) 967-1010**

*(Registrant's telephone number, including area code)*

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

| <b>Title of Each Class</b>        | <b>Name of each exchange on which registered</b> |
|-----------------------------------|--|
| <b>Common Stock, No Par Value</b> | <b>Nasdaq Global Market</b>                      |

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

**None**

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

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

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

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

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

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

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

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the stock was last sold as of June 30, 2015 (\$19.19 per share as quoted on the Nasdaq Global Market) was \$91,167,353.

As of March 1, 2016 16,188,376 shares of the registrant's common stock, no par value, were outstanding.

Portions of the Registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on June 17, 2016, are incorporated by reference into Part III.

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## EXPLANATORY NOTE

On November 4, 2016, the Audit Committee of the Board of Directors (the "Board") of Lifeway Foods, Inc. (the "Company"), upon the recommendation of management, determined that the consolidated financial statements (the "Previously Issued Financial Statements") presented in the Company's reports for the annual period ended December 31, 2015, and the reports of the independent registered public accounting firm thereon, and related quarterly periods for the annual period ended December 31, 2015 as set forth in the Company's previous filings with the Securities and Exchange Commission (the "SEC") (the "Revised Periods") should no longer be relied upon as a result of the following classification errors:

During fiscal year 2015 certain indirect manufacturing overhead costs were classified as an element of General and Administrative (G&A) expenses in our Statements of Income and Comprehensive Income. These indirect manufacturing overhead costs are more appropriately classified as an element of Cost of Goods Sold.

A description of the restatement is presented in Note 1, under the caption Restatements of prior period financial statements. The classification errors described above have no impact on the Company's previously-reported net sales, income from operations, net income, or basic and diluted earnings per common share presented in its Consolidated Statements of Income and Comprehensive Income, nor does it have a material effect on the Company's previously-reported Consolidated Balance Sheets, Consolidated Statements of Cash Flows, or Consolidated Statements of Changes in Stockholders' Equity.

Additionally, during the first quarter of 2015 certain executive compensation was classified in Selling expenses that management determined should be classified as G&A expenses. Management has determined that these compensation reclassifications are not material.

This Form 10-K/A reflects changes to the Company's consolidated financial statements and certain notes to the consolidated financial statements including Note 1, Basis of presentation, out of period adjustments and restatements of prior periods. In addition, in connection with the restatement this Form 10-K/A reflects the revisions to Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of Part II and revisions to the disclosures regarding controls and procedures in Item 9A of Part II.

## FORWARD LOOKING STATEMENTS

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

This document and any documents incorporated by reference herein also identify important factors which could cause actual results to differ materially from those indicated by forward looking statements. These risks and uncertainties include

price competition;

the decisions of customers or consumers;

the actions of competitors;

changes in the pricing of commodities;

the effects of government regulation;

possible delays in the introduction of new products;

customer acceptance of products and services; and

the other risks and uncertainties that are set forth in Item 1, "Business", Item 1A "Risk Factors" and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations".

These factors are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors could also have material adverse effects on future results. Except as otherwise required to be disclosed in periodic reports required to be filed by public companies with the Securities and Exchange Commission ("SEC") pursuant to the SEC's rules, we have no duty to update these statements, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## **PART I**

### **ITEM 1 BUSINESS**

#### **OVERVIEW**

Lifeway Foods, Inc. (the "Company" or "Lifeway") was co-founded in 1986 by Michael and Ludmila Smolyansky shortly after their emigration from Russia to the United States. Mr. and Mrs. Smolyansky were the first to successfully introduce Kefir to the U.S. consumer on a commercial scale, initially catering to ethnic consumers in the Chicago metropolitan area. In the thirty years that have followed, Lifeway has grown to become the largest producer and marketer of Kefir in the U.S. and an important player in the broader market spaces of probiotic-based products and natural, "better for you" foods.

#### **PRODUCTS**

Lifeway's primary product is drinkable kefir, a fermented dairy product. Kefir has a tart and tangy taste similar to yogurt and the consistency of a smoothie. Kefir also has a slightly effervescent quality all its own. Unlike yogurt though, Lifeway incorporates a unique blend of probiotic kefir cultures in the fermentation process. The probiotic feature, in concert with the base-line nutritional value of a staple beverage that is high in protein, calcium and vitamin D, and low in calories, presents a unique and differentiated taste profile that we believe appeals to a broad and growing demographic.

Because of its drinkable feature, kefir requires no spoon and is ideal for on-the-go consumption ... straight from the bottle. Lifeway's Kefir is commonly consumed as part of a healthy breakfast or as an "any-time, better for you" snack in its native form or as a smoothie input. Kefir also serves as a base for lower-calorie dressings, dips, marinades, soups or sauces and as a basic ingredient in other healthy, home-prepared foods. Recipes are made available through the company's website.

In addition to the drinkable kefir that we broadly market to consumers of all ages, we also market and sell our ProBugs line of drinkable kefir which is delivered in our proprietary non-spill pouches (and in 3.5 oz. bottles) intended for children with caring, health-conscious parents. Our frozen kefir offers a nutritional profile similar to our drinkable kefir but in a frozen bar and pint size container conventionally thought of as an indulgent treat. In addition to kefir, Lifeway produces a variety of Kefir-based Eastern European style soft cheeses.



Gross sales of products by category were as follows for the years ended December 31:

| In thousands                       | 2015    |       | 2014    |       | 2013    |       |
|------------------------------------|---------|-------|---------|-------|---------|-------|
|                                    | \$      | %     | \$      | %     | \$      | %     |
| Drinkable Kefir other than ProBugs | 118,090 | 86.0% | 110,297 | 84.7% | 90,441  | 83.0% |
| ProBugs drinkable Kefir            | 7,936   | 5.8%  | 7,868   | 6.0%  | 7,127   | 6.5%  |
| Lifeway cheese products            | 9,725   | 7.1%  | 10,266  | 7.9%  | 9,388   | 8.6%  |
| Frozen Kefir                       | 1,493   | 1.1%  | 1,785   | 1.4%  | 2,010   | 1.9%  |
| Gross Sales                        | 137,244 | 100%  | 130,216 | 100%  | 108,966 | 100%  |

**Product innovation and new product development**

The company is committed to maintaining its position as the leading producer of Kefir and routinely evaluates opportunities for new product flavors and formulations, improved package design, new product configurations and other forms of routine innovation. As of December 31, 2015 the company offered over 50 unique varieties of its Kefir product including more than 20 unique flavors delivered to consumers on three different milk platforms (fat-free, 1% and whole milk) as well as in both organic and conventional ingredient profiles. During 2015 our routine innovations led to the introduction of several new items, including our new 16 ounce protein enhanced Kefir aimed at the fitness-oriented consumer looking to incorporate more protein into their diets.

Beyond routine innovation, the company has an on-going effort to extend the strength of the Lifeway brand and leverage the capabilities of the Lifeway organization into categories outside of the dairy aisle including into non-food categories. Though we have not yet delivered a product to the market place that has clear commercial viability, our efforts will continue.

The company's innovation, research and development efforts are largely accomplished leveraging an intuitive entrepreneurial, unstructured approach; not a highly formalized, distinct "R&D" function commonly found with large food processors. Research and development costs are not significant.

### **Product Quality Assurance**

The Company employs many skilled production managers across its three Kefir producing facilities who closely monitor our kefir-production process. The production managers have a complement of deep capabilities that spans from traditional dairy operations to the artisan, old-world practices first introduced by Michael and Ludmila Smolyansky at the inception of the Company. We conduct routine tests, tastings and evaluations to ensure that each batch of kefir conforms to the Company's product quality and safety standards. The Company leverages both on-site and third party quality control labs.

The Company includes a clearly legible "freshness" code on every Kefir product in order to ensure that our customers enjoy only the freshest products. To maintain the best of product freshness in the channel, we expect our channel customers (a) to ensure that our products are delivered directly to the retailer's dairy cooler and (b) to rotate such product in a routine and timely way. Due to the perishable nature of our products and the costs associated with moving product back through the channel, the Company does not offer return privileges to any of its channel customers; however, from time to time we do provide our customers with allowances for non-saleable product.

### **DISTRIBUTION**

Lifeway's products reach the consumer through three primary "route-to-market" pathways:

- Direct store delivery ("DSD");

- Retail-direct; and,

- Distributor.

Under the direct store delivery (DSD) route to market, we distribute our products directly to the grocer's dairy cooler using a fleet of company-owned vehicles and a team of seasoned Lifeway merchandisers who engage face-to-face with store management to ensure optimal product assortments and presentation. We operate our DSD model in the Chicago metropolitan area only. Sales to our DSD customers represents less than 10% of total company net sales.

Under the retail-direct channel, our products are sold to the retailer and shipped to that retailer's distribution center. In turn our retail customer then delivers the product to their respective stores within their chain. Customers in this route-to-market grouping include among others Kroger, Wal Mart and Costco. Under the retail direct model, optimal

product merchandising, assortments and product presentation are attended to by the retailer with support from Lifeway's broker network. Sales to our retail-direct customers represents about 50% of total company net sales.

Under the distributor channel, our products are sold to distributors and shipped to that distributors designated warehouse. In turn, our distributor customers then sell the product to their retail customers and ship the products to their retail customers. Our distributors often use a DSD model of their own to make deliveries directly to individual stores but also make deliveries to the retailer's warehouse. Our distributor customers include among others United Natural Foods, Kehe Foods and C&S Wholesale. Optimal product merchandising, assortments and product presentation at the retail end of the channel are attended to by the distributor with support from Lifeway's broker network. Sales to our distributor customers represents about 40% of total company net sales.

**Distribution outside of the U.S.**

Substantially all of Lifeway's products are distributed within the United States; however, certain of our distributors sell our products to retailers in Mexico, Costa Rica, Dubai, Hong Kong, China, and the Caribbean. Additionally, the company's products reach a small number of consumers across Canada and in London, England under third party co-manufacturing agreements and in-country distributor arrangements.

### **Distribution arrangements**

Beyond the customer's purchase order, we do not have written agreements with our distributors. Consequently we believe that our arrangements with distributors allow us the latitude to establish new relationships with distributors as the need arises. Lifeway does not offer exclusive territories to any of its distributors.

Distributors are provided Lifeway products at wholesale prices for distribution to their retail accounts. Lifeway believes that the price at which its products are sold to its distributors is competitive with the prices generally paid by distributors for similar products in the markets served. Each distributor carries a line of Lifeway's products on its trucks, checks the retail stores for space allocated to Lifeway's products, determines inventory requirements of the store and places Lifeway products directly into the retailers' dairy cases. Lifeway believes this method of distribution best serves the needs of each retail store, and is the best available means to ensure consistency and quality of product handling, quality control, flavor selection and favorable retail display.

### **MARKETING**

The Company engages in an on-going and wide variety marketing and media campaigns - primarily digital and social media, print advertising in some newspapers and magazines and to a lesser extent television advertising. These marketing and media efforts are complemented by participation in sponsorships of cultural and community events, various festivals, industry-related trade shows and in-store promotional events. Our marketing efforts also include co-op advertising programs with our retail customers and various couponing campaigns.

Our marketing efforts are aimed at stimulating demand with our existing consumers and at driving trial with new consumers by elevating Kefir awareness. Our Kefir awareness marketing seeks to promote the verifiable nutritional profile, purity and good taste of our Kefir and to promote the common perception that our products may have a particular health benefit, such as promoting digestion.

### **COMPETITION**

Lifeway competes with a limited number of other domestic kefir producers and consequently faces a small amount of direct competition for kefir products; however, Lifeway's kefir-based products compete with other dairy products, notably yogurt. Many producers of yogurt and other dairy products are well-established and have significantly greater financial resources than Lifeway to promote their products.

## **SUPPLIERS**

We purchase our ingredients such as raw milk, cane and other forms of sugar and packaging materials from unaffiliated suppliers. Lifeway is not limited or contractually bound to any supplier beyond the terms of our purchase orders, which generally do not exceed our expected demand for periods more than one year. Lifeway has ready access to multiple suppliers for all of its ingredients and packaging requirements.

## **MAJOR CUSTOMERS**

During the year ended December 31, 2015 one distributor, United Natural Foods, Inc., represented approximately 19% of the Company's total sales and one retail customer, Kroger, represented approximately 7% of the Company's total sales. These customers collectively accounted for approximately 19% of accounts receivable as of December 31, 2015.

## **SEGMENTS**

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 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.

## **GROUPE DANONE SA**

Since October, 1999 Groupe Danone SA has been the beneficial owner of approximately 20% of the outstanding common stock of Lifeway. Lifeway and Danone are parties to a Stockholders' Agreement dated October 1, 1999, which as amended provides Danone the right to nominate one director, provides Danone with anti-dilutive rights relating to future offerings and grants Danone limited registration rights.

Danone's interest as of December 31, 2015 was approximately 21%.

## **PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS**

The Company has obtained United States trademark registrations for over 20 trademarks, including ProBug Design 1, ProBug Design 2, Penelope ProBug Design, BA3APHBIII (a Stylized presentation of "bazarny" in Cyrillic characters), Bambino, Bazarny, Bio Kefir, Goo-Berry Pie, Helios Nutrition, Korovka, KPECTBRHCKNN (a Stylized

presentation of "krestyanskiy" in Cyrillic characters-means "peasant"), Kwashenka, La Fruta, Lifeway, Orange Creamy Crawler, Phytoboost, Playgroup Pack, Pride of Main Street, PRO2O, ProBugs, Starfruit, Sublime Slime Lime and Sweet Kiss.

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

The Company regards its Lifeway family of trademarks and other trademarks as having substantial value and as being an important factor in the marketing of its products. The Company is not aware of any trademark infringements that could materially affect its current business or any prior claim to the trademarks that would prevent the Company from using such trademarks in its business. The Company's policy is to pursue registration of its marks whenever appropriate and to vigorously oppose any infringements of its marks.

## **REGULATION**

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

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

## **SEASONALITY**

The Company's business is not seasonal.

## EMPLOYEES

As of December 31, 2015 the Company employed approximately 370 employees.

## AVAILABLE INFORMATION

The Company maintains a corporate website for investors at [www.lifeway.net](http://www.lifeway.net) and it makes available, free of charge, through this website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports that the Company files with or furnishes to the Securities and Exchange Commission (the "SEC"), as soon as reasonably practicable after it electronically files such material with, or furnishes it to, the SEC.

## ITEM 1A RISK FACTORS

In evaluating and understanding us and our business, you should carefully consider the risks described below, in conjunction with all of the other information included in this Annual Report on Form 10-K, including "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in Part II, Item 7 and "Quantitative and Qualitative Disclosures About Market Risk" contained in Part II, Item 7A. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently believe are not material, may become important factors that adversely affect our business. If any of the events or circumstances described in the following risk factors actually occurs, our business, financial condition, results of operations, and future prospects could be materially and adversely affected.

*Our product categories face a high level of competition, which could negatively impact our sales and results of operations.*

We face significant competition in each of our product categories. Competition in our product categories is based on product innovation, product quality, price, brand recognition and loyalty, effectiveness of marketing, promotional activity, and our ability to identify and satisfy consumer tastes and preferences. We believe that our brands have benefited in many cases from being the first to introduce products in their categories, and their success has attracted competition from other food and beverage companies that produce branded products, as well as from private label competitors. Some of our competitors, such as Groupe Danone, General Mills, Inc., Dean Foods, WhiteWave Foods, Hain Celestial Group, and Nestle S.A., have substantial financial and marketing resources. These competitors and



others may be able to introduce innovative products more quickly or market their products more successfully than we can, which could cause our growth rate to be slower than we anticipate and could cause sales to decline.

We also compete with producers of non-organic products, which have lower ingredient and production-related costs. As a result, these non-organic producers may be able to offer conventional products to customers at a lower price point. This could cause us to lower our prices, resulting in lower profitability or, in the alternative, cause us to lose market share if we fail to lower prices. Furthermore, private label competitors are generally able to sell their products at lower prices because private label products typically have lower marketing costs than their branded counterparts. If our products fail to compete successfully with other branded or private label offerings, demand for our products and our sales volumes could be negatively impacted.

Additionally, due to high levels of competition, certain of our key retailers may demand price concessions on our products or may become more resistant to price increases for our products. Increased price competition and resistance to price increases have had, and may continue to have, a negative effect on our results of operations.

***We may not be able to successfully implement our growth strategy for our brands on a timely basis or at all.***

We believe that our future success depends, in part, on our ability to implement our growth strategy of leveraging our existing brands and products to drive increased sales. Our ability to implement this strategy depends, among other things, on our ability to:

enter into distribution and other strategic arrangements with third-party retailers and other potential distributors of our products;

compete successfully in the product categories in which we choose to operate;

introduce new and appealing products and innovate successfully on our existing products;

develop and maintain consumer interest in our brands;

increase our brand recognition and loyalty; and

enter into strategic arrangements with third-party growers and other providers to supply our necessary raw materials.



We may not be able to implement this growth strategy successfully, and our sales and income growth rates may not be sustainable over time. Our sales and results of operations will be negatively affected if we fail to implement our growth strategy or if we invest resources in a growth strategy that ultimately proves unsuccessful.

***If we fail to anticipate and respond to changes in consumer preferences, demand for our products could decline.***

Consumer tastes and preferences are difficult to predict and they evolve over time. Demand for our products depends on our ability to identify and offer products that appeal to these shifting preferences. Factors that may affect consumer tastes and preferences include:

dietary trends and increased attention to nutritional values, such as the sugar, fat, protein, fiber or calorie content of different foods and beverages;

concerns regarding the health effects of specific ingredients and nutrients, such as sugar, other sweeteners, dairy, soybeans, nuts, oils, vitamins, fiber and minerals;

concerns regarding the public health consequences associated with obesity, particularly among young people; and

increasing awareness of the environmental and social effects of food processing .

If consumer demand for our products declines, our sales volumes and our business could be negatively affected.

***We are subject to the risk of product contamination and product liability claims, which could harm our reputation, force us to recall products and incur substantial costs.***

The sale of food products for human consumption involves the risk of injury to consumers. Such injuries may result from tampering by unauthorized third parties, misbranding, product contamination or spoilage including the presence of foreign objects, substances, chemicals, other agents, or residues introduced during the growing, storage, processing, handling or transportation phases. We also may be subject to liability if our products or production processes violate applicable laws or regulations, including environmental, health, and safety requirements, or in the event our products cause injury, illness, or death.

In addition, our product advertising could make us the target of claims relating to false or deceptive advertising under U.S. federal and state laws, including the consumer protection statutes of some states, or laws of other jurisdictions in which we operate. Lifeway is from time to time engaged in such litigation matters none of which presently is expected to have a material adverse effect on its business results or operations.

A significant product liability, consumer fraud, or other legal judgment against us or a widespread product recall would negatively impact our profitability. Moreover, claims or liabilities of this sort might not be covered by insurance or by any rights of indemnity or contribution that we may have against others. Even if a product liability, consumer fraud, or other claim is found to be without merit or is otherwise unsuccessful, the negative publicity surrounding such assertions regarding our products or processes could materially and adversely affect our reputation and brand image, particularly in categories that are promoted as having strong health and wellness credentials. Any loss of consumer confidence in our brand, our products and the ingredients we use or in the safety and quality of our products would be costly and might not be overcome.

***The loss of any of our largest customers could negatively impact our sales and results of operations.***

Two of our customers together accounted for 26% of our net sales in the fiscal year ended December 31, 2015. We do not generally enter into written agreements with our customers, and where such agreements exist, they are generally terminable at will by the customer. In addition, our customers sometimes award contracts based on competitive bidding, which could result in lower profits for contracts we win and the loss of business for contracts we lose. The loss of any large customer for an extended period of time could negatively affect our sales and results of operations.

*We may not be able to successfully complete strategic acquisitions, establish joint ventures, or integrate brands that we acquire.*

We intend to continue to grow our business in part through the acquisition of new brands and through the establishment of strategic alliances including potential joint ventures .. We cannot be certain that we will successfully be able to:

identify suitable acquisition candidates or joint venture partners and accurately assess their value, growth potential, strengths, weaknesses, contingent and other liabilities, and potential profitability;

secure regulatory clearance for our acquisitions and joint ventures;

negotiate acquisitions and joint ventures on terms acceptable to us; or

integrate any acquisitions that we complete.

Acquired companies or brands may not achieve the level of sales or profitability that justify our investment in them, or an acquired company may have unidentified liabilities for which we, as a successor owner, may be responsible. These transactions typically involve a number of risks and present financial and other challenges, including the existence of unknown disputes, liabilities, or contingencies and changes in the industry, location, or regulatory or political environment in which these investments are located, that may arise after entering into such arrangements.

The success of any acquisitions we complete will depend on our ability to effectively integrate the acquired brands or products into our existing operations. We may experience difficulty entering new categories or geographies, integrating new products into our product mix, integrating an acquired brand's distribution channels and sales force, achieving anticipated cost savings, or retaining key personnel and customers of the acquired business. Integrating an acquired brand into our existing operations requires management resources and may divert management's attention from our day-to-day operations. If we are not successful in integrating the operations of acquired brands, or in executing strategies and business plans related to our joint ventures, our business could be negatively affected.

We may have to pay cash, incur debt, or issue equity, equity-linked, or debt securities to pay for any such acquisition, any of which could adversely affect our financial results.

***Our continued success depends on our ability to innovate successfully and to innovate on a cost-effective basis.***

A key element of our growth strategy is to introduce new and appealing products and to successfully innovate on our existing products. Success in product development is affected by our ability to anticipate consumer preferences, and to utilize our management's ability to launch new or improved products successfully and on a cost-effective basis. Furthermore, the development and introduction of new products requires substantial marketing expenditures, which we may not be able to finance or which we may be unable to recover if the new products do not achieve commercial success and gain widespread market acceptance. If we are unsuccessful in our product innovation efforts, our business could be negatively affected.

***Reduced availability of raw materials and other inputs, as well as increased costs for our raw materials and other inputs, could adversely affect us.***

Our business depends heavily on raw materials, such as conventional and organic raw milk, used in the production of our products. Our raw materials are generally sourced from third-party suppliers, and we are not assured of continued supply, pricing, or exclusive access to raw materials from any of these suppliers. In addition, a substantial portion of our raw materials are agricultural products, which are vulnerable to adverse weather conditions and natural disasters, such as floods, droughts, frost, earthquakes, and pestilence. Adverse weather conditions and natural disasters also can lower dairy and crop yields and reduce supplies of these ingredients or increase their prices. Other events that adversely affect our third-party suppliers and that are out of our control could also impair our ability to obtain the raw materials and other inputs that we need in the quantities and at the prices that we desire. Such events include problems with our suppliers' businesses, finances, labor relations, costs, production, insurance, and reputation.

The organic ingredients (including milk) we use in some of our products are less plentiful and available from a fewer number of suppliers than their conventional counterparts. Competition with other manufacturers in the procurement of organic product ingredients may increase in the future if consumer demand for organic products increases. In addition, the dairy industry continues to experience periodic imbalances between supply and demand for organic raw milk. Industry regulation and the costs of organic farming compared to costs of conventional farming can impact the supply of organic raw milk in the market. Oversupply levels of organic raw milk can increase competitive pressure on our products and pricing, while supply shortages can cause higher input costs and reduce our ability to deliver product to our customers. Cost increases in raw materials and other inputs could cause our profits to decrease significantly compared to prior periods, as we may be unable to increase our prices to offset the increased cost of these raw materials and other inputs. If we are unable to obtain raw materials and other inputs for our products or offset any increased costs for such raw materials and inputs, our business could be negatively affected.

***Failure to maintain sufficient internal production capacity may result in our inability to meet customer demand and/or increase our operating costs and capital expenditures.***

The success of our business depends, in part, on maintaining a strong production platform and we rely primarily on internal production resources to fulfill our manufacturing needs. Certain of our manufacturing plants are operating at high rates of utilization, and we may need to expand our production facilities or increase our reliance on third parties to provide manufacturing and supply services, commonly referred to as "co-packing" agreements, for a number of our products. A failure by any future co-packers to comply with food safety, environmental, or other laws and regulations may disrupt our supply of products. In addition, we have experienced, and expect to continue to experience, increased distribution and warehousing costs due to capacity constraints resulting from our growth.

If we need to enter into co-packing, warehousing or distribution agreements in the future, we can provide no assurance that we would be able to find acceptable third party providers or enter into agreements on satisfactory terms or at all. Our inability to maintain sufficient internal capacity or establish satisfactory co-packing, warehousing and distribution arrangements could limit our ability to operate our business or implement our strategic growth plan, and could negatively affect our sales volumes and results of operations.

In addition, our recent initiatives to expand our production platform and our productive capacity, could fail to achieve such objectives and in any case could increase our operating costs beyond our expectations and could require significant additional capital expenditures. If we cannot maintain sufficient production, warehousing and distribution capacity, either internally or through third party agreements, we may be unable to meet customer demand and/or our manufacturing, distribution and warehousing costs may increase, which could negatively affect our business.

***Disruption of our supply or distribution chains could adversely affect our business.***

Damage or disruption to our manufacturing or distribution capabilities due to weather, natural disaster, fire, environmental incident, terrorism, pandemic, strikes, the financial or operational instability of key suppliers, distributors, warehousing, and transportation providers, or other reasons could impair our ability to manufacture or distribute our products. In addition, most of our products are processed in a single facility, and damage or disruption to this facility could impair our ability to process and sell those products. If we are unable or it is not financially feasible to mitigate the likelihood or potential impact of such events, our business and results of operations could be negatively affected and additional resources could be required to restore our supply chain.

***Our substantial debt and financial obligations could adversely affect our financial condition and ability to operate our business.***

As of December 31, 2015, we had outstanding borrowings of approximately \$8 million substantially all of which consists of term loan borrowings. We also had additional borrowing capacity of approximately \$5 million under our line of credit, of which none was outstanding as of December 31, 2015.

Our loan agreements contain certain restrictions and requirements that among other things:

require us to maintain a minimum fixed charged ratio and a tangible net worth thresholds;

limit our ability to obtain additional financing in the future for working capital, capital expenditures and acquisitions, to fund growth or for general corporate purposes;

limit our future ability to refinance our indebtedness on terms acceptable to us or at all;

limit our flexibility in planning for or reacting to changes in our business and market conditions or in funding our strategic growth plan; and

impose on us financial and operational restrictions.



Our debt level and the terms of our financing arrangements could adversely affect our financial condition and limit our ability to successfully implement our growth strategy.

Our ability to meet our debt service obligations will depend on our future performance, which will be affected by the other risk factors described in this Annual Report on Form 10-K. If we do not generate enough cash flow to pay our debt service obligations, we may be required to refinance all or part of our existing debt, sell our assets, borrow more money or raise equity. There is no guarantee that we will be able to take any of these actions on a timely basis, on terms satisfactory to us, or at all.

Our notes bear interest at variable rates. If market interest rates increase, it will increase our debt service requirements, which could adversely affect our cash flow.

Our loan agreements also contain provisions that restrict our ability to:

borrow money or guarantee debt;

create liens;

make specified types of investments and acquisitions;

pay dividends on or redeem or repurchase stock;

enter into new lines of business;

enter into transactions with affiliates; and

sell assets or merge with other companies.

These restrictions on the operation of our business could harm us by, among other things, limiting our ability to take advantage of financing, merger and acquisition opportunities, and other corporate opportunities. Various risks, uncertainties, and events beyond our control could affect our ability to comply with these covenants. Unless cured or waived, a default would permit lenders to accelerate the maturity of the debt under the credit agreement and to

foreclose upon the collateral securing the debt.

***We may need additional financing in the future, and we may not be able to obtain that financing.***

From time to time, we may need additional financing to support our business and pursue our growth strategy, including strategic acquisitions. Our ability to obtain additional financing, if and when required, will depend on investor demand, our operating performance, the condition of the capital markets, and other factors. We cannot assure you that additional financing will be available to us on favorable terms when required, or at all. If we raise additional funds through the issuance of equity, equity-linked, or debt securities, those securities may have rights, preferences, or privileges senior to those of our common stock, and, in the case of equity and equity-linked securities, our existing stockholders may experience dilution.

***Our international operations subject us to business risks that could cause our revenue and profitability to decline.***

We intend to expand distribution of our products worldwide. Risks associated with our operations as we expand outside of the United States may include, among other things:

legal and regulatory requirements in multiple jurisdictions that differ from those in the United States and change from time to time, such as tax, labor, and trade laws, as well as laws that affect our ability to manufacture, market, or sell our products;

foreign currency exposures;

political and economic instability, such as the recent debt crisis in Europe;

trade protection measures and price controls; and

diminished protection of intellectual property in some countries.

If one or more of these business risks occur, our business and results of operations could be negatively affected.

***Loss of our key management or other personnel, or an inability to attract such management and other personnel, could negatively impact our business.***

We depend on the skills, working relationships, and continued services of key personnel, including our experienced senior management team. We also depend on our ability to attract and retain qualified personnel to operate and expand our business. If we lose one or more members of our senior management team, or if we fail to attract talented new employees, our business and results of operations could be negatively affected.

***Our workforce could become unionized in the future, which could materially and adversely affect the stability of our production and materially reduce our profitability.***

Our employees have the right at any time under the National Labor Relations Act to form or affiliate with a union and certain of our employees have undertaken the process of forming a union. If our employees form or affiliate with a union and the terms of a union collective bargaining agreement are significantly different from our current compensation and job assignment arrangements with our employees, these arrangements could materially and adversely affect the stability of our operations and materially reduce our profitability.

***Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products and brands.***

We consider our intellectual property rights, particularly our trademarks, but also our trade secrets, copyrights, and licenses, to be a significant and valuable aspect of our business. We attempt to protect our intellectual property rights through a combination of trademark, copyright, and trade secret laws, as well as licensing agreements, third-party confidentiality, nondisclosure, and assignment agreements, and by policing third-party misuses of our intellectual property. Our failure to obtain or maintain adequate protection of our intellectual property rights, or any change in law or other changes that serve to lessen or remove the current legal protections of our intellectual property, may diminish our competitiveness and could materially harm our business.

We also face the risk of claims that we have infringed third parties' intellectual property rights. Any claims of intellectual property infringement, even those without merit, could be expensive and time consuming to defend, cause us to cease making, licensing, or using products that incorporate the challenged intellectual property, require us to

redesign or rebrand our products or packaging, divert management's attention and resources, or require us to enter into royalty or licensing agreements to obtain the right to use a third party's intellectual property. Any royalty or licensing agreements, if required, may not be available to us on acceptable terms or at all. Additionally, a successful claim of infringement against us could result in our being required to pay significant damages, enter into costly license or royalty agreements, or stop the sale of certain products, any of which could have a negative effect on our results of operations.

***Litigation or legal proceedings could expose us to significant liabilities and have a negative impact on our reputation.***

We are party to various litigation claims and legal proceedings in the ordinary course of our business. In the opinion of management, the resolution of current litigation claims and legal proceedings will not have a material adverse effect on the Company's consolidated statements of financial condition. We evaluate these litigation claims and legal proceedings to assess the likelihood of unfavorable outcomes and to estimate, if possible, the amount of potential losses. Based on these assessments and estimates, we establish reserves or disclose the relevant litigation claims or legal proceedings, as appropriate. These assessments and estimates are based on the information available to management at the time and involve a significant amount of management judgment. Actual outcomes or losses may differ materially from our current assessments and estimates. If actual outcomes or losses differ materially from our current assessments and estimates or additional litigation or legal proceedings are initiated, we could be exposed to significant liabilities.

***Our business is subject to various environmental and health and safety laws and regulations, which may increase our compliance costs or subject us to liabilities.***

Our business operations are subject to numerous requirements in the United States relating to the protection of the environment and health and safety matters, including the Clean Air Act, the Clean Water Act, the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, and the National Organic Standards of the U.S. Department of Agriculture, as well as similar state and local statutes and regulations in the United States and in each of the countries in which we do business in Europe. These laws and regulations govern, among other things, air emissions and the discharge of wastewater and other pollutants, the use of refrigerants, the handling and disposal of hazardous materials, and the cleanup of contamination in the environment.

We could incur significant costs, including fines, penalties and other sanctions, cleanup costs, and third-party claims for property damage or personal injury as a result of the failure to comply with, or liabilities under, environmental, health, and safety requirements. New legislation, as well as current federal and other state regulatory initiatives relating to these environmental matters, could require us to replace equipment, install additional pollution controls, purchase various emission allowances, or curtail operations. These costs could negatively affect our results of operations and financial condition.

***Violations of laws or regulations related to the food industry, as well as new laws or regulations or changes to existing laws or regulations related to the food industry, could adversely affect our business.***

The food production and marketing industry is subject to a variety of federal, state, local, and foreign laws and regulations, including food safety requirements related to the ingredients, manufacture, processing, storage, marketing, advertising, labeling, and distribution of our products, as well as those related to worker health and workplace safety. Our activities, both in and outside of the United States, are subject to extensive regulation. We are regulated by, among other federal and state authorities, the U.S. FDA, the U.S. Federal Trade Commission ("FTC"), and the U.S. Departments of Agriculture, Commerce, and Labor, as well as by similar authorities abroad within the regulatory framework of the European Union and its members. Governmental regulations also affect taxes and levies, healthcare costs, energy usage, immigration, and other labor issues, all of which may have a direct or indirect effect on our business or those of our customers or suppliers.

In addition, the marketing and advertising of our products could make us the target of claims relating to alleged false or deceptive advertising under federal, state, and foreign laws and regulations, and we may be subject to initiatives that limit or prohibit the marketing and advertising of our products to children.

We are also subject to federal laws and regulations relating to our organic products and production. For example, as required by the National Organic Program ("NOP"), we rely on third parties to certify certain of our products and production locations as organic. Because the Organic Foods Production Act of 1990, which created the NOP, was so recently adopted, many regulations and informal positions taken by the NOP are subject to continued review and scrutiny.

Changes in these laws or regulations or the introduction of new laws or regulations could increase our compliance costs, increase other costs of doing business for us, our customers, or our suppliers, or restrict our actions, which could adversely affect our results of operations. In some cases, increased regulatory scrutiny could interrupt distribution of our products, as could be the case in the United States as the FDA enacts the Food Safety Modernization Act of 2011, or force changes in our production processes and our products. Further, if we are found to be in violation of applicable laws and regulations in these areas, we could be subject to civil remedies, including fines, injunctions, or recalls, as well as potential criminal sanctions, any of which could have a material adverse effect on our business.

***Three of our directors and executive officers control a significant portion of our common stock and their interests may not align with the interests of our other shareholders.***

Ludmila Smolyansky, the chairman of our board, Julie Smolyansky, our chief executive officer, president and director and Edward Smolyansky, our chief financial and accounting officer, chief operating officer, treasurer and secretary (together, the "Smolyansky Family") own approximately 49.6% of our issued and outstanding common stock. This significant concentration of share ownership may adversely affect the trading price of our common stock because investors often perceive a disadvantage in owning shares in a company with one or several controlling shareholders.

Furthermore, our directors and officers, as a group, which own in excess of 49.8% of our issued and outstanding common stock have the ability to significantly influence or control the outcome of all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions, such as mergers, consolidations or the sale of substantially all of our assets.

This concentration of ownership may have the effect of delaying or preventing a change in control of our company which could deprive our shareholders of an opportunity to receive a premium for their shares as part of a sale of our company and might reduce the price of our common stock. In addition, without the consent of the Smolyansky Family, we could be prevented from entering into transactions that could be beneficial to us. The Smolyansky Family may cause us to take actions that are opposed by other shareholders as their interests may differ from those of other shareholders.

*We have identified material weaknesses in our internal control over financial reporting. Our failure to establish and maintain effective internal control over financial reporting could result in material misstatements in our financial statements, our failure to meet our reporting obligations and cause investors to lose confidence in our reported financial information, which in turn could cause the trading price of our securities to decline.*

We have identified material weaknesses in our internal control over financial reporting. A description of the material weaknesses can be found in Item 9A of this report. As a result of such weaknesses, our management concluded that our disclosure controls and procedures and internal control over financial reporting were not effective as of December 31, 2015.

Unless and until these material weaknesses have been remediated, or should new material weaknesses arise or be discovered in the future material misstatements could occur and go undetected in the Company's interim or annual consolidated financial statements and we may be required to restate our financial statements. In addition, we may experience delays in satisfying our reporting obligations or to comply with SEC rules and regulations, which could result in investigations and sanctions by regulatory authorities. Any of these results could adversely affect our business and the value of our common stock.

**ITEM 1B UNRESOLVED STAFF COMMENTS**

None

**ITEM 2 PROPERTIES**

We operate the following facilities:

| <b>Location</b>            | <b>Owned / Leased</b> | <b>Principal Use</b>  |
|----------------------------|-----------------------|---|
| Morton Grove, Illinois     | Owned                 | Production of kefir and cheese, principal executive offices |
| Waukesha, Wisconsin        | Owned                 | Production of kefir, administrative offices                 |
| Niles, Illinois            | Owned                 | Distribution center, administrative offices                 |
| Philadelphia, Pennsylvania | Owned                 | Production of kefir and cheese, administrative offices      |
| Skokie, Illinois           | Owned                 | Production of cheese  |
| Sauk Centre, Minnesota     | Owned                 | Administrative offices                                      |

The Company believes that its facilities are adequate for its current needs and that suitable additional space will be available on commercially acceptable terms as required. The Company believes that Lifeway has adequate insurance coverage for all of its properties.

### **ITEM 3      LEGAL PROCEEDINGS**

From time to time we are engaged in litigation matters arising in the ordinary course of business none of which presently is reasonably likely to have a material adverse effect on our financial position or results of operations.

### **ITEM 4      MINE SAFETY DISCLOSURES**

None



**PART II**

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

Our common stock is listed on The Nasdaq Global Market under the symbol "LWAY." Trading commenced on March 29, 1988.

As of February 29, 2016, there were approximately 65 holders of record of Lifeway's Common Stock. The Company has no information regarding beneficial owners whose shares are held in street name.

**Common stock price**

The following table shows the high and low sale prices per share of our common stock as reported on The Nasdaq Global Market for each quarter during the two most recent fiscal years is set forth in the following table:

|                | Common<br>Stock Price<br>Range |         |
|----------------|--------------------------------|---------|
|                | 2014                           |         |
|                | Low                            | High    |
| First Quarter  | \$13.35                        | \$15.99 |
| Second Quarter | \$12.59                        | \$15.50 |
| Third Quarter  | \$12.34                        | \$14.78 |
| Fourth Quarter | \$15.00                        | \$20.33 |
|                | 2015                           |         |
| First Quarter  | \$16.79                        | \$22.38 |
| Second Quarter | \$17.20                        | \$21.90 |
| Third Quarter  | \$10.16                        | \$20.00 |
| Fourth Quarter | \$9.88                         | \$12.56 |

**Stock Performance Graph**

The following graph compares the cumulative total stockholder return on Lifeway's common stock over the last five fiscal years based on the market price of the common shares and assumes reinvestment of dividends, with the cumulative total return of companies in the Russell 2000 Stock Index and the S&P Packaged Foods group.

The table below assumes an investment of \$100 on December 31, 2011 in our common stock, the Russell 2000 Index and the S&P Packaged Foods group.

|                          | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|--------------------------|------|------|------|------|------|------|
| Lifeway                  | 100  | 101  | 92   | 167  | 194  | 116  |
| Russell 2000 Index       | 100  | 95   | 108  | 148  | 153  | 144  |
| S&P Packaged Foods group | 100  | 114  | 122  | 156  | 170  | 195  |

### **Dividend Policy**

Lifeway does not routinely declare and pay dividends. From time to time however our Board of Directors may declare and pay dividends depending on the Company's operating cash flow, financial condition, capital requirements and such other factors as the Board of Directors may deem relevant.

There were no dividends declared or paid in fiscal 2015 and 2014.

**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) |
|-------------------------|----------------------------------|------------------------------|--|--|
| 10/1/2015 to 10/31/2015 | 41,607                           | \$ 11.56                     | 41,607   | \$ 3,019   |
| 11/1/2015 to 11/30/2015 | 35,054                           | \$ 10.63                     | 35,054   | \$ 2,647   |
| 12/1/2015 to 12/31/2015 | 59,526                           | \$ 11.56                     | 59,526   | (b)\$ 1,958  |
| Total                   | 136,187                          | \$ 11.32                     | 136,187  | \$ 1,958   |

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

(b) Includes 30,000 shares purchased by the company in privately negotiated transactions, in accordance with all applicable securities laws and regulations.

**ITEM 6 SELECTED FINANCIAL DATA**

The following table sets forth selected financial data for each of the fiscal years in the five-year period ended December 31, 2015:

| Thousands except per share information | 2015      | 2014      | 2013     | 2012     | 2011     |
|--|-----------|-----------|----------|----------|----------|
| Net Sales                              | \$118,587 | \$118,960 | \$97,524 | \$81,351 | \$69,970 |
| Income from Operations                 | 4,403     | 4,235     | 8,031    | 8,845    | 5,076    |
| Net Income                             | 1,972     | 1,956     | 4,990    | 5,620    | 2,855    |
| Total assets                           | 64,918    | 63,424    | 63,674   | 53,507   | 51,473   |

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|   |        |        |        |        |        |
|---|--------|--------|--------|--------|--------|
| Notes payable                               | 7,119  | 8,125  | 8,999  | 4,956  | 5,540  |
| Total equity                                | 45,256 | 44,700 | 42,950 | 39,313 | 35,357 |
| Basic and diluted earnings per common share | 0.12   | 0.12   | 0.31   | 0.34   | 0.17   |
| Dividends per share                         | –      | –      | 0.08   | 0.07   | –      |

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

The following discussion of the financial condition and results of operations for the twelve-months ended December 31, 2015, 2014 and 2013 should be read in conjunction with the audited consolidated financial statements and the notes to those statements that are included elsewhere in this report on 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 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 bounds 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 in Part I, Item 1A. 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.

### *Results of Operation*

#### Comparison of Year Ended December 31, 2015 to Year Ended December 31, 2014

##### Net sales

The following table summarizes our net sales:

|   | Year ended December 31, |           | Change   |        |
|---|-------------------------|-----------|----------|--------|
|   | 2015                    | 2014      | \$       | %      |
| Gross Sales   | \$137,244               | \$130,216 | \$7,028  | 5.4 %  |
| Less: Discounts & promotional allowances            | (18,657 )               | (11,256 ) | (7,401)  | 65.8 % |
| Net Sales   | \$118,587               | \$118,960 | \$(373 ) | -0.3 % |
| Discounts & promotional allowances % to gross sales | 13.6 %                  | 8.6 %     |          |        |

Net sales declined by \$373 or 0.3% during the year ended December 31, 2015 from \$118,960 during the same period in 2014. The decrease in net sales reflects a 5.4% increase in gross sales reflecting higher volumes of drinkable Kefir, higher cream sales, and increased private label sales offset by lower sales of cheese and frozen product and significantly higher discounts and promotional allowances given to customers.

**Cost of goods sold & gross profit**

The following table summarizes our cost of goods sold and gross profit:

|  | Year ended December 31, |           | Change      |         |
|--|-------------------------|-----------|-------------|---------|
|  | 2015                    | 2014      | \$          | %       |
| Purchases, net                             | \$ 51,776               | \$ 59,378 | \$ (7,602 ) | -12.8 % |
| Testing                                    | 113                     | 51        | 62          | 121.6%  |
| Supplies                                   | 2,026                   | 1,414     | 612         | 43.3 %  |
| Salaries production                        | 12,078                  | 9,465     | 2,613       | 27.6 %  |
| Contract work                              | 145                     | 158       | (13 )       | -8.2 %  |
| Freight                                    | 13,206                  | 12,790    | 416         | 3.3 %   |
| Labor and overhead                         | 6,948                   | 4,305     | 2,643       | 61.4 %  |
| Cost of Goods Sold, excluding depreciation | 86,292                  | 87,561    | (1,269 )    | -1.4 %  |
| Depreciation expense                       | 2,413                   | 2,536     | (123 )      | -4.9 %  |
| Cost of Goods Sold                         | \$ 88,705               | \$ 90,097 | \$ (1,392 ) | -1.5 %  |
| Gross profit                               | \$ 29,882               | \$ 28,863 | \$ 1,019    | 3.5 %   |
| Gross Profit % to net sales                | 25.2 %                  | 24.3 %    |             |         |

Gross profit as a percent of net sales increased to 25.2% during the year ended December 31, 2015 from 24.3% during the same period in 2014. The increase in the gross profit percent reflects lower input costs, primarily lower milk prices, partially offset by higher labor and overhead costs and the elevated level of promotional allowances and discounts given to customers. During the second quarter of 2015, our Waukesha facility began producing kefir, requiring the classification of certain of the facility's labor and overhead costs as Cost of Goods Sold, versus their classification as G&A in 2014 (before production had begun). The higher labor and overhead costs in 2015 reflects the Waukesha production and its relatively low capacity utilization.

### Selling Expenses

The following table summarizes our selling expenses:

|                                   | Year ended December 31, |           | Change |         |
|-----------------------------------|-------------------------|-----------|--------|---------|
|                                   | 2015                    | 2014      | \$     | %       |
| Salesperson commissions           | \$ 2,285                | \$ 2,259  | \$ 26  | 1.2 %   |
| Advertising                       | 5,006                   | 3,875     | 1,131  | 29.2 %  |
| Salaries                          | 3,627                   | 3,331     | 296    | 8.9 %   |
| Other marketing & promotion costs | 216                     | 403       | (187 ) | -46.4 % |
| Travel                            | 758                     | 1,743     | (985 ) | -56.5 % |
| Selling expense                   | \$ 11,892               | \$ 11,611 | \$ 281 | 2.4 %   |
| % to net sales                    | 10.0 %                  | 9.8 %     |        |         |

Selling expenses increased by \$281 or 2.4% to \$11,892 during the year ended December 31, 2015 from \$11,611 during the same period in 2014 reflecting an increase in advertising and higher salaries and partially offset by lower travel related costs. The lower travel related costs reflects a concerted effort to contain these costs in 2015. Selling expenses as a percentage of sales were 10.0% for the year ended December 31, 2015 compared to 9.8% for the same period in 2014.

### General and administrative expenses

The following table summarizes our general and administrative expenses:



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|                                  | Year ended December |           | Change   |         |
|----------------------------------|---------------------|-----------|----------|---------|
|                                  | 31,<br>2015         | 2014      | \$       | %       |
| Salaries                         | \$ 6,671            | \$ 6,177  | \$ 494   | 8.0 %   |
| Rent                             | 265                 | 298       | (33 )    | -11.1 % |
| Equipment lease                  | 12                  | 8         | 4        | 50 %    |
| Auto expense                     | 135                 | 93        | 42       | 45.2 %  |
| Office supplies                  | 167                 | 325       | (158 )   | -48.6 % |
| Professional fees                | 4,768               | 3,086     | 1,682    | 54.5 %  |
| Telephone expense                | 165                 | 99        | 66       | 66.7 %  |
| Facilities                       | 211                 | 1,515     | (1,304 ) | -86.1 % |
| Miscellaneous                    | 477                 | 700       | (223 )   | -31.8 % |
| General & administrative expense | \$ 12,871           | \$ 12,301 | \$ 570   | 4.6 %   |
| % to net sales                   | 10.9 %              | 10.3 %    |          |         |

General and administrative expenses increased \$570 or 4.6% to \$12,871 during the year ended December 31, 2015 from \$12,301 during the same period in 2014. The increase is primarily a result of increases in professional fees and salaries partially offset by lower facilities costs. Professional fees, which consists primarily of legal and accounting fees increased by \$1,682 or 54.5% to \$4,768 during the year ended December 31, 2015 from \$3,086 during the same period in 2014. The higher professional fees primarily arise from our process improvement initiatives aimed at remediating internal control deficiencies, redundancies and inefficiencies associated with retaining a new audit firm, elevated legal fees associated the company's delayed SEC filings and related matters, and fees paid to executive search firms. During the second quarter of 2015, our Waukesha facility began producing kefir, requiring the classification of certain of the facility's 2015 labor and overhead costs as Cost of Goods Sold, versus their classification as G&A in 2014 (before production had begun). The lower facilities costs in 2015 were primarily driven by this change in classification.

**Income from operations and net income**

The company reported income from operations of \$4,403 during the year ended December 31, 2015, compared to \$4,235 during the same period in 2014. The provision for income taxes was \$2,020, or a 50.6% effective rate for the year ended December 31, 2015 compared to a provision for income taxes of \$2,242 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 \$1,972 or \$0.12 per basic and diluted common share for the year ended December 31, 2015 compared to \$1,956 or \$0.12 per basic and diluted common share in the same period in 2014.

**Comparison of Year Ended December 31, 2014 to Year Ended December 31, 2013****Net sales**

The following table summarizes our net sales:

|   | Year ended December 31, |           | Change   |       |
|---|-------------------------|-----------|----------|-------|
|   | 2014                    | 2013      | \$       | %     |
| Gross Sales   | \$130,216               | \$108,966 | \$21,250 | 19.5% |
| Less: Discounts & promotional allowances            | (11,256)                | (11,442)  | 186      | -1.6% |
| Net Sales   | \$118,960               | \$97,524  | \$21,436 | 22.0% |
| Discounts & promotional allowances % to gross sales | 8.6%                    | 10.5%     |          |       |

Total consolidated net sales increased by \$21,436 (approximately 22%) to \$118,960 during the year ended December 31, 2014 from \$97,524 during the year ended December 31, 2013, primarily as a result of a \$21,250 (approximately 19.5%) increase in total consolidated gross sales to \$130,216 during the year ended December 31, 2014 from \$108,966 during the year ended December 31, 2013, offset by a decrease in discounts and allowances in fiscal year 2014 as compared to fiscal year 2013. The increase in total consolidated gross sales resulted primarily from an increase in volume of products sold. The increase included \$18,062 from an increase in volume of products sold and

\$3,188 from increases in prices of products sold.

### Cost of goods sold & gross profit

The following table summarizes our cost of goods sold and gross profit:

|  | Year ended   |          | Change   |        |
|--|--------------|----------|----------|--------|
|  | December 31, |          | \$       | %      |
|  | 2014         | 2013     |          |        |
| Purchases, net                             | \$59,379     | \$47,145 | \$12,234 | 25.9 % |
| Testing                                    | 51           | 37       | 14       | 37.8 % |
| Supplies                                   | 1,414        | 780      | 634      | 81.3 % |
| Salaries production                        | 9,465        | 7,981    | 1,484    | 18.6 % |
| Contract work                              | 158          | 69       | 89       | 129.0% |
| Freight                                    | 12,790       | 9,560    | 3,230    | 33.8 % |
| Labor and overhead                         | 4,304        | 2,703    | 1,601    | 59.2 % |
| Cost of Goods Sold, excluding depreciation | 87,561       | 68,275   | 19,286   | 28.2 % |
| Depreciation expense                       | 2,536        | 1,626    | 910      | 56.0 % |
| Cost of Goods Sold                         | \$90,097     | \$69,901 | \$20,196 | 28.9 % |
| Gross profit                               | \$28,863     | \$27,623 | \$1,240  | 4.5 %  |
| Gross Profit % to net sales                | 24.3 %       | 28.3 %   |          |        |

Total cost of goods sold, increased by \$20,196 (approximately 28.9%) to \$90,097 during the year ended December 31, 2014 from \$69,901 during the year ended December 31, 2013. This increase is a result of increases in cost of goods sold, excluding depreciation expense, and depreciation expense.

Cost of goods sold, excluding depreciation expense, increased by \$19,286 (approximately 28.2%) to \$87,561 during the year ended December 31, 2014 from \$68,275 during the year ended December 31, 2013. This increase is primarily a result of increases in purchases, supplies, salaries, freight and labor and overhead.

Purchases increased by \$12,233 (approximately 25.9%) to \$59,378 during the year ended December 31, 2014 from \$47,145 during the year ended December 31, 2013 primarily as a result of the increase in volume of goods produced. The increase in purchases included approximately \$9,196 from an increase in volume of purchases and approximately \$3,065 from increases in prices of products purchased.

Supplies increased \$634 (approximately 81.3%) to \$1,414 during the year ended December 31, 2014 from \$780 during the year ended December 31, 2013. The increase is primarily a result of increased purchases related to the Company's Wisconsin facility purchased in July, 2013.

Salaries increased \$1,484 (approximately 18.6%) to \$9,465 during the year ended December 31, 2014 from \$7,981 during the year ended December 31, 2013. The increase was a result of additional employees hired in connection with the purchase of the Wisconsin facility in July 2013.

Freight increased \$3,230 (approximately 33.8%) to \$12,790 during the year ended December 31, 2014 from \$9,560 during the year ended December 31, 2013. The increase was primarily as a result of an increase in the volume of our products sold and shipped.

Labor and overhead increased \$1,601 (approximately 59.2%) to \$4,304 during the year ended December 31, 2014 from \$2,703 during the year ended December 31, 2013. The increase was primarily as a result of increased costs related to the Company's Wisconsin facility purchased in July 2013.

Depreciation expense increased by \$910 (approximately 56.0%) to \$2,536 during the year ended December 31, 2014 from \$1,627 during the year ended December 31, 2013. The increase is partially attributable to an increase in

depreciation expense of \$470 during 2014 related to an adjustment to the useful lives of the Starfruit leasehold improvements and the depreciation expense of \$320 associated with assets placed in service at the Lifeway Wisconsin location since July 2013.

## Selling Expenses

The following table summarizes our selling expenses:

|                         | Year ended<br>December 31, |          | Change   |        |
|-------------------------|----------------------------|----------|----------|--------|
|                         | 2014                       | 2013     | \$       | %      |
| Salesperson commissions | \$ 2,259                   | \$ 1,989 | \$ 270   | 13.6 % |
| Advertising             | 3,875                      | 2,439    | 1,436    | 58.9 % |
| Salaries                | 3,311                      | 2,823    | 508      | 18.0 % |
| Promotions payable      | 403                        | 247      | 156      | 63.2 % |
| Travel                  | 1,743                      | 1,633    | 110      | 6.7 %  |
| Selling expense         | \$ 11,611                  | \$ 9,131 | \$ 2,480 | 27.2 % |
| % to net sales          | 9.8 %                      | 9.4 %    |          |        |

Selling expenses increased by \$2,480 (approximately 27.2%) to \$11,611 during the year ended December 31, 2014 from \$9,131 during the year ended December 31, 2013. This increase resulted primarily from increases in advertising and salaries.

Advertising increased \$1,436 (approximately 58.9%) to \$3,875 during the year ended December 31, 2014 from \$2,439 during the year ended December 31, 2013. The increase was a result of a greater volume of advertisements purchased.

Salaries increased \$508 (approximately 18.0%) to \$3,311 during the year ended December 31, 2014 from \$2,823 during the year ended December 31, 2013. The increase was a result of additional headcount and incentive compensation.

### General and administrative expenses

The following table summarizes our general and administrative expenses:

|   | Year ended<br>December 31, |          | Change   |         |
|---|----------------------------|----------|----------|---------|
|   | 2014                       | 2013     | \$       | %       |
| Salaries  | \$ 6,177                   | \$ 4,570 | \$ 1,607 | 35.2 %  |
| Rent  | 298                        | 347      | (49 )    | -14.1 % |
| Equipment lease                                 | 8                          | 5        | 3        | 60.0 %  |
| Auto expense                                    | 93                         | 70       | 23       | 32.9 %  |
| Office supplies                                 | 325                        | 302      | 23       | 7.6 %   |
| Professional fees                               | 3,086                      | 2,525    | 561      | 22.2 %  |
| Telephone expense                               | 99                         | 72       | 27       | 37.5 %  |
| Facilities                                      | 1,515                      | 1,370    | 145      | 10.6 %  |
| Miscellaneous                                   | 700                        | 487      | 213      | 43.7 %  |
| General & administrative expense                | \$ 12,301                  | \$ 9,748 | \$ 2,553 | 26.2 %  |
| General & administrative expense % to net sales | 10.3 %                     | 10.0 %   |          |         |

General and administrative expenses increased \$2,553 (approximately 26.2%) to \$12,301 during the year ended December 31, 2014 from \$9,748 during the year ended December 31, 2013. The increase is primarily a result of an increase in salaries and professional fees.

Salaries increased \$1,607 (approximately 35.2%) to \$6,177 during the year ended December 31, 2014 from \$4,570 during the year ended December 31, 2013. The increase reflects higher compensation for the Company's senior executives.

Professional fees increased \$561 (approximately 22.2%) to \$3,086 during the year ended December 31, 2014 from \$2,525 during the year ended December 31, 2013. The Company became an accelerated filer as of December 31, 2013. As a result of becoming an accelerated filer, the Company was required to make certain limited additional disclosures on an accelerated timeline for the filing of its Form 10-K for the fiscal year ended December 31, 2013, filed April 2, 2014. Thereafter all of the Company's filings with the SEC were subject to full disclosure required by

accelerated filers. The increase in professional fees resulted from the increased disclosure requirements as a result of the Company becoming an accelerated filer and from responding to comments from the SEC.

### **Income from operations and net income**

Income from operations decreased by \$3,796 (approximately 47%) to \$4,235 during the year ended December 31, 2014, from \$8,031 during the year ended December 31, 2013.

Provision for income taxes was \$2,242 or a 53% effective tax rate, for the year ended December 31, 2014 compared with \$2,867 or a 36% effective tax rate, during the year ended December 31, 2013. Income taxes are discussed in Note 10 of the Notes to Consolidated Financial Statements.

Net income was \$1,956 or \$0.12 per share for the year ended December 31, 2014 compared to \$4,990 or \$0.31 per share for the year ended December 31, 2013.

### *Liquidity and Capital Resources*

We anticipate being able to fund the Company's foreseeable liquidity requirements internally. We also have unused credit lines as discussed in footnote 8 to the consolidated financial statements and we anticipate future compliance with our loan agreements. 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 \$6,745 during the year ended December 31, 2015 compared to net cash provided by operating activities of \$5,092 in the same period in 2014. The increase is primarily attributable to the favorable timing of payments to suppliers and service providers and lower income tax payments in 2015 partially offset by increased inventory levels in 2015.

Net cash used in investing activities was \$1,780 during the year ended December 31, 2015 compared to net cash used in investing activities of \$4,261 in the same period in 2014. The higher level of net cash used in investing activities in 2014 reflects the elevated spending on purchases of property and equipment in 2014, primarily related to the Waukesha Wisconsin facility. Net cash used in 2015 benefited from proceeds related to the sale of property and equipment during the 2015 period.

Net cash used in financing activities was \$2,579 during the year ended December 31, 2015 compared to net cash used in investing activities of \$877 in the same period in 2014. The increase in cash used in investing activities reflects share repurchase activity in 2015 and slightly higher note payable payments in 2015.

The Company had a net increase in cash and cash equivalents of \$2,386 during the year ended December 31, 2015 compared to a net decrease in cash and cash equivalents of \$46 in the same period in 2014.

On September 24, 2015, the Company's Board of Directors authorized a stock repurchase program under which the Company may repurchase up to \$3.5 million 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. During the three and twelvemonths ended December 31, 2015 the company acquired 136 shares at an aggregate cost of \$1,542.



At December 31, 2015, 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, which unless renewed expires in July 2016, remained unused at December 31, 2015 and is available for other general corporate purposes.

In July 2013, we purchased certain assets of Golden Guernsey located in Waukesha Wisconsin. The Golden Guernsey assets position us to scale-up our kefir producing capacity in tandem with future growth and provide us with an additional production platform that we believe creates greater supply chain productivity and flexibility opportunities. Beyond kefir production, this new facility also vertically extends Lifeway into milk processing and bottle manufacturing operations, both of which historically had been sourced from unaffiliated third party suppliers. Our milk processing, which consists of converting raw milk into conventional milk, and our bottle manufacturing operations commenced in April of 2014. Our kefir production commenced operations in July of 2015.

On March 14, 2016, the Company entered into an endorsement agreement (the "Agreement") with Ludmila Smolyansky, the Company's Chairman of the Board. Under the terms and conditions of the Agreement, Ms. Smolyansky grants an unlimited, perpetual, non-exclusive, worldwide and, except as set forth therein, royalty free, right to use, reuse, publish, reproduce, perform, copy, create derivative works, exhibit, broadcast and display Ms. Smolyansky's name, image and likeness in Marketing Materials (as defined in the Agreement). As consideration for such license, the Company agrees to pay Ms. Smolyansky a royalty equal to \$0.02 for each Company product or item sold by Lifeway during each calendar month bearing Ms. Smolyansky's first name, last name or other identifying personal characteristics; provided however that such royalty will not exceed \$50 in any month and such royalty payments will cease upon the death of Ms. Smolyansky.

***Off-Balance Sheet Arrangements***

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

***Contractual Obligations***

|                             | Payments due by period |       |                  |           |           |
|-----------------------------|------------------------|-------|------------------|-----------|-----------|
|                             |                        | Total | Less than 1 year | 1-3 years | 3-5 years |
| Contractual obligations     |                        |       |                  |           |           |
| Long-Term Debt Obligations  | \$7,959                | \$840 | \$7,119          | \$        | –         |
| Operating Lease Obligations | \$210                  | \$70  | \$140            | \$        | –         |
| Total                       | \$8,169                | \$910 | \$7,259          | \$        | –         |

***Critical Accounting Policies***

The preparation of financial statements in accordance with US GAAP requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. US GAAP provides the framework from which to make these estimates, judgments and assumptions. We believe our estimates, judgments and assumptions are reasonable; however, future results could differ from those estimates. Management regularly assesses its accounting policies and has discussed the development and selection of critical accounting policies with its Audit Committee of the Board of Directors. For further information concerning accounting policies, refer to the notes to the consolidated financial statements.

***Intangible asset valuation.*** Goodwill and other indefinite lived intangibles are not subject to amortization but rather is tested for impairment annually and whenever events or changes in circumstances indicate that impairment may have occurred. Our estimates of fair value for goodwill impairment testing are determined based on the market capitalization of the company. Other indefinite-lived intangible assets are tested for impairment by comparing the fair value of the asset to the carrying value. Fair value of our other indefinite-lived intangible assets is determined based on discounted cash flow analyses that include significant management assumptions such as revenue growth rates, weighted average cost of capital, and assumed royalty rates. If our estimate of fair value is less than the carrying value, the asset is reduced to fair value.

As of December 31, 2015 we had \$10.4 million of goodwill and the market capitalization of the Company exceeded its carrying value by more than 100%. As of December 31, 2015 we had \$3.7 million of other indefinite lived intangible assets which we estimate have a fair value in excess of carrying value by more than 20%.

*Sales discounts & allowances.* From time to time, we grant certain sales discounts to customers which are classified as a reduction in sales. The measurement and recognition of discounts and allowances involves the use of judgment and our estimates are made based on historical experience and other factors. As of December 31, 2015 we had \$1.7 million of accrued discounts and allowances.

*Income taxes.* We pay income taxes based on tax statutes, regulations and case law of the various jurisdictions in which we operate. At any one time, multiple tax years are subject to audit by the various taxing authorities. Income taxes are accounted for under the asset and liability method. Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

We recognize an income tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities based on the technical merits of the position. The income tax benefit recognized in our financial statements from such a position is measured based on the largest estimated benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

**ITEM 7A      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 December 31, 2015, we had an outstanding balance under our bank term loans of approximately \$8.0 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 December 31, 2015 of approximately \$8.0 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 \$80. For a detailed discussion of our loans, including a discussion of the applicable interest rate, please refer to Note 8, Notes Payable under Part II, Item 8 in this Annual Report on Form 10-K.



**ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA****LIFEWAY FOODS, INC. AND SUBSIDIARIES****Consolidated Balance Sheets****December 31, 2015 and 2014***(In thousands)*

|  | December 31,<br>2015<br><i>Restated</i> | 2014     |
|--|---|----------|
| Current assets   |   |          |
| Cash and cash equivalents  | \$5,646                                 | \$3,260  |
| Investments, at fair value   | 2,091                                   | 2779     |
| Certificates of deposits in financial institutions   | 513                                     | 150      |
| Inventories  | 7,664                                   | 5,814    |
| Accounts receivable, net of allowance for doubtful accounts and discounts of \$1,800 and \$1,050 in 2015 and 2014 respectively | 9,886                                   | 10,214   |
| Prepaid expenses and other current assets  | 156                                     | 252      |
| Other receivables  | 45                                      | 134      |
| Deferred income taxes  | 556                                     | 408      |
| Refundable income taxes  | 449                                     | 1,141    |
| Total current assets   | 27,006                                  | 24,152   |
| Property and equipment, net  | 21,375                                  | 21,892   |
| Intangible assets  |   |          |
| Goodwill & indefinite-lived intangibles  | 14,068                                  | 14,068   |
| Other intangible assets, net   | 2,344                                   | 3,060    |
| Total intangible assets  | 16,412                                  | 17,128   |
| Other Assets   | 125                                     | 252      |
| Total assets   | \$64,918                                | \$63,424 |
| Current liabilities  |   |          |
| Current maturities of notes payable  | \$840                                   | \$872    |
| Accounts payable   | 8,393                                   | 5,587    |
| Accrued expenses   | 1,538                                   | 2,066    |

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|  |          |          |
|--|----------|----------|
| Accrued income taxes   | 52       | –        |
| Total current liabilities  | 10,823   | 8,525    |
| Notes payable  | 7,119    | 8,125    |
| Deferred income taxes  | 1,719    | 2,074    |
| Total liabilities  | 19,661   | 18,724   |
| Stockholders' equity   |          |          |
| Common stock, no par value; 40,000 shares authorized; 17,274, shares issued; 16,210 and 16,346 shares outstanding at 2015 and 2014 | 6,509    | 6,509    |
| Paid-in-capital  | 2,033    | 2,033    |
| Treasury stock, at cost  | (9,730 ) | (8,188 ) |
| Retained earnings  | 46,516   | 44,544   |
| Accumulated other comprehensive loss, net of taxes   | (71 )    | (198 )   |
| Total stockholders' equity   | 45,257   | 44,700   |
| Total liabilities and stockholders' equity   | \$64,918 | \$63,424 |

**See accompanying notes to consolidated financial statements**

**LIFEWAY FOODS, INC. AND SUBSIDIARIES****Consolidated Statements of Income and Comprehensive Income****December 31, 2015, 2014 and 2013***(In thousands, except per share data)*

|   | 2015<br><i>Restated</i> | 2014       | 2013       |
|---|-------------------------|------------|------------|
| Gross Sales   | \$ 137,244              | \$ 130,216 | \$ 108,966 |
| Less: discounts and allowances                                | (18,657 )               | (11,256 )  | (11,442 )  |
| Net sales   | 118,587                 | 118,960    | 97,524     |
| Cost of goods sold  | 86,292                  | 87,561     | 68,275     |
| Depreciation expense  | 2,413                   | 2,536      | 1,626      |
| Total cost of goods sold                                      | 88,705                  | 90,097     | 69,901     |
| Gross profit  | 29,882                  | 28,863     | 27,623     |
| Selling expenses  | 11,892                  | 11,611     | 9,131      |
| General and administrative                                    | 12,871                  | 12,301     | 9,748      |
| Amortization expense  | 716                     | 716        | 713        |
| Total operating expenses                                      | 25,479                  | 24,628     | 19,592     |
| Income from operations  | 4,403                   | 4,235      | 8,031      |
| Other income (expense):                                       |                         |            |            |
| Interest and dividend income                                  | 112                     | 122        | 116        |
| Rental income   | 7                       | 4          | 12         |
| Interest expense  | (236 )                  | (277 )     | (203 )     |
| Gain (Loss) on sale of investments, net reclassified from OCI | (72 )                   | 99         | 195        |
| Gain (Loss) on sale of equipment                              | 253                     | 7          | (305 )     |
| Impairment of investments                                     | (475 )                  | -          | -          |
| Other Income (Expense)  | -                       | 8          | 11         |
| Total other income (expense)                                  | (411 )                  | (37 )      | (174 )     |
| Income before provision for income taxes                      | 3,992                   | 4,198      | 7,857      |
| Provision for income taxes                                    | 2,020                   | 2,242      | 2,867      |



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|   |         |         |         |
|---|---------|---------|---------|
| Net income  | \$1,972 | \$1,956 | \$4,990 |
| Basic and diluted earnings per common share                                     | \$0.12  | \$0.12  | \$0.31  |
| Weighted average number of shares outstanding                                   | 16,331  | 16,346  | 16,346  |
| <b>COMPREHENSIVE INCOME</b>   |         |         |         |
| Net income  | \$1,972 | \$1,956 | \$4,990 |
| Other comprehensive income (loss), net of tax:                                  |         |         |         |
| Unrealized gains (losses) on investments, net of \$30, \$94 and (\$50) of taxes | (47 )   | (146 )  | 64      |
| Reclassifications to earnings:  |         |         |         |
| Other than temporary impairment of investments, net of \$84 of taxes            | 130     | –       | –       |
| Realized (gains) losses on investments, net of (\$28), \$39 and \$85 of taxes   | 44      | (60 )   | (110 )  |
| Comprehensive income  | \$2,099 | \$1,750 | \$4,944 |

**See accompanying notes to consolidated financial statements**

## LIFEWAY FOODS, INC. AND SUBSIDIARIES

## Consolidated Statements of Stockholders' Equity

For the Years Ended December 31, 2015, 2014 and 2013

*(In thousands)*

|   | Common Stock     |         |                       |           | Paid In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss),<br>Net of Tax | Total<br>Equity |
|---|------------------|---------|-----------------------|-----------|--------------------|----------------------|--|-----------------|
|   | Issued<br>Shares | \$      | In treasury<br>Shares | \$        |                    |                      |  |                 |
| Balances at January 1, 2013                     | 17,274           | \$6,509 | (928 )                | \$(8,188) | \$2,033            | \$38,905             | \$ 54  | \$39,313        |
| Other comprehensive income                      | —                | —       | —                     | —         | —                  | —                    | (46 )  | (46 )           |
| Net income for the year ended December 31, 2013 | —                | —       | —                     | —         | —                  | 4,990                |  | 4,990           |
| Dividends declared (\$.08 per share)            |                  |         |                       |           |                    | (1,307 )             |  | (1,307 )        |
| Balances at December 31, 2013                   | 17,274           | \$6,509 | (928 )                | \$(8,188) | \$2,033            | \$42,588             | \$ 8   | \$42,950        |
| Balances at January 1, 2014                     | 17,274           | \$6,509 | (928 )                | \$(8,188) | \$2,033            | \$42,588             | \$ 8   | \$42,950        |
| Other comprehensive income                      | —                | —       | —                     | —         | —                  | —                    | (206 )   | (206 )          |
| Net income for the year ended December 31, 2014 | —                | —       | —                     | —         | —                  | 1,956                |  | 1,956           |
| Balances at December 31, 2014                   | 17,274           | \$6,509 | (928 )                | \$(8,188) | \$2,033            | \$44,544             | \$ (198 )  | \$44,700        |
| Balances at January 1, 2015                     | 17,274           | \$6,509 | (928 )                | \$(8,188) | \$2,033            | \$44,544             | \$ (198 )  | \$44,700        |
| Other comprehensive income                      | —                | —       | —                     | —         | —                  | —                    | 127  | 127             |
| Treasury stock purchased                        |                  |         | 136                   | (1,542)   |                    |                      |  | (1,542 )        |

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|   |        |         |         |           |         |          |                  |
|---|--------|---------|---------|-----------|---------|----------|------------------|
| Net income for the year ended December 31, 2015 | -      | -       | -       | -         | -       | 1,972    | 1,972            |
| Balances at December 31, 2015                   | 17,274 | \$6,509 | (1,064) | \$(9,730) | \$2,033 | \$46,516 | \$ (71 )\$45,257 |

**See accompanying notes to consolidated financial statements**

**LIFEWAY FOODS, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows****For the Years Ended December 31, 2015, 2014 and 2013***(In thousands)*

|   | December 31,<br><b>Restated</b> |         |         |
|---|---------------------------------|---------|---------|
|   | 2014                            | 2013    |         |
|   | <b>2015</b>                     |         |         |
| Cash flows from operating activities:                       |                                 |         |         |
| Net income  | \$1,972                         | \$1,956 | \$4,990 |
| Adjustments to reconcile net income to operating cash flow: |                                 |         |         |
| Depreciation and amortization                               | 3,129                           | 3,252   | 2,339   |
| Loss (Gain) on sale of investments, net                     | 72                              | (99 )   | (196 )  |
| Impairment of investments                                   | 475                             | –       | –       |
| Deferred income taxes                                       | (585 )                          | (720 )  | (238 )  |
| Bad debt expense  | 73                              | 205     | 33      |
| (Gain) Loss on sale of equipment                            | (253 )                          | (7 )    | 305     |
| (Increase) decrease in operating assets:                    |                                 |         |         |
| Accounts receivable   | 507                             | 55      | (1,742) |
| Other receivables   | 89                              | (31 )   | (94 )   |
| Inventories   | (1,849)                         | 1,085   | (960 )  |
| Refundable income taxes                                     | 691                             | (126 )  | (930 )  |
| Prepaid expenses and other current assets                   | 95                              | (124 )  | (6 )    |
| Increase (decrease) in operating liabilities:               |                                 |         |         |
| Accounts payable  | 2,229                           | (1,136) | 2,466   |
| Accrued expenses  | 48                              | 782     | 128     |
| Income taxes payable  | 52                              | –       | (254 )  |
| Net cash provided by operating activities                   | 6,745                           | 5,092   | 5,841   |
| Cash flows from investing activities:                       |                                 |         |         |
| Purchases of investments                                    | (1,489)                         | (3,280) | (3,519) |
| Proceeds from sale of investments                           | 1,714                           | 2,774   | 3,001   |
| Redemption of certificates of deposits                      | 272                             | 15      | 424     |
| Investments in certificates of deposits                     | (635 )                          | (150 )  | –       |
| Purchases of property and equipment                         | (1,995)                         | (3,684) | (8,480) |
| Proceeds from sale of equipment                             | 353                             | 64      | 711     |
| Net cash used in investing activities                       | (1,780)                         | (4,261) | (7,863) |

Cash flows from financing activities:

|  |         |         |         |
|--|---------|---------|---------|
| Purchase of treasury stock                             | (1,542) | –       | –       |
| Dividends paid   | –       | –       | (1,308) |
| Net proceeds from debt issuance                        | –       | –       | 4,975   |
| Repayment of notes payable                             | (1,037) | (877 )  | (625 )  |
| Net cash provided by (used in) financing activities    | (2,579) | (877 )  | 3,042   |
| Net increase (decrease) in cash and cash equivalents   | 2,386   | (46 )   | 1,020   |
| Cash and cash equivalents at the beginning of the year | 3,260   | 3,306   | 2,286   |
| Cash and cash equivalents at the end of the year       | \$5,646 | \$3,260 | \$3,306 |
| Supplemental cash flow information:                    |         |         |         |
| Cash paid for income taxes                             | \$2,245 | \$3,080 | \$4,363 |
| Cash paid for interest                                 | \$235   | \$267   | \$206   |

**See accompanying notes to consolidated financial statements**

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2015, 2014 and 2013**

*(In thousands)*

**Note 1 - Basis of presentation, out of period adjustments and restatement of prior period**

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

Out-of-period adjustments recorded during fiscal 2014

During fiscal 2014, adjustments to correct the accounting for certain items related to periods prior to 2014, in the aggregate, decreased income before provision for income taxes by approximately \$600,000 and net income by approximately \$400,000 for the year ended December 31, 2014. These errors related to an understatement of accrued expenses and the provision for income taxes arising primarily from inaccurate accounting for certain employee, including officer, expense reports and an understatement of depreciation expense arising from assigning incorrect useful lives. The Company determined these adjustments to be immaterial, individually and in the aggregate, to our previously filed consolidated financial statements.

Restatements of prior period financial statements

*Matters affecting the statement of income and comprehensive income*

During fiscal year 2015 certain indirect manufacturing overhead costs were classified as an element of General and Administrative (G&A) expense in our previously issued Statements of Income and Comprehensive Income. These indirect manufacturing overhead costs are more appropriately classified as an element of Cost of Goods Sold.

Accordingly, the classification errors have been restated in the Consolidated Statements of Income and Comprehensive Income.

These classification errors have no impact on the Company's previously-reported net sales, income from operations, net income, or basic and diluted earnings per common share presented in its Consolidated Statements of Income and Comprehensive Income.

The Company determined the classification errors related to the 2015 Consolidated Statements of Income and Comprehensive Income were quantitatively large enough to require a restatement of 2015 and has captioned those periods as "restated."

*Matters affecting the balance sheet and statement of cash flows*

The Company also determined that certain operating assets and liabilities at December 31, 2015 were not properly classified in our previously issued Consolidated Balance Sheets. These classification errors did not have a material impact on the Company's previously issued Consolidated Balance Sheets and Consolidated Statements of Cash Flows. To provide a higher degree of transparency and enhanced comparability between periods, these classification errors have been restated. Certain trade receivables at December 31, 2015 were reclassified from non-current assets to current assets to reflect the expected settlement of those receivables within one year; certain investments that do not meet the definition of available-for-sale securities were reclassified from investments at fair value to other assets; and we reclassified certain accounts payable amounts from accrued expenses to accounts payable.

Reclassifications of prior period financial statements

During the first quarter of 2015, certain executive compensation expense was classified as Selling expenses that management determined should have been classified as G&A expense. These classification changes are reflected in the Consolidated Statements of Income and Comprehensive Income for 2015. The reclassification has also been reflected in the 2014 and 2013 Consolidated Statements of Income and Comprehensive Income to conform to the 2015 presentation and such reclassifications do not change total operating expenses or net income in those periods.

These adjustments had the following impact on our 2015 interim and annual Consolidated Statement of Income and Comprehensive Income:

|                          | <b>(Unaudited)</b>                  |            |                | <b>(Unaudited)</b>                  |            |                |
|--------------------------|-------------------------------------|------------|----------------|-------------------------------------|------------|----------------|
|                          | <b>Three Months Ended</b>           |            |                | <b>Six Months Ended</b>             |            |                |
|                          | <b>March 31, 2015</b>               |            |                | <b>June 30, 2015</b>                |            |                |
|                          | As<br>Previously<br>Reported<br>(a) | Adjustment | As<br>Restated | As<br>Previously<br>Reported<br>(a) | Adjustment | As<br>Restated |
| 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        |

|                          | <b>(Unaudited)</b>                  |                   |                | <b>(Unaudited)</b>                  |                   |                |
|--------------------------|-------------------------------------|-------------------|----------------|-------------------------------------|-------------------|----------------|
|                          | <b>Nine Months Ended</b>            |                   |                | <b>Twelve Months Ended</b>          |                   |                |
|                          | <b>September 30, 2015</b>           |                   |                | <b>December 31, 2015</b>            |                   |                |
|                          | As<br>Previously<br>Reported<br>(c) | Adjustment<br>(b) | As<br>Restated | As<br>Previously<br>Reported<br>(d) | Adjustment<br>(b) | As<br>Restated |
| Net Sales                | \$89,042                            | \$ –              | \$89,042       | \$118,587                           | \$ –              | \$118,587      |
| Cost of Goods Sold       | 64,588                              | 1,137             | 65,725         | 86,986                              | 1,719             | 88,705         |
| Gross Profit             | 24,454                              | (1,137 )          | 23,317         | 31,601                              | (1,719 )          | 29,882         |
| Selling expenses         | 9,486                               | (860 )            | 8,626          | 12,752                              | (860 )            | 11,892         |
| General & administrative | 10,920                              | (277 )            | 10,643         | 13,730                              | (859 )            | 12,871         |
| Amortization             | 537                                 | –                 | 537            | 716                                 | –                 | 716            |



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|                        |         |          |         |         |          |         |
|------------------------|---------|----------|---------|---------|----------|---------|
| Operating expenses     | 20,943  | (1,137 ) | 19,806  | 27,198  | (1,719 ) | 25,479  |
| Income from Operations | \$3,511 | \$ –     | \$3,511 | \$4,403 | \$ –     | \$4,403 |

- (a) As previously reported in our first and second quarter 2016 Form 10-Q filings.
- (b) Includes the reclassification of certain executive compensation from Selling to G&A expenses.
- (c) As previously reported in our third quarter 2015 Form 10-Q filed on November 9, 2015.
- (d) As previously reported in our 2015 Form 10-K filed on March 16, 2016.

The reclassifications related to certain executive compensation had the following impact on our 2014 and 2013 Consolidated Statement of Income and Comprehensive Income:

|                          | <b>Twelve Months Ended</b> |                         |                | <b>Twelve Months Ended</b> |                         |                |
|--------------------------|----------------------------|-------------------------|----------------|----------------------------|-------------------------|----------------|
|                          | <b>December 31, 2014</b>   |                         |                | <b>December 31, 2013</b>   |                         |                |
|                          | <b>As</b>                  |                         |                | <b>As</b>                  |                         |                |
|                          | <b>Previously</b>          | <b>Reclassification</b> | <b>As</b>      | <b>Previously</b>          | <b>Reclassification</b> | <b>As</b>      |
|                          | <b>Reported</b>            |                         | <b>Revised</b> | <b>Reported</b>            |                         | <b>Revised</b> |
|                          | <b>(d)</b>                 |                         |                | <b>(d)</b>                 |                         |                |
| Selling expenses         | \$14,534                   | \$ (2,923               | ) \$11,611     | \$11,296                   | \$ (2,165               | ) \$9,131      |
| General & administrative | 9,378                      | 2,923                   | 12,301         | 7,583                      | 2,165                   | 9,748          |
| Amortization             | 716                        | –                       | 716            | 713                        | –                       | 713            |
| Operating expenses       | \$24,628                   | \$ –                    | \$24,628       | \$19,592                   | \$ –                    | \$19,592       |

## **Note 2 - Summary of significant accounting policies**

### Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities revenues and expenses. 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

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, amounts invoiced to customers for

shipping charges are included in gross sales and the related cost in cost of goods sold.

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 promotion 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 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.

#### 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 value judged to be other-than-temporary on available-for-sale securities are recorded as a component of other income. 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 cost basis; the financial condition of the investee; and the intent and ability to retain the investment for a sufficient period of time to allow for possible recovery in the fair value of the investment.

Inventories

Inventories are stated at the lower of first in, first out cost or market.

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 |

Goodwill and other intangible assets

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 for impairment 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, such as 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.

**Note 2 - Summary of significant accounting policies -- Continued**

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

Intangible assets are being amortized over the following useful lives:

| Category               | Years |
|------------------------|-------|
| Recipes                | 4     |
| Trade names            | 8-15  |
| Formula                | 10    |
| Customer lists         | 8-10  |
| 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 allowance for doubtful accounts.

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 income tax 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 December 31, 2015

and 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 costs

The Company expenses advertising costs as incurred. For the years ended December 31, 2015, 2014 and 2013 total advertising expenses were \$5,006, \$3,875, and \$2,686, respectively.

#### Earnings per common share

Earnings per common share were computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. For the years ended December 31, 2015, 2014, and 2013, there were no common stock equivalents outstanding.

### **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.

In November 2015, the FASB issued new guidance regarding the balance sheet classification of deferred 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 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 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. Early adoption of the guidance is not permitted. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.



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 in the statement of financial position 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.

### Note 3 - Intangible Assets

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

|   | December 31, |          |
|---|--------------|----------|
|   | 2015         | 2014     |
| Goodwill                                      | \$10,368     | \$10,368 |
| Brand names                                   | 3,700        | 3,700    |
| Goodwill & indefinite lived intangible assets | \$14,068     | \$14,068 |

Other intangible assets, net consists of the following:

|   | December 31, |         |
|---|--------------|---------|
|   | 2015         | 2014    |
| 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                              | 5,900        | 5,184   |
| Intangible assets, net                                | \$2,344      | \$3,060 |

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

|      |         |
|------|---------|
| 2016 | \$697   |
| 2017 | 672     |
| 2018 | 635     |
| 2019 | 210     |
| 2020 | 130     |
|      | \$2,344 |

#### Note 4 - Investments

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

| December 31, 2015     | Cost    | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|-----------------------|---------|---------------------|----------------------|---------------|
| Common stocks & ETF's | \$690   | \$ 17               | \$ (94 )             | \$613         |
| Mutual Funds          | 27      | –                   | (1 )                 | 26            |
| Preferred Securities  | 98      | 6                   | –                    | 104           |
| Corporate Bonds       | 1,393   | 43                  | (88 )                | 1,348         |
| Total                 | \$2,208 | \$ 66               | \$ (183 )            | \$2,091       |

| December 31, 2014     | Cost    | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|-----------------------|---------|---------------------|----------------------|---------------|
| Common stocks & ETF's | \$530   | \$ 20               | \$ (64 )             | \$486         |
| Mutual Funds          | 445     | –                   | (11 )                | 435           |
| Preferred Securities  | 180     | –                   | (2 )                 | 178           |
| Corporate Bonds       | 1,949   | 2                   | (270 )               | 1,680         |
| Total                 | \$3,104 | \$ 22               | \$ (347 )            | \$2,779       |

| December 31, 2013     | Cost    | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|-----------------------|---------|---------------------|----------------------|---------------|
| Common stocks & ETF's | \$1,006 | \$ 98               | \$ (32 )             | \$1,072       |
| Mutual Funds          | 55      | 2                   | –                    | 57            |
| Preferred Securities  | 465     | 13                  | (16 )                | 462           |
| Corporate Bonds       | 973     | 1                   | (49 )                | 925           |
| Total                 | \$2,499 | \$ 114              | \$ (97 )             | \$2,516       |

Gross gains of \$48, \$177, and \$248 and gross losses of \$120, \$78 and \$53 were realized on the sales of investments during the years ended December, 2015, 2014 and 2013 respectively.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2015, 2014 and, 2013:

| 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 )         |

| 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               | \$ (49 )          | \$141                | \$ (15 )          | \$303      | \$ (64 )          |
| Mutual Funds          | 435                 | (10 )             | –                    | –                 | 435        | (10 )             |
| Preferred Securities  | 81                  | (2 )              | –                    | –                 | 81         | (2 )              |
| Corporate Bonds       | 1,056               | (195 )            | 497                  | (76 )             | 1,553      | (271 )            |
|                       | \$1,734             | \$ (256 )         | \$638                | \$ (91 )          | \$2,372    | \$ (347 )         |

| December 31, 2013     | 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 | \$213               | \$ (32 )          | \$–                  | \$ –              | \$213      | \$ (32 )          |
| Mutual Funds          | –                   | –                 | –                    | –                 | –          | –                 |
| Preferred Securities  | 224                 | (15 )             | –                    | –                 | 224        | (15 )             |
| Corporate Bonds       | 616                 | (43 )             | 97                   | (7 )              | 713        | (50 )             |
|                       | \$1,053             | \$ (90 )          | \$97                 | \$ (7 )           | \$1,150    | \$ (97 )          |

The Company's investments in equity securities, mutual funds, and corporate bonds consist 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 of approximately \$475 during fiscal 2015 with respect to certain structured notes. The impairment losses are included in "other income (expense)" in the accompanying consolidated statements of income and comprehensive income. 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:

|                     | December 31, |         |
|---------------------|--------------|---------|
|                     | 2015         | 2014    |
| Finished goods      | \$2,946      | \$2,373 |
| Production supplies | 2,636        | 2,070   |
| Raw materials       | 2,082        | 1,371   |
| Total inventories   | \$7,664      | \$5,814 |

**Note 6 - Property and equipment**

Property and equipment consist of the following:

|                               | December 31, |          |
|-------------------------------|--------------|----------|
|                               | 2015         | 2014     |
| Land                          | \$1,807      | \$1,856  |
| Buildings and improvements    | 16,387       | 15,126   |
| Machinery and equipment       | 22,907       | 20,435   |
| Vehicles                      | 1,298        | 1,245    |
| Office equipment              | 709          | 465      |
| Construction in process       | 311          | 2,409    |
|                               | 43,419       | 41,536   |
| Less accumulated depreciation | 22,044       | 19,644   |
| Total property and equipment  | \$21,375     | \$21,892 |

**Note 7 - Accrued Expenses**

Accrued expenses consist of the following:

|                                   | December 31, |         |
|-----------------------------------|--------------|---------|
|                                   | 2015         | 2014    |
| Accrued payroll and payroll taxes | \$859        | \$892   |
| Accrued property tax              | 377          | 331     |
| Other                             | 3,027        | 843     |
|                                   | \$1,538      | \$2,066 |

**Note 8 - Notes Payable**

Notes payable consist of the following:

|   | December 31, |         |
|---|--------------|---------|
|   | 2015         | 2014    |
| Variable rate bank notes due May 31, 2018. Principal and interest payable monthly with a balloon payment due at maturity. | \$3,846      | \$4,352 |
| Variable rate bank notes due May 31, 2019. Principal and interest payable monthly with a balloon payment due at maturity. | 4,113        | 4,584   |
| 5.99% secured equipment notes fully paid and extinguished July, 2015  | –            | 12      |
| 6.65% secured equipment notes fully paid and extinguished July, 2015  | –            | 49      |
| Total notes payable   | 7,959        | 8,997   |
| Less current maturities   | 840          | 872     |
| Total long-term portion   | \$7,119      | \$8,125 |

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 December 31, 2015. Further, under the agreements the Company is required to deliver its annual and quarterly financial statements and related SEC filings within specified timeframes.

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 December 31, 2015 there were no borrowings under the facility. Unless renewed the facility expires in May 2016.

Future maturities of notes payables are as follows:

For the year ending December 31,

|      |       |
|------|-------|
| 2016 | \$840 |
|------|-------|



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|       |         |
|-------|---------|
| 2017  | 840     |
| 2018  | 3,166   |
| 2019  | 3,113   |
| Total | \$7,959 |

**Note 9 - Commitments and contingencies**

*Lease obligations* -The Company leases three stores for its Starfruit subsidiary. Total rent expense for these leases was \$124, \$143 and \$347 for the years ended December 31, 2015, 2014 and 2013 respectively. The Company is also responsible for additional rent equal to real estate taxes and other operating expenses. Future annual minimum base rental payments under these leases as of December 31, 2015 are approximately \$70 for each of the next three years and are not significant thereafter.

*Litigation* -The Company is 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 10 - Income taxes**

The provision for income taxes consists of the following:

|                            | For the Years Ended<br>December 31, |         |         |
|----------------------------|-------------------------------------|---------|---------|
|                            | 2015                                | 2014    | 2013    |
| Current:                   |                                     |         |         |
| Federal                    | \$1,888                             | \$2,143 | \$2,552 |
| State and local            | 717                                 | 819     | 554     |
| Total current              | 2,605                               | 2,962   | 3,106   |
| Deferred                   | (585 )                              | (720 )  | (239 )  |
| Provision for income taxes | \$2,020                             | \$2,242 | \$2,867 |

A reconciliation of the U.S. federal statutory rate to the effective tax rate used in the provision for income taxes is as follows:

|      |      |      |
|------|------|------|
| 2015 | 2014 | 2013 |
|------|------|------|

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|  | Amount  | Percentage |    | Amount  | Percentage |    | Amount  | Percentage |    |
|--|---------|------------|----|---------|------------|----|---------|------------|----|
| Federal income tax expense computed at the statutory rate            | \$1,357 | 34.0       | %  | \$1,428 | 34.0       | %  | \$2,666 | 34.0       | %  |
| State and local tax expense, net                                     | 337     | 8.4        | %  | 215     | 5.1        | %  | 745     | 9.5        | %  |
| U.S. domestic manufacturers' deduction & other permanent differences | 300     | 7.5        | %  | 464     | 11.0       | %  | (455 )  | (5.8       | )% |
| Additions for tax positions of prior years                           | 50      | 1.3        | %  | 215     | 5.1        | %  | 0       | 0          | %  |
| Change in tax rates  | –       | 0          | %  | (138 )  | (3.2       | )% | 0       | 0          | %  |
| Change in tax estimate   | (24 )   | (0.6       | )% | 58      | 1.4        | %  | (89 )   | (1.1       | )% |
| Provision for income taxes   | \$2,020 | 50.6       | %  | \$2,242 | 53.4       | %  | \$2,867 | 36.6       | %  |

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

|  | 2015  | 2014  | 2013 |
|--|-------|-------|------|
| Balance at January 1                       | \$215 | \$–   | \$ – |
| Additions for tax positions of prior years | 50    | 215   | –    |
| Balance at December 31                     | \$265 | \$215 | \$ – |

The Company recognizes interest related to unrecognized tax benefits in interest expense and penalties in general and administrative expenses.

The amount of interest and penalties recognized in the consolidated statements of income and comprehensive income was approximately \$--, \$65, and \$- during 2015, 2014 and 2013 respectively. The amount of interest and penalties recognized in the consolidated balance sheets was approximately \$65 at December 31, 2015 and 2014, respectively.

Amounts for deferred tax assets and liabilities are as follows:

|   | December 31, |           |           |
|---|--------------|-----------|-----------|
|   | 2015         | 2014      | 2013      |
| Non-current deferred tax assets (liabilities) arising from: |              |           |           |
| Accumulated depreciation and amortization                   | \$(1,719)    | \$(2,074) | \$(2,896) |
| Capital loss carry-forwards                                 | -            | -         | 53        |
| Total non-current net deferred tax liabilities              | (1,719)      | (2,074)   | (2,843)   |
| Current deferred tax assets arising from:                   |              |           |           |
| Capital loss carry-forward & investment impairment          | 164          | 9         | -         |
| Unrealized losses (gain) on investments                     | 45           | 127       | (8 )      |
| Inventory   | 308          | 233       | 308       |
| Allowances for doubtful accounts and discounts              | 39           | 39        | 22        |
| Total current deferred tax assets                           | 556          | 408       | 322       |
| Net deferred tax liability                                  | \$(1,163)    | \$(1,666) | \$(2,521) |

#### 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 December 31, 2015 and 2014.

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, common stock and exchange traded funds (ETF's), are 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 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.

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 for the years ended December 31, 2015 and 2014. The assets presented here 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 |         |         | Total |
|-----------------------|----------------------------|---------|---------|-------|
|                       | December 31, 2015          |         |         |       |
|                       | Level 1                    | Level 2 | Level 3 |       |
| Mutual Funds          | \$26                       | \$-     | \$-     | \$26  |
| Common Stocks & ETF's | 613                        | -       | -       | 613   |
| Preferred Securities  | -                          | 104     | -       | 104   |
| Corporate Bonds       | -                          | 1,187   | 161     | 1,348 |

|                       | Assets at Fair Value as of |         |         | Total |
|-----------------------|----------------------------|---------|---------|-------|
|                       | December 31, 2014          |         |         |       |
|                       | Level 1                    | Level 2 | Level 3 |       |
| Mutual Funds          | \$435                      | \$-     | \$-     | \$435 |
| Common Stocks & ETF's | 486                        | -       | -       | 486   |
| Preferred Securities  | -                          | 178     | -       | 178   |
| Corporate Bonds       | -                          | 1,680   | -       | 1,680 |

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 -- Stock-based 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 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 (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. Total stock based compensation arising from this award, which will be recognized in periods subsequent to 2015 is approximately \$60.

There was no stock based compensation expense in each of the three years ending December 31, 2015, 2014 and 2013. There were no options, restricted stock or other equity instruments awarded or outstanding at any time during each of the three years ending December 31, 2015, 2014 and 2013.

**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 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.

Gross sales of products by category were as follows for the years ended December 31:

|                                    | 2015      | 2014      | 2013      |
|------------------------------------|-----------|-----------|-----------|
| Lifeway Farmer Cheese              | \$9,725   | \$10,266  | \$9,388   |
| Drinkable Kefir other than ProBugs | 118,090   | 110,297   | 90,441    |
| ProBugs                            | 7,936     | 7,868     | 7,127     |
| Frozen Kefir                       | 1,493     | 1,785     | 2,010     |
| Total sales                        | \$137,244 | \$130,216 | \$108,966 |

***Significant Customers*** -- Sales are predominately to companies in the retail food industry, located within the United States. Two major customers accounted for approximately 26%, 28% and 35% of gross sales for the years ended December 31, 2015, 2014 and 2013, respectively. These customers accounted for approximately 20% and 23% of accounts receivable as of December 31, 2015 and 2014 respectively.

**Note 14 - Share repurchase program**



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 the Company's common stock not to exceed an aggregate of 250 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.

Pursuant to the share repurchase program, during the three and twelve months ended December 31, 2015 the company repurchased 136 shares at a cost of \$1,542, or about \$11.32 per share. Approximately \$1,958 remained available under this program as of December 31, 2015.

#### **Note 15 – Related party transactions**

The Company obtained consulting services from the Chairman of its board of directors. Fees paid to the chairperson were \$1,000, \$747 and \$408 during the fiscal years ended December 31, 2015, 2014 and 2013 respectively and were included in general and administrative expense in the accompanying consolidated statements of income and comprehensive income.

On December 14, 2015, the Company entered into a stock purchase agreement (the "Stock Purchase Agreement") with Ludmila Smolyansky, the Company's Chairman of the Board pursuant to which Ms. Smolyansky agreed to sell to the Company 30 and the Company agreed to purchase such shares under its previously disclosed repurchase plan at a purchase price equal to the product of (a) 30 multiplied by (b) the average of the last reported closing sale price of the Common Stock on the Nasdaq Global Market for each of the five (5) Trading Days (as defined in the Stock Purchase Agreement) immediately preceding the date of the Stock Purchase Agreement. The transaction was consummated on December 15, 2015.

On March 14, 2016, the Company entered into an endorsement agreement (the "Agreement") with Ludmila Smolyansky, the Company's Chairman of the Board. Under the terms and conditions of the Agreement, Ms. Smolyansky grants an unlimited, perpetual, non-exclusive, worldwide and, except as set forth therein, royalty free, right to use, reuse, publish, reproduce, perform, copy, create derivative works, exhibit, broadcast and display Ms. Smolyansky's name, image and likeness in Marketing Materials (as defined in the Agreement). As consideration for such license, the Company agrees to pay Ms. Smolyansky a royalty equal to \$0.02 for each Company product or item sold by Lifeway during each calendar month bearing Ms. Smolyansky's first name, last name or other identifying personal characteristics; provided however that such royalty will not exceed \$50 in any month and such royalty payments will cease upon the death of Ms. Smolyansky.



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders of

Lifeway Foods, Inc. and Subsidiaries

Morton Grove, Illinois

We have audited the accompanying consolidated balance sheet of Lifeway Foods, Inc. and Subsidiaries (the "Company") as of December 31, 2015 and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for the year then ended. In connection with our audit of the consolidated financial statements, we have also audited the financial statement schedule of valuation and qualifying accounts (Item 15). These consolidated financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audit.

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

In our opinion, the consolidated financial statements referred to above, restated as discussed in note 1, present fairly, in all material respects, the financial position of Lifeway Foods, Inc. and Subsidiaries as of December 31, 2015, and the results of their operations and their cash flows for the year then ended, in conformity with generally accepted accounting principles in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relationship to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in note 1 to the consolidated financial statements, the Company's 2015 consolidated financial statements have been restated to correct certain misstatements.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Lifeway Foods, Inc. and Subsidiaries' internal control over financial reporting as of December 31, 2015, based on criteria established in the *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 7, 2017 expressed an adverse opinion thereon.

/s/ Mayer Hoffman McCann P.C.

Chicago, Illinois

April 7, 2017

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders of

Lifeway Foods, Inc. and Subsidiaries

Morton Grove, Illinois

We have audited the accompanying consolidated balance sheet of Lifeway Foods, Inc. and Subsidiaries (the "Company") as of December 31, 2014 and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for the year then ended. In connection with our audit of the financial statements, we have also audited the 2014 financial statement schedule of valuation and qualifying accounts (Item 15). These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lifeway Foods, Inc. and Subsidiaries at December 31, 2014, and the results of their operations and their cash flows for the year then ended, in conformity with generally accepted accounting principles in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relationship to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ Crowe Horwath LLP

Oakbrook, Illinois

August 13, 2015

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders

Lifeway Foods, Inc. and Subsidiaries

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

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

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

/s/ Plante & Moran, PLLC

Chicago, Illinois

April 2, 2014

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of

Lifeway Foods, Inc. and Subsidiaries

Morton Grove, Illinois

We have audited Lifeway Foods, Inc. and Subsidiaries' (the "Company") internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

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

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

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

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weaknesses in internal control over financial reporting have been identified and included in management's assessment:

1) Financial reporting controls –

- a) The financial statement preparation process requires the involvement of a small team of company employees and the preparation process lacks sufficient, competent and independent review.
- b) The Company has not consistently demonstrated effective preparation, support and review practices over journal entries and account reconciliations.

Accounting for income taxes – The Company did not have adequate design of controls that provide reasonable assurance that the accounting for income taxes was in accordance with U.S. GAAP. Specifically, the Company 2) relied on third-party subject matter experts and did not have sufficient technical expertise in the income tax function to provide adequate review and control with respect to the complete and accurate recording of inputs to the consolidated income tax provision and related accruals.

Accounting for inventory – The Company's inventory compilation procedures are highly manual and were not 3) designed to ensure that (a) all inventory that is counted in their physical inventory is properly included in the priced-out-physical inventory and (b) the costs used to extend the physical count were accurate.

These material weaknesses were considered in determining the nature, timing, and the extent of audit tests applied in our audit of the consolidated financial statements and financial statement schedule of the Company as of and for the year ended December 31, 2015, and this report does not affect our report dated March 15, 2016 on such consolidated financial statements and financial statement schedule.

In our opinion, because of the effect of the material weaknesses described above on achieving the objectives of the criteria established in *Internal Control—Integrated Framework (2013)* issued by COSO, the Company has not maintained effective internal control over financial reporting as of December 31, 2015.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows of the Company, and our report dated April 7, 2017 expressed an unqualified opinion.

/s/ Mayer Hoffman McCann P.C.

Chicago, Illinois

April 7, 2017

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

On September 12, 2015, the Audit Committee of the Board of Directors of Lifeway Foods, Inc. (the "Company") engaged Mayer Hoffman McCann P. C. ("MHM") as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2015.

During the fiscal years ended December 31, 2014 and 2013 through September 12, 2015 neither the Company nor anyone acting on the Company's behalf consulted with MHM in any capacity, nor consulted with any member of that firm, as to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered as to the consolidated financial statements, nor was a written report or oral advice rendered that was an important factor considered by the Company or any of its employees in reaching a decision as to an accounting, auditing or financial reporting issue, or any matter that was either the subject of a disagreement, as defined in Item 304(a)(1)(iv) of Regulation S-K and the related instructions thereto, or a reportable event within the meaning set forth in Item 304(a)(1)(v) of Regulation S-K.

On August 20, 2015, the Company was notified by its independent registered public accounting firm, Crowe Horwath LLP ("Crowe") that it would not stand for reappointment as the Company's independent registered public accounting firm for 2015. The Company had engaged Crowe as the Company's independent registered public accounting firm for the year ended December 31, 2014.

During the year ended December 31, 2014 and the subsequent interim period through August 20, 2015, there were no: (1) disagreements with Crowe on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements, if not resolved to their satisfaction, would have caused them to make reference in connection with their opinion to the subject matter of the disagreement, or (2) reportable events under Item 304(a)(1)(v) of Regulation S-K except that, as disclosed in Item 9A of the Company's annual report on Form 10-K for its fiscal year ended December 31, 2014 (the "2014 Form 10-K"), the Company's President and Chief Executive Officer and its Chief Financial Officer concluded that the Company's internal controls were not effective because material weaknesses existed in the Company's internal control over financial reporting.

The audit report of Crowe on the effectiveness of internal control over financial reporting as of December 31, 2014 contained an adverse opinion but it did not contain a disclaimer of opinion nor was it modified or qualified as to the uncertainty, audit scope, or accounting principles. The adverse opinion as of December 31, 2014 was due to the effect of the material weaknesses and Crowe concluded in its audit report that the Company did not maintain effective internal control over financial reporting as a result of the material weaknesses reported in Item 9A of our 2014 Form

10-K.

On June 24, 2014, after determining that the Company would benefit from the review, advice and perspective of a new auditing firm, the Company dismissed Plante Moran, PLLC ("PM") as the independent registered public accounting firm for the Company effective immediately. The Board and the Audit Committee of the Board (the "Audit Committee") approved the dismissal of PM.

During the year ended December 31, 2013 and the subsequent interim period through June 24, 2014, there were no: (1) disagreements with PM on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements, if not resolved to their satisfaction, would have caused them to make reference in connection with their opinion to the subject matter of the disagreement, or (2) reportable events under Item 304(a)(1)(v) of Regulation S-K except that, as disclosed in Item 9A of our annual report on Form 10-K for our fiscal year ended December 31, 2013 (the "2013 Form 10-K"), our President and Chief Executive Officer and our Chief Financial Officer concluded that our internal controls were not effective because pervasive material weaknesses existed in our internal control over financial reporting.

The audit report of PM on the Company's consolidated financial statements as of and for the year ended December 31, 2013 did not contain an adverse opinion or disclaimer of opinion, and was not qualified or modified as to uncertainty, audit scope or accounting principles.

The audit report of PM on the effectiveness of internal control over financial reporting as of December 31, 2013 contained an adverse opinion but it did not contain a disclaimer of opinion nor was it modified or qualified as to the uncertainty, audit scope, or accounting principles. The adverse opinion as of December 31, 2013 was due to the effect of the material weaknesses and PM concluded in its audit report that the Company did not maintain effective internal control over financial reporting as a result of the material weaknesses reported in Item 9A of our 2013 Form 10-K.

On June 20, 2014, the Registrant engaged Crowe Horwath LLP as the Company's independent registered public accounting firm for the year ending December 31, 2014. The engagement was approved by the Audit Committee and the Board. During the years ended December 31, 2013 and 2012, and the subsequent interim period prior to the engagement of Crowe Horwath LLP, the Company did not consult with Crowe Horwath LLP regarding any of the matters or events set forth in Item 304(a)(2)(i) and (ii) of Regulation S-K.

**ITEM 9A. CONTROLS AND PROCEDURES.**

**Evaluation of Disclosure Controls and Procedures**

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

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934 (the "Exchange Act")). Based on this evaluation, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of December 31, 2015 in ensuring that information required to be disclosed by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified under the Exchange Act rules and forms due to the material weaknesses described below. As a result, we performed additional analysis and other post-closing procedures to ensure our consolidated financial statements were prepared in accordance with generally accepted accounting principles. Accordingly, management believes the consolidated financial statements included in this Form 10-K fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented.

The attestation report of Mayer Hoffman McCann P.C., the company's independent registered public accounting firm, regarding the company's internal control over financial reporting is provided under "Financial Statements and Supplementary Data."

**Management's Annual Report on Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is identified in Exchange Act Rules 13a-15(f). Internal control over financial reporting is a process designed by,

or under the supervision of, our principal executive officer, principal financial officer and principal accounting officer, and effected by the Board of Directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Our internal control over financial reporting includes those policies and procedures that:

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

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

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

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

Management, including our Chief Executive Officer and our Chief Financial Officer, assessed the effectiveness of our internal control over financial reporting as of December 31, 2015. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control - Integrated Framework (2013). Based on this assessment, management has concluded that we did not maintain effective internal control over financial reporting as of December 31, 2015, due to the fact that certain material weaknesses previously identified in the 2014 Form 10-K filing on August 14, 2015 continue to exist at December 31, 2015, as discussed below.

Clarifying note: On April 7, 2017 the Company filed this Form 10-K/A to correct certain reclassification errors that are more fully described in Note 1 to the consolidated financial statements. The reclassification errors are consistent with and arise from the material weaknesses as they were described below at the time of the original 2015 Form 10-K filing. The identification and correction of such errors are a reflection of management's remediation of those material weaknesses. Further, during fiscal 2016 we identified an additional material weakness in the area of inventory that we believe existed as of December 31, 2015 and have provided the related discussion below.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis.

#### **Material Weaknesses as of December 31, 2015 (the "2015 Material Weaknesses")**

1. Financial reporting controls -
  - a. The financial statement preparation process requires the involvement of a small team of company employees and the preparation process lacks sufficient, competent and independent review.
  - b. The Company has not consistently demonstrated effective preparation, support and review practices over journal entries and account reconciliations.



- Accounting for income taxes - The Company did not have adequate design of controls that provide reasonable assurance that the accounting for income taxes was in accordance with U.S. GAAP. Specifically, we relied on
2. third-party subject matter experts and did not have sufficient technical expertise in the income tax function to provide adequate review and control with respect to the complete and accurate recording of inputs to the consolidated income tax provision and related accruals.

- Accounting for inventory - Our inventory compilation procedures are highly manual and were not designed to
3. ensure that (a) all inventory that is counted in our quarterly physical inventory is properly included in the priced-out-physical inventory and (b) that the costs used to extend the physical count were accurate.

### **Remediation Efforts and Status of the 2015 Material Weaknesses**

#### *Financial reporting controls*

During 2015, we increased the size of our accounting department and revised the competency requirements for our team. Enabled by those foundational changes, we have eliminated our reliance on most of the accounting and reporting activities that were previously completed by third-party service providers. Among other things, our third-party service providers no longer support our financial statement and footnote preparation process.

All of our journal entries and most of our account reconciliations are now prepared and reviewed by company personnel, with significantly reduced involvement of the third-party serviced providers. Further, compliance with our updated journal entry and account reconciliation policies has been consistently emphasized with our team and compliance and timeliness has improved significantly. In 2016, we intend to (a) continue to demonstrate compliance with these policies and (b) further repatriate and / or improve the timeliness and effectiveness of those financial reporting activities that remain with of our third-party service providers.

#### *Accounting for income taxes*

With the addition of our new VP of Finance, during 2015 we demonstrated a more consistent, thorough and effective review over the accounting for income taxes, reducing our reliance on the third-party service providers. In 2016, (a) we intend to continue to demonstrate effectiveness of our review process and (b) we will further repatriate and / or improve the timeliness and effectiveness of those tax accounting activities that remain with of our the third-party service providers.



## **Remediation of Prior Material Weaknesses**

We have made remediation of our material weaknesses a top priority at Lifeway and we are committed to continually improving our internal controls over financial reporting. During 2015 and continuing through the date of this filing, management has allocated significant time and resources towards such improvements. The material weaknesses that were previously reported in our 2014 10-K and that have been remediated are as follows:

### *Entity level controls*

During December 2014, the Company identified and engaged an outside consultant to perform the function of internal audit. In 2015, the consultant assisted us in documenting, evaluating and improving the design and operating effectiveness of our internal controls over financial reporting.

During December 2014, the newly established Compensation Committee of the Board of Directors of the Company (the "Committee") hired outside advisors to advise the Committee and the Company on developing and/or changing processes, procedures and policies related to compensation practices, including expense reimbursement. During 2015, the Committee worked with these advisors and implemented new processes and procedures to better govern and monitor executive compensation.

During 2015, the Audit Committee met with management and MHM on a frequent basis to review matters of accounting, financial reporting and internal control. Among other things, increased emphasis was placed on the remediation of material weaknesses and other improvements in internal control over financial reporting. Management's progress against remediation was effectively monitored.

In July 2015, the Company hired a Vice President of Finance with public company reporting experience and hired an assistant to the controller. These additions to the Company's management and staff were made to enable more effective and consistent leadership and organizational focus on accounting, financial reporting and internal controls among other things.

### *Accounting for Fixed Assets*

We implemented a process for ensuring that all fixed asset additions are timely identified and recorded and that such additions are assigned the proper useful life and are placed in service in the proper accounting period. The new process is operated by our accounting staff with significantly reduced reliance on a third-party accounting service provider. We also performed more timely reconciliations of our fixed asset subsidiary records to our general ledger.

In 2016, we intend to implement a new fixed asset system, at which time we will no longer have any reliance on the third-party accounting service provider.

#### *Accounting for Corporate Credit Card Expenditures*

In tandem with updating its travel and expense policies, the Company has implemented a third-party software solution for processing expense reports that provides an effective and efficient monitoring tool over the timeliness of expense report submissions and reinforces compliance with Company's substantiation requirements and spending limits. We have also established a routine of on-going, independent review and approval of expense reimbursement requests. Further, our accounting over the proper classification of such expenses has become more accurate.

#### **Conclusion**

We believe that the remediation measures discussed above will be sufficient to remediate the material weaknesses we have identified. As we continue to evaluate and work to improve our internal controls over financial reporting, we may determine that additional measures are necessary to address control deficiencies. Moreover, we may decide to modify certain of the remediation measures we implement as we continue to evaluate and work to improve our internal controls over financial reporting.

#### **Changes in Internal Control over Financial Reporting**

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

#### **ITEM 9B. OTHER INFORMATION.**

None.



## **PART III**

### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

#### **Code of Ethics**

The Company has adopted a Code of Ethics applicable to all Officers which is available on the Company's Internet website at [www.lifeway.net](http://www.lifeway.net). Any person may, without charge, request a copy of such Code of Ethics by contacting the Company at (847) 967-1010 or by email at [info@lifeway.net](mailto:info@lifeway.net).

Other information required by this Item 10 will be included in our definitive Proxy Statement to be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K and is incorporated herein by reference.

### **ITEM 11. EXECUTIVE COMPENSATION**

Information required by this Item 11 will be included in our definitive Proxy Statement to be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K and is incorporated herein by reference.

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

Information required by this Item 12 will be included in our definitive Proxy Statement to be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K and is incorporated herein by

reference.

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

Information required by this Item 13 will be included in our definitive Proxy Statement to be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K and is incorporated herein by reference.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.**

Information required by this Item 14 will be included in our definitive Proxy Statement to be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K and is incorporated herein by reference.

**PART IV****ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.**

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

## 2. Financial Statement Schedules

**Schedule II - Valuation and qualifying accounts**

Lifeway Foods, Inc. and subsidiaries

December 31, 2015

(In Thousands)

|                                  | Balance<br>at<br>beginning<br>of<br>period | Additions<br>Charged<br>to<br>costs and<br>expenses | Deductions<br>-<br>describe | Balance<br>at<br>end of<br>period |
|----------------------------------|--|---|-----------------------------|-----------------------------------|
| Year Ended 31 December 2015:     |  |   |                             |                                   |
| Deductions from assets accounts: |  |   |                             |                                   |
| Allowance for doubtful accounts  | \$ 100                                     | \$ 73   | \$ 73                       | (1) \$ 100                        |
| Reserve for promotions discount  | 950  | 17,972  | 17,222                      | (2) 1,700                         |
| Total                            | \$ 1,050                                   | \$ 18,045   | \$ 17,295                   | \$ 1,800                          |
| Year Ended 31 December 2014:     |  |   |                             |                                   |
| Deductions from assets accounts: |  |   |                             |                                   |
| Allowance for doubtful accounts  | \$ 50                                      | \$ 129  | \$ 79                       | (1) \$ 100                        |
| Reserve for promotions discount  | 1,000                                      | 10,395  | 10,445                      | (2) 950                           |
| Total                            | \$ 1,050                                   | \$ 10,524   | \$ 10,524                   | \$ 1,050                          |
| Year Ended 31 December 2013:     |  |   |                             |                                   |
| Deductions from assets accounts: |  |   |                             |                                   |
| Allowance for doubtful accounts  | \$ 25                                      | \$ 45   | \$ 20                       | (1) \$ 50                         |



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|                                 |       |           |           |     |          |
|---------------------------------|-------|-----------|-----------|-----|----------|
| Reserve for promotions discount | 945   | 10,861    | 10,806    | (2) | 1,000    |
| Total                           | \$970 | \$ 10,906 | \$ 10,826 |     | \$ 1,050 |

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(1)Uncollectible accounts written off, net of recoveries.

(2)Discounts taken by customers during year.

## EXHIBITS

3.1 Amended and Restated Bylaws (incorporated by reference to Exhibit No. 3.5 to Lifeway's Current Report on Form 8-K dated and filed on December 10, 2002 (File No. 000-17363)).

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10.14 Ninth Modification to Loan and Security Agreement effective as of May 31, 2014, by and among The PrivateBank and Trust Company, Lifeway Foods, Inc., Fresh Made, Inc., Helios Nutrition Limited, Pride of Main Street Dairy, LLC, Starfruit, LLC and Lifeway Wisconsin, Inc.

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Main Street Dairy, LLC, Starfruit, LLC and Lifeway Wisconsin, Inc.

Employment Agreement by and between the Company and John Waldron, dated as of July 20, 2015  
10.22 (incorporated by reference to Exhibit 1.01 to Lifeway's Current Report on Form 8-K dated December 14, 2015  
and filed on December 18, 2015 (File No. 000-17363)).

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31.2 Rule 13a-14(a)/15d-14(a) Certification of John P. Waldron

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99.1\* Press release dated March 15, 2016 reporting the Company's financial results for the three months and year  
ended December 31, 2015.

101 Interactive Data Files

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

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**SIGNATURES**

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

**LIFEWAY  
FOODS,  
INC.**

Date: April 7, 2017 By: /s/ John P. Waldron  
John P. Waldron  
Chief Financial Officer



## INDEX OF EXHIBITS

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