UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended: June 30, 2017

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

For the transition period from __________ to __________

Commission File Number: 000-17363

LIFEWAY FOODS, INC.

(Exact Name of Registrant as Specified in its Charter)

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

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

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

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

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

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

Large accelerated filer ☐	Accelerated filer ☐
Non-accelerated filer ☐	Smaller reporting company ☒
Emerging growth company ☐	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

As of August 3, 2017, 16,068,430 shares of the registrant's common stock, no par value, were outstanding.

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PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
June 30, 2017 and December 31, 2016
(In thousands)

	June 30, 2017 (Unaudited)	December 31, 2016
Current assets		
Cash and cash equivalents	$ 9,349	$ 8,812
Accounts receivable, net of allowance for doubtful accounts and discounts & allowances of $1,500 and $1,600 at June 30, 2017 and December 31, 2016 respectively	10,388	9,594
Inventories, net	8,097	8,042
Prepaid expenses and other current assets	1,285	785
Refundable income taxes	342	309
Total current assets	**29,461**	**27,542**
Property, plant and equipment, net	**23,010**	**21,832**
Intangible assets		
Goodwill & indefinite-lived intangibles	14,068	14,068
Other intangible assets, net	1,311	1,647
Total intangible assets	**15,379**	**15,715**
Other assets	**125**	**125**
Total assets	**$ 67,975**	**$ 65,214**
Current liabilities		
Current maturities of notes payable	$ 3,419	$ 840
Accounts payable	6,285	5,718
Accrued expenses	3,813	2,169
Accrued income taxes	75	654
Total current liabilities	**13,592**	**9,381**
Notes payable	**3,280**	**6,279**
Deferred income taxes, net	**1,192**	**1,192**
Other long-term liabilities	**351**	**–**
Total liabilities	**18,415**	**16,852**
Stockholders' equity		
Common stock, no par value; 40,000 shares authorized; 17,274 shares issued; 16,154 outstanding	6,509	6,509
Paid-in capital	2,236	2,198
Treasury stock, at cost	(10,340)	(10,340)
Retained earnings	51,155	49,995
Total stockholders' equity	**49,560**	**48,362**
Total liabilities and stockholders' equity	**$ 67,975**	**$ 65,214**

See accompanying notes to consolidated financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Income and Comprehensive Income
For the three months and six months ended June 30, 2017 and 2016
(Unaudited)
(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	**2016**	**2017**	**2016**
Net sales	**$ 31,733**	**$ 31,131**	**$ 63,850**	**$ 63,701**
Cost of goods sold	21,857	20,763	44,931	44,002
Depreciation expense	597	633	1,183	1,264
Total cost of goods sold	22,454	21,396	46,114	45,266
Gross profit	**9,279**	**9,735**	**17,736**	**18,435**
Selling expenses	3,400	3,463	7,638	6,427
General and administrative	3,813	3,046	7,598	6,992
Amortization expense	168	177	336	353
Total operating expenses	**7,381**	**6,686**	**15,572**	**13,772**
Income from operations	**1,898**	**3,049**	**2,164**	**4,663**
Other income (expense):				
Interest expense	(61)	(47)	(118)	(105)
Loss on sale of investments, net reclassified from OCI	–	(15)	–	(27)
Loss on sale of property and equipment	–	(151)	(5)	(151)
Other income, net	–	60	–	77
Total other income (expense)	(61)	(153)	(123)	(206)
Income before provision for income taxes	**1,837**	**2,896**	**2,041**	**4,457**
Provision for income taxes	801	789	881	1,395
Net income	**$ 1,036**	**$ 2,107**	**$ 1,160**	**$ 3,062**
Earnings per common share:				
Basic	$ 0.06	$ 0.13	$ 0.07	$ 0.19
Diluted	$ 0.06	$ 0.13	$ 0.07	$ 0.19
Weighted average common shares:				
Basic	16,154	16,149	16,154	16,169
Diluted	16,203	16,149	16,211	16,169
COMPREHENSIVE INCOME				
Net income	**$ 1,036**	**$ 2,107**	**$ 1,160**	**$ 3,062**
Other comprehensive income (loss), net of tax:				
Unrealized gains on investments, net of taxes	–	12	–	56
Reclassifications to earnings:				
Realized gains on investments, net of taxes	–	24	–	17
Comprehensive income	**$ 1,036**	**$ 2,143**	**$ 1,160**	**$ 3,135**

See accompanying notes to consolidated financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
For the Six Months Ended June 30, 2017 and 2016
(Unaudited)
(In thousands, except share data)

	Common Stock						Accumulated Other Comprehensive	
	Issued		In treasury		Paid-In	Retained	Income (Loss),	Total
	Shares	$	Shares	$	Capital	Earnings	Net of Tax	Equity
Balance, January 1, 2016	**17,274**	**$ 6,509**	**(1,064)**	**$ (9,730)**	**$ 2,033**	**$ 46,516**	**$ (71)**	**$ 45,257**
Other comprehensive income	–	–	–	–	–		73	73
Treasury stock purchased	–	–	(69)	(738)	–	–	–	(738)
Stock-based compensation	–	–	–	–	42	–	–	42
Net income	–	–	–	–	–	3,062	–	3,062
Balance, June 30, 2016	**17,274**	**$ 6,509**	**(1,133)**	**$(10,468)**	**$ 2,075**	**$ 49,578**	**$ 2**	**$ 47,696**
Balance, January 1, 2017	**17,274**	**$ 6,509**	**(1,120)**	**$(10,340)**	**$ 2,198**	**$ 49,995**	$ –	**$ 48,362**
Stock-based compensation	–	–	–	–	38	–	–	38
Net income	–	–	–	–	–	1,160	–	1,160
Balance, June 30, 2017	**17,274**	**$ 6,509**	**(1,120)**	**$(10,340)**	**$ 2,236**	**$ 51,155**	$ –	**$ 49,560**

See accompanying notes to consolidated financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2017 and 2016
(Unaudited)
(In thousands)

	2017	2016
Cash flows from operating activities:		
Net income	**$ 1,160**	**$ 3,062**
Adjustments to reconcile net income to operating cash flow:		
Depreciation and amortization	1,519	1,617
Loss on sale of investments, net	–	27
Reserve for inventory obsolescence	131	–
Stock-based compensation	775	42
Loss on sale of property and equipment	5	151
(Increase) decrease in operating assets:		
Accounts receivable	(793)	(502)
Inventories	(185)	(1,649)
Refundable income taxes	(33)	(70)
Prepaid expenses and other current assets	(500)	(448)
Increase (decrease) in operating liabilities:		
Accounts payable	564	(1,710)
Accrued expenses	1,259	765
Accrued income taxes	(579)	576
Net cash provided by operating activities	**3,323**	**1,861**
Cash flows from investing activities:		
Purchases of investments	–	(479)
Proceeds from sale of investments	–	1,024
Redemption of certificates of deposits	–	513
Purchases of property and equipment	(2,400)	(1,382)
Proceeds from sale of property and equipment	34	39
Net cash used in investing activities	**(2,366)**	**(285)**
Cash flows from financing activities:		
Purchase of treasury stock	–	(738)
Repayment of notes payable	(420)	(420)
Net cash used in financing activities	**(420)**	**(1,158)**
Net increase in cash and cash equivalents	**537**	**418**
Cash and cash equivalents at the beginning of the period	8,812	5,646
Cash and cash equivalents at the end of the period	**$ 9,349**	**$ 6,064**
Supplemental cash flow information:		
Cash paid for income taxes, net of refunds	$ 1,493	$ 886
Cash paid for interest	$ 118	$ 105

See accompanying notes to consolidated financial statements

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2017 and December 31, 2016
(Unaudited)
(In thousands, except per share data)

Note 1 – Basis of Presentation

Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. ("U.S. GAAP") for interim financial information, and do not include all of the information and disclosures required for complete, audited financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation, have been included. For further information, refer to the consolidated financial statements and disclosures included in Company's Annual Report on Form 10-K as of and for the year ended December 31, 2016. Certain amounts in prior-year financial statements were reclassified to conform to the current-year presentation. The results for the period are not necessarily indicative of the results to be expected for other interim periods or the full year.

Principles of consolidation

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

Note 2 – Significant Accounting Policies

Use of estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made in preparing the consolidated financial statements include the reserve for promotional allowances, the valuation of goodwill and intangible assets, stock-based and incentive compensation, and deferred income taxes.

Revenue Recognition

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

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

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

Advertising and promotional costs

The Company expenses advertising costs as incurred. For the six months ended June 30, 2017 and 2016 total advertising expenses were $2,811 and $2,753 respectively. For the three months ended June 30, 2017 and 2016 total advertising expenses were $1,043 and $1,811 respectively.

Recently Adopted Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-09, Compensation-Stock Compensation – Improvements to Employee Share-Based Payment Accounting. The new guidance simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, statutory tax withholding requirements, classification of awards as either equity or liabilities, and classification in the statement of cash flows. Under this ASU, excess tax benefits and deficiencies are no longer recognized as additional paid-in capital in the consolidated balance sheets. This guidance was effective on January 1, 2017. The adoption of this amendment had no impact on the consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, Income Taxes – Balance Sheet Classification of Deferred Taxes. This new guidance simplifies the presentation of deferred income taxes and 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. This guidance was effective on January 1, 2017. The Company elected to adopt this guidance as of the first fiscal quarter in 2017 and has applied the update on a retrospective basis. The Company changed its accounting principle to reduce the cost and complexity inherent in recording deferred taxes as current and noncurrent on the consolidated balance sheets. As a result, the Company has reclassified $662 of current deferred tax asset to noncurrent deferred tax liability in the consolidated balance sheet as of December 31, 2016.

In July 2015, the FASB issued ASU 2015-11, Inventory – Simplifying the Measurement of 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 was effective on January 1, 2017. The adoption of this amendment had no impact on the consolidated financial statements.

Recently Issued Accounting Pronouncements

In May 2017, the FASB issued ASU No. 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting. The new guidance provides clarity and reduces both diversity in practice and cost of complexity when accounting for a change to the terms of or conditions of a share-based payment award. The amendments in this Update provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. The new guidance will be effective for fiscal years beginning on or after December 15, 2017 and interim periods within those years. Early adoption of the guidance is permitted. The adoption of this amendment is not expected to have a material impact on the consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other: Simplifying the Test for Goodwill Impairment. The new guidance simplifies the subsequent measurement of goodwill by removing the second step of the two-step impairment test. The amendment requires an entity to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The new guidance will be effective for annual periods or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. The amendment should be applied on a prospective basis. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The adoption of this amendment is not expected to have a material impact on the consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments. The new guidance is intended to address the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows, such as debt prepayment or debt extinguishment costs, contingent consideration payments made after an acquisition, proceeds from the settlement of insurance claims, and other topics. The new guidance will be effective for fiscal years beginning on or after December 15, 2017 and interim periods within those years. Early adoption of the guidance is permitted. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases. The guidance requires lessees to recognize lease assets and lease liabilities in the balance sheet and disclose key information about leasing arrangements, such as information about variable lease payments and options to renew and terminate leases. The amended guidance will require both operating and finance leases to be recognized in 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. Early adoption is permitted. The amendments in this ASU should be adopted using a modified retrospective transition approach, which requires application of the new guidance at the beginning of the earliest comparative period presented in the year of adoption. We do not intend to early adopt the standard. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Recognition and Measurement of Financial Assets and Financial 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. The adoption of this amendment is not expected to have an impact on the consolidated financial statements.

In May 2014, the 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. The standard allows for either “full retrospective” adoption, meaning the standard is applied to all of the periods presented, or “modified retrospective” adoption, meaning the standard is applied only to the most current period presented in the financial statements. ASU 2014-09 also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. On August 12, 2015, the FASB approved a one year delay of the effective date to reporting periods beginning after December 15, 2017, while permitting companies to voluntarily adopt the new standard as of the original effective date. In December 2016, the FASB issued ASU No. 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers, which clarifies narrow aspects of ASC 606 or corrects unintended application of the guidance. The effective date and transition requirements for ASU 2016-20 are the same as the effective date and transition requirements for 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 this amendment 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. Our completed evaluation will include the impact of the new standard on certain common practices currently employed by us, such as rebates, in-store display and demo allowances, allowances for non-saleable product, and coupons. We currently expect to utilize the modified retrospective transition method and to adopt the ASU on January 1, 2018. Based on our findings to date, we do not expect the standard to have a material impact on our results of operations or financial position; however, our assessment is not yet complete. During 2017, we plan to finalize our review and method of adoption.

Note 3 – Inventories, net

Inventories consisted of the following:

	June 30, 2017	December 31, 2016
Ingredients	$ 1,992	$ 2,256
Packaging	2,731	2,770
Finished goods	3,374	3,016
Total inventories	$ 8,097	$ 8,042

Note 4 – Property, Plant and Equipment, net

Property, plant and equipment consisted of the following:

	June 30, 2017	December 31, 2016
Land	$ 1,747	$ 1,747
Buildings and improvements	16,533	16,428
Machinery and equipment	25,465	23,122
Vehicles	934	848
Office equipment	728	709
Construction in process	1,653	1,873
	47,060	44,727
Less accumulated depreciation	(24,050)	(22,895)
Total property, plant and equipment, net	$ 23,010	$ 21,832

Note 5 – Intangible Assets

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

	June 30, 2017	December 31, 2016
Goodwill	$ 10,368	$ 10,368
Brand names	3,700	3,700
Goodwill and indefinite-lived intangible assets	$ 14,068	$ 14,068

Other intangible assets, net consisted of the following:

	June 30, 2017	December 31, 2016
Recipes	$ 44	$ 44
Customer lists and other customer related intangibles	4,529	4,529
Customer relationship	985	985
Trade names	2,248	2,248
Formula	438	438
	8,244	8,244
Accumulated amortization	(6,933)	(6,597)
Other intangible assets, net	$ 1,311	$ 1,647

Note 6 – Accrued Expenses

Accrued expenses consisted of the following:

	June 30, 2017	December 31, 2016
Payroll and incentive compensation	$ 3,207	$ 1,560
Real estate taxes	331	394
Other	275	215
	$ 3,813	$ 2,169

Note 7 – Notes Payable

	June 30, 2017	December 31, 2016
Variable rate term loan due May 31, 2018. Principal and interest (3.54% at June 30, 2017) payable monthly with a balloon payment due at maturity.	$ 3,085	$ 3,339
Variable rate term loan due May 31, 2019. Principal and interest (3.55% at June 30, 2017) payable monthly with a balloon payment due at maturity.	3,614	3,780
Total notes payable	6,699	7,119
Less current portion	(3,419)	(840)
Total long-term portion	$ 3,280	$ 6,279

The variable rate term loans 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. Further, under the agreements the Company is required to deliver its annual and quarterly financial statements and related SEC filings within specified timeframes. The Company was in compliance with these financial covenants at June 30, 2017.

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 June 30, 2017 there were no borrowings under the facility. The facility expires in July 2018.

Note 8 – Commitments and contingencies

Lease obligations

The Company leases three retail stores for its Lifeway Kefir Shop subsidiary, certain machinery and equipment, and office space under operating leases. Total lease expense was $322 and $160 for the six months ended June 30, 2017 and 2016, respectively. Total lease expense was $165 and $70 for the three months ended June 30, 2017 and 2016, respectively.

Litigation

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

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

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

In a letter dated May 19, 2016, the Company received a request to voluntarily produce documents in connection with a confidential, informal inquiry by the Division of Enforcement of the SEC concerning the Company's internal controls, disclosure controls procedures, and internal control over financial reporting for fiscal years 2013 through the date of the letter. The SEC has informed the Company that the inquiry should not be construed as an indication that any violation of any federal securities law has occurred or as a reflection upon the merits of any person, company, or securities involved. Since receiving the letter, the Company has been cooperating with the SEC and will continue to do so.

Note 9 – Income taxes

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

The effective tax rate for the three months ended June 30, 2017 was 43.6% compared to 27.2% for the three months ended June 30, 2016. The effective tax rate for the six months ended June 30, 2017 was 43.1% compared to 31.3% for the six months ended June 30, 2016.

Note 10 – Fair Value Measurements

The Company's financial assets and liabilities include cash and cash equivalents, accounts receivable, accounts payable and notes payable, and are reported at carrying value which approximates fair value.

Note 11 – Stock-based and Other Compensation

Stock Options

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. At June 30, 2017, 3.448 million shares remain available under the Omnibus Incentive Plan. The Company has not established a pace for the frequency of awards under the Omnibus Incentive Plan, and may choose to suspend the issuance of new awards in the future and may grant additional awards at any time including issuing special grants of restricted stock, restricted stock units, and stock options to attract and retain new and existing executives.

The following table summarizes stock option activity during the six months ended June 30, 2017:

	Options	Weighted average exercise price	Weighted average remaining contractual life	Aggregate intrinsic value
Outstanding at December 31, 2016	45	$ 10.45		
Granted	–	$ –		
Exercised	–	$ –		
Forfeited	–	$ –		
Outstanding at June 30, 2017	45	$ 10.45	8.70	$ (51)
Exercisable at June 30, 2017	21	$ 10.75	8.60	$ (30)

For the six months ended June 30, 2017 and 2016 total pre-tax stock-based compensation expense recognized in the consolidated statements of income and comprehensive income was $29 and $42, respectively. For the six months ended June 30, 2017 and 2016 tax-related benefits of $11 and $16 were also recognized. For the three months ended June 30, 2017 and 2016 total pre-tax stock-based compensation expense recognized in the consolidated statements of income and comprehensive income was $14 and $21, respectively. For the three months ended June 30, 2017 and 2016 tax-related benefits of $5 and $8 were also recognized. As of June 30, 2017, the total remaining unearned compensation related to non-vested stock options was $32, which is expected to be amortized over the weighted-average remaining service period of 1.27 years.

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

Restricted Stock Units

Pursuant to the 2015 Omnibus Incentive Plan, Lifeway granted 2 Restricted Stock Units (“RSUs”) to certain key employees in December 2016. An RSU represents the right to receive one share of common stock in the future. RSUs have no exercise price.

The following table summarizes RSU activity during the six months ended June 30, 2017:

	RSU’s
Outstanding at December 31, 2016	2
Granted	–
Shares issued upon vesting	–
Forfeited	–
Outstanding at June 30, 2017	2
Weighted average grant date fair value per share	$ 10.54

We expense RSU’s over the service period. For the six months ended June 30, 2017 and 2016 total pre-tax stock-based compensation expense recognized in the consolidated statements of income and comprehensive income was $9 and $0, respectively. For the six months ended June 30, 2017 and 2016 tax-related benefits of $4 and $0 were also recognized. For the three months ended June 30, 2017 and 2016 total pre-tax stock-based compensation expense recognized in the consolidated statements of income and comprehensive income was $4 and $0, respectively. For the three months ended June 30, 2017 and 2016 tax-related benefits of $2 and $0 were also recognized. As of June 30, 2017, the total remaining unearned compensation related to non-vested RSU’s was $11, which is expected to be amortized over the weighted-average remaining service period of 0.96 years.

Incentive Compensation

In March 2016 Lifeway established an incentive-based compensation program (the “2016 Plan”) for certain senior executives and key employees (the “participants”). The incentive compensation was based on the achievement of certain sales and EBITDA performance levels versus respective targets in 2016. Under the 2016 Plan, the senior executives had the opportunity to earn cash and equity-based incentive compensation in amounts ranging from $0 to $4,000 for fiscal 2016 depending on the performance levels compared to the respective targets. For the six months and three months ended June 30, 2016, bonuses of $1,040 and $640 were expensed under the 2016 Plan, respectively.

In January 2017, Lifeway established an incentive-based compensation program (the "2017 Plan") for certain senior executives and key employees (the "participants"). The number of participants under the 2017 Plan was expanded from the 2016 Plan. Under the 2017 Plan, incentive compensation is based on (a) the achievement of certain sales and EBITDA performance levels versus respective targets in 2017, and (b) for certain senior executives, the achievement of individual performance objectives. Under the 2017 Plan, collectively the participants may earn cash and equity based incentive compensation in amounts ranging from $0 to $11,025 depending on the Company's performance levels compared to the respective targets and the senior executive's performance compared to their individual objectives. The equity portion of the incentive compensation is payable in restricted stock that vests one-third in each of the three years from the 2017 grant dates. For the six months ended June 30, 2017, $1,985 was accrued under the 2017 Plan, of which $1,248 was recorded as cash bonus expense and $737 was recorded as stock-based compensation expense in the consolidated statements of income and comprehensive income. For the three months ended June 30, 2017, $1,167 was accrued under the 2017 Plan, of which $859 was recorded as cash bonus expense and $308 was recorded as stock-based compensation expense in the consolidated statements of income and comprehensive income.

Retirement Benefits

The Company has a defined contribution plan which is available to substantially all full-time employees. Under the terms of the plan the Company matches employee contributions under a prescribed formula. For the six months ended June 30, 2017 and 2016 total contribution expense recognized in the consolidated statements of income and comprehensive income was $237 and $173, respectively. For the three months ended June 30, 2017 and 2016 total contribution expense recognized in the consolidated statements of income and comprehensive income was $134 and $91, respectively.

Note 12 – Segments, Products and Customers

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

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

Net sales of products by category were as follows:

	Six months ended June 30,		Three months ended June 30,	
	2017	**2016**	**2017**	**2016**
Drinkable Kefir (a)	$ 55,248	$ 54,602	$ 27,488	$ 26,535
Lifeway cheese products	5,189	5,099	2,591	2,462
Pro Bugs Kefir products	2,767	3,357	1,315	1,716
Frozen Kefir	646	643	339	418
Net Sales	$ 63,850	$ 63,701	$ 31,733	$ 31,131

(a) Excludes ProBugs Kefir products, and includes cream, cupped Kefir and cupped cheese products, supplements and other.

Significant Customers – Sales are predominately to companies in the retail food industry, located within the United States. Two major customers accounted for approximately 23% of net sales for the six months ended June 30, 2017 and 2016, and 22% and 23% of net sales for the three months ended June 30, 2017 and 2016, respectively.

Note 13 – Related party transactions

The Company obtains consulting services from the Chairperson of its board of directors. Fees earned by the Chairperson are included in general and administrative expenses in the accompanying consolidated statements of income and comprehensive income and were $500 and $539 during the six months ended June 30, 2017 and 2016, respectively, and $250 and $213 during the three months ended June 30, 2017 and 2016, respectively.

The Company is also a party to a royalty agreement with the Chairperson of its board of directors under which the Company pays the Chairperson a royalty based on the sale of certain Lifeway product, not to exceed $50 in any fiscal month. Royalties earned by the Chairperson are included in selling expenses in the accompanying consolidated statements of income and comprehensive income and were $300 during the six months ended June 30, 2017 and 2016, and $150 during the three months ended June 30, 2017 and 2016.

Note 14 – Subsequent Event

On August 2, 2017, the Company completed a tender offer to purchase for cash 86 shares of its common stock at a purchase price of $9.50 per share, for a total cost of approximately $900, which includes $86 of costs directly attributable to the tender offer. These shares represented approximately 0.5% of the Company's total outstanding common stock as of July 26, 2017. The share purchases and related costs were funded through the Company's cash and cash equivalents on hand.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in this Form 10-Q is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements, the accompanying notes, and the MD&A included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016 (the "Form 10-K"). Unless otherwise specified, any description of "our", "we", and "us" in this MD&A refer to Lifeway Foods, Inc. and subsidiaries.

Cautionary Statement Regarding Forward-Looking Statements

In addition to historical information, this quarterly report contains "forward-looking" statements within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements may be identified by the use of words such as "anticipate," "intend," "plan," "believe," "estimate," "expect," "future," "likely," "may," "should," "will" and similar terms or terminology, or the negative of such terms or other comparable terminology. Examples of forward-looking statements include, among others, statements we make regarding

- Expectations of the effect on our financial condition of claims, litigation, environmental costs, contingent liabilities and governmental and regulatory investigations and proceedings;
- Strategy for acquisitions, customer retention, growth, product development, market position, financial results and reserves; Estimates of the amounts of sales allowances and discounts to our customers and consumers;
- Our belief that we will maintain compliance with our loan agreements and have sufficient liquidity to fund our business operations;

Forward-looking statements are neither historical facts nor assurances of future performance. Instead, they are based only on our current beliefs, expectations and assumptions regarding the future of our business, future plans and strategies, projections, anticipated events and trends, the economy and other future conditions. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict and many of which are outside of our control. Our actual results and financial condition may differ materially from those indicated in the forward-looking statements. Therefore, you should not rely on any of these forward-looking statements. Important factors that could cause our actual results and financial condition to differ materially from those indicated in the forward-looking statements include, among others, the following:

- The impact of investigative and legal proceedings;
- Developments and changes in laws and regulations, including regulation of the dairy or food industries through legislative action and revised rules and standards applied by the Food & Drug Administration (FDA);
- Economic and financial conditions, including volatility in interest and exchange rates, commodity and equity prices, and the value of our assets;
- Changes in the price of milk and other key materials and disruptions in supply chains for these materials;
- Strategic actions, including acquisitions and dispositions and our success in launching new products;
- The impact on our competitive position if we do not maintain compliance with our loan agreements and/or sufficient liquidity to fund our business operations;
- Such other factors as discussed throughout Part I, Item 1 "Business"; Part I, Item 1A "Risk Factors"; and Part II, Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2016 and that are described from time to time in our filings with the SEC.

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. We intend these forward-looking statements to speak only at the date made. Except as otherwise required to be disclosed in periodic reports required to be filed by public companies with the 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.

Three Months Ended June 30, 2017 Compared to Three Months Ended June 30, 2016

Results of Operations

	June 30,		Change	
	2017	2016	$	%
Net sales	**$ 31,733**	**$ 31,131**	**$ 602**	**1.9%**

Cost of goods sold	$ 21,857	$ 20,763	$ (1,094)	
Depreciation expense	597	633	36	
Total cost of goods sold	**$ 22,454**	**$ 21,396**	**$ (1,058)**	**(4.9%)**
Gross profit	**$ 9,279**	**$ 9,735**	**$ (456)**	**(4.7%)**
Gross Profit % to net sales	*29.2%*	*31.3%*		
Selling expenses	**$ 3,400**	**$ 3,463**	**$ 63**	**1.8%**
Selling expenses % to net sales	*10.7%*	*11.1%*		
General & administrative expenses	**$ 3,813**	**$ 3,046**	**$ (767)**	**(25.2%)**
General & administrative % to net sales	*12.0%*	*9.8%*		
Amortization expense	**$ 168**	**$ 177**	**$ 9**	**5.1%**
Total operating expenses	**$ 7,381**	**$ 6,686**	**$ (695)**	**(10.4%)**
Total operating expense % to net sales	*23.3%*	*21.5%*		
Income from operations	**$ 1,898**	**$ 3,049**	**$ (1,151)**	**(37.8%)**
Income from operations % to net sales	*6.0%*	*9.8%*		

Net Sales

Net sales increased by $602 or 1.9% to $31,733. Volume / mix added 2.7% to net sales; pricing added 0.8% to net sales and trade promotion subtracted 1.6% from overall net sales. The 2.7% volume / mix increase was driven by the impact of new item introductions; higher volumes of our branded drinkable kefir and higher sales of private label product.

Gross Profit

Gross profit as a percent of net sales decreased to 29.2% during the three-month period ended June 30, 2017 from 31.3% during the same three-month period in 2016. The lower gross profit percent reflects higher milk costs and increased trade promotion partially offset by lower freight and delivery costs.

Selling Expenses

Selling expenses decreased by $63 or 1.8% to $3,400 during the three-month period ended June 30, 2017 from $3,463 during the same period in 2016. The lower selling expenses reflects lower advertising costs, partially offset by higher salaries. The lower advertising expense was driven by timing, as we ran an advertising campaign focused on our Pro Bugs product line during the second quarter of 2016, but had no comparable campaign in the second quarter of 2017. The increase in salaries reflects a headcount increase in our salesforce. Selling expenses as a percentage of net sales were 10.7% for the three-month period ended June 30, 2017 compared to 11.1% for the same period in 2016.

General and administrative expenses

General and administrative expenses increased $767 or 25.2% to $3,813 during the three-month period ended June 30, 2017 from $3,046 during the same period in 2016. The increase is primarily a result of higher compensation partially offset by lower professional fees.

Income from operations and net income

The company reported income from operations of $1,898 during the three months ended June 30, 2017, compared to $3,049 during the same period in 2016. Provision for income taxes was $801 during the three months ended June 30, 2017, compared to a provision for income taxes of $789 during the same period in 2016. Our effective tax rate (ETR) for the three months ended June 30, 2017 was 43.6% compared to an ETR of 27.2% in the same period last year. The increase in the ETR was driven by the following:

- During the three months ended June 30, 2017 the company provided an additional $117 of tax provision for uncertain tax positions, which increased the ETR by 6.4%.

- During the three months ended June 30, 2016 the Company recorded an income tax benefit of $273 as a result of the favorable settlement of uncertain tax positions, which reduced the ETR by 9.2%.

Income taxes are discussed in Note 9 in the Notes to the Consolidated Financial Statements.

We reported net income of $1,036 or $0.06 per basic and diluted common share for the three-month period ended June 30, 2017 compared to net income of $2,107 or $0.13 per basic and diluted common share in the same period in 2016.

Comparison of the six-month period ended June 30, 2017 to the six-month period ended June 30, 2016

Results of Operations

	June 30,		Change	
	2017	**2016**	**$**	**%**
Net sales	**$ 63,850**	**$ 63,701**	**$ 149**	0.2%
Cost of goods sold	$ 44,931	$ 44,002	$ (929)	
Depreciation expense	1,183	1,264	81	
Total cost of goods sold	**$ 46,114**	**$ 45,266**	**$ (848)**	**(1.9%)**
Gross profit	**$ 17,736**	**$ 18,435**	**$ (699)**	**(3.8%)**
Gross Profit % to net sales	*27.8%*	*28.9%*		
Selling expenses	**$ 7,638**	**$ 6,427**	**$ (1,211)**	**(18.8%)**
Selling expenses % to net sales	*12.0%*	*10.1%*		
General & administrative expenses	**$ 7,598**	**$ 6,992**	**$ (606)**	**(8.7%)**
General & administrative % to net sales	*11.9%*	*11.0%*		
Amortization expense	**$ 336**	**$ 353**	**$ 17**	**4.8%**
Total operating expenses	**$ 15,572**	**$ 13,772**	**$ (1,800)**	**(13.1%)**
Total operating expense % to net sales	*24.4%*	*21.6%*		
Income from operations	**$ 2,164**	**$ 4,663**	**$ (2,499)**	**(53.6%)**
Income from operations % to net sales	*3.4%*	*7.3%*		

Net Sales

Net sales increased by $149 or 0.2% to $63,850. Volume / mix added 1.0% to net sales; pricing added 0.7% to net sales and trade promotion subtracted 1.5% from overall net sales. The 1.0% volume / mix improvement was driven by the impact of new item introductions and an increase in sales of private label product. The increased trade promotion was driven in part by increased coupon redemption and trade spending related to new product introductions.

Gross Profit

Gross profit as a percent of net sales decreased to 27.8% during the six-month period ended June 30, 2017 from 28.9% during the same period in 2016. The lower gross profit percent reflects higher milk costs and increased trade promotion partially offset by lower freight and delivery costs.

Selling Expenses

Selling expenses increased by $1,211 or 18.8% to $7,638 during the six-month period ended June 30, 2017 from $6,427 during the same period in 2016. The increased selling expenses reflects certain advertising and marketing related costs including an advertising campaign that aired in the first quarter of 2017 to coincide with an annual natural products conference, the production costs associated with a national coupon campaign launched in the first quarter of 2017 and increased costs related to trade shows. Higher salaries, driven by a headcount increase in our salesforce, also contributed to the increased selling expenses. Selling expenses as a percentage of net sales were 12.0% for the six-month period ended June 30, 2017 compared to 10.1% for the same period in 2016.

General and administrative expenses

General and administrative expenses increased $606 or 8.7% to $7,598 during the six-month period ended June 30, 2017 from $6,992 during the same period in 2016. The increase is primarily a result of increases in salaries partially offset by lower professional fees. The increase in salaries reflects higher levels of executive compensation for senior management driven by incentive compensation and an increase in the headcount of the overall management team.

Income from operations and net income

The company reported income from operations of $2,164 during the six months ended June 30, 2017, compared to $4,663 during the same period in 2016. Provision for income taxes was $881, or a 43.1% effective tax rate (ETR) during the six months ended June 30, 2017, compared to a provision for income taxes of $1,395 or a 31.3% effective tax rate, during the same period in 2016. The increase in the ETR was driven by the following:

- During the six months ended June 30, 2017 the Company provided an additional $121 of tax provision for uncertain tax positions, which increased the ETR by 6.0%.

- During the six months ended June 30, 2016 the Company recorded an income tax benefit of $273 as a result of the favorable settlement of uncertain tax positions, which reduced the ETR by 6.0%.

Income taxes are discussed in Note 9 in the Notes to the Consolidated Financial Statements.

We reported net income of $1,160 or $0.07 per basic and diluted common share for the six-month period ended June 30, 2017 compared to $3,062 or $0.19 per basic and diluted common share in the same period in 2016.

Liquidity and Capital Resources

Sources and Uses of Cash

We anticipate being able to fund the Company's foreseeable liquidity requirements internally. We also have unused credit lines as discussed in Note 7 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 $3,323 during the six months ended June 30, 2017 compared to net cash provided by operating activities of $1,861 in the same period in 2016. The increase in cash provided by operating activities reflects an increase in non-cash charges primarily related to stock-based compensation and the impact of relatively lower working capital during 2017. The favorable impact of working capital on operating cash flow was driven by the favorable timing of payments to suppliers and service providers and lower inventory levels.

Net cash used in investing activities was $2,366 during the six months ended June 30, 2017 compared to net cash used in investing activities of $285 in the same period in 2016. The lower level of net cash used in investing activities in the 2016 period reflects liquidity provided from our investments in part to fund share repurchase activity. Capital spending was $2,400 during the six months ended June 30, 2017 compared to $1,382 in the same period in 2016 reflecting our continuing investments in new production equipment.

Net cash used in financing activities was $420 during the six months ended June 30, 2017 compared to net cash used in financing activities of $1,158 in the same period in 2016. We repurchased approximately 69 shares of common stock at a cost of $738 in the six months ended June 30, 2016. There were no share repurchases in the same period in 2017. On September 24, 2015, the Company's Board of Directors authorized a stock repurchase program under which the Company may repurchase up to $3,500 of common stock not to exceed an aggregate of 250 shares. Approximately $1,200 remained available under this authorized program as of June 30, 2017. As disclosed in the Offer to Purchase attached as an exhibit to the Company's Schedule TO filed with the SEC on June 26, 2017, the Company suspended its repurchase program. The repurchase program has no expiration date and may be resumed or discontinued at any time.

The Company had a net increase in cash and cash equivalents of $537 during the six-month period ended June 30, 2017 compared to a net increase in cash and cash equivalents of $418 in the same period in 2016.

At June 30, 2017, the Company had $3,419 of current maturities of notes payable. We intend to fund these maturities with available cash balances and / or new financing facilities. The Company also has a $5 million revolving credit facility. This facility expires in July 2018, remained unused at June 30, 2017 and is available for other general corporate purposes. The company is in compliance with the covenants contained in its loan agreements.

On August 2, 2017, the Company completed a tender offer to purchase for cash 86 shares of its common stock at a purchase price of $9.50 per share, for a total cost of approximately $900, which includes $86 of costs directly attributable to the tender offer. These shares represented approximately 0.5% of the Company's total outstanding common stock as of July 26, 2017. The share purchases and related costs were funded through the Company's cash and cash equivalents on hand.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

For information regarding our exposure to certain market risk, see Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in the Form 10-K. There have been no significant changes in our market risk exposures from the 2016 year-end.

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures

Our evaluation of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act was performed under the supervision and with the participation of our senior management, including our Chief Executive Officer and Chief Financial Officer. The purpose of disclosure controls and procedures is to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

As previously disclosed under "Item 9A—Controls and Procedures" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, we concluded that our internal control over financial reporting was not effective based on the material weakness identified. Based on the material weakness, which we view as an integral part of our disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the quarter ended June 30, 2017, our disclosure controls and procedures were not effective. Nevertheless, based on a number of factors, including the performance of additional procedures by management designed to ensure the reliability of our financial reporting, we believe that the consolidated financial statements in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial position, results of operations and cash flows for the periods presented in conformity with GAAP.

(b) Changes in Internal Control over Financial Reporting

Our remediation efforts were ongoing during the three months ended June 30, 2017. Remediation generally requires making changes to how controls are designed and implemented and then adhering to those changes for a sufficient period of time such that the effectiveness of those changes is demonstrated with an appropriate amount of consistency. We have taken certain remediation steps to address the material weaknesses referenced above and to improve our control over financial reporting. If not remediated these deficiencies could result in material misstatements to our consolidated financial statements.

In addition to the actions previously disclosed under "Item 9A—Controls and Procedures" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, our remediation initiatives summarized below, are intended to further address our specific material weaknesses and to continue to enhance our internal control over financial reporting.

Management's Remediation Initiatives

During the six months ended June 30, 2017 we took the following actions to improve our internal controls over financial reporting:

- We have continued to emphasize the importance of, and monitor the sustained compliance with, the execution of our internal controls over financial reporting.
- We have continued to work with our third-party service provider to ensure that our accounting and reporting for income taxes are timely and accurate.
- We have increased the number of employees authorized to review and sign checks from two to three to improve timeliness and add redundancy to the internal controls over the cash disbursements process.
- We have commenced an initiative to install software and implement new procedures designed to improve user provisioning and user access rights to our ERP system.

There were no other material changes in our internal control over financial reporting that occurred during the six months ended June 30, 2017 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

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

ITEM 1A. RISK FACTORS.

There have been no material changes to the Risk Factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

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

Issuer Purchases of Equity Securities

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. MINE SAFETY DISCLOSURE.

Not applicable.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

31.1	Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Officer's Certificate Pursuant to 15 U.S.C. 7241, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1*	Press release dated August 14, 2017 reporting the Company's financial results for the three and six months ended June 30, 2017.
101	Interactive Data Files.

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

SIGNATURES

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

LIFEWAY FOODS, INC.

Date: August 14, 2017

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

Date: August 14, 2017

By: /s/ John P. Waldron
John P. Waldron
Chief Financial Officer
(Principal Financial and Accounting Officer)

INDEX OF EXHIBITS

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99.1*	Press release dated August 14, 2017 reporting the Company's financial results for the three and six months ended June 30, 2017.
101	Interactive Data Files.

EXHIBIT 31.1

SECTION 302 CERTIFICATION OF C.E.O.
CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Julie Smolyansky, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lifeway Foods, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2017

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

EXHIBIT 31.2

SECTION 302 CERTIFICATION OF C.F.O.
CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, John P. Waldron, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lifeway Foods, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2017

By: /s/ John P. Waldron
John P. Waldron
Chief Financial Officer
(Principal Financial and Accounting Officer)

EXHIBIT 32.1

SECTION 906 CERTIFICATION OF C.E.O.
CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Lifeway Foods, Inc. (the "Company") for the period ended June 30, 2017 as filed with the SEC (the "Report"), the undersigned, in the capacity and on the date indicated below, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to her knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 14, 2017

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

EXHIBIT 32.2

SECTION 906 CERTIFICATION OF C.F.O.
CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT
TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Lifeway Foods, Inc. (the "Company") for the period ended June 30, 2017 as filed with the SEC (the "Report"), the undersigned, in the capacity and on the date indicated below, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 14, 2017

By: /s/ John P. Waldron
John P. Waldron
Chief Financial Officer
(Principal Financial and Accounting Officer)

Exhibit 99.1

Lifeway®

Lifeway Foods, Inc. Announces Results for the Second Quarter Ended June 30, 2017

Morton Grove, IL — August 14, 2017 — Lifeway Foods, Inc., (Nasdaq: LWAY), the leading U.S. supplier of kefir cultured dairy products, today reported financial results for the second quarter ended June 30, 2017.

"In the face of a retail business climate that continues to prove challenging, our focus on both the consumer and the customer is producing important and meaningful results," said CEO Julie Smolyanksy. "Lifeway posted a 1.9% increase in net sales for the quarter led by increased consumption of our flagship products and the encouraging launch of our new cupped kefir product line. Our leadership team has never been more inspired to execute against our strategic framework as we partner with the trade to deliver sustainable growth not only with category-expanding innovation but through our core kefir portfolio."

Second Quarter Results

Second quarter net sales increased by $602 or 1.9% to $31,733. Higher volumes of our branded drinkable kefir, private label products and the impact of our new cupped kefir were partially offset by increased trade promotion to support expanded distribution of drinkable and cupped kefir."

Gross profit as a percent of net sales decreased to 29.2% during the three-month period ended June 30, 2017 from 31.3% during the same three-month period in 2016. The lower gross profit percent reflects higher milk costs and increased trade promotion partially offset by lower delivery costs.

Selling expenses decreased by $63 or 1.8% to $3,400 during the three-month period ended June 30, 2017 from $3,463 during the same period in 2016. The decline in selling expenses was driven by lower advertising costs mostly offset by higher sales salaries. The lower level of advertising in the second quarter is largely due to timing as we promoted our Pro Bugs product line with an ad campaign last year and had no comparable campaign this year. The higher sales salaries reflects our strategic initiative to elevate customer focus and improve selling effectiveness supported by an augmented sales organization which was launched in the first quarter of 2017. Selling expenses as a percentage of net sales were 10.7% for the three-month period ended June 30, 2017 compared to 11.1% for the same period in 2016.

General and administrative expenses increased $767 or 25.2% to $3,813 during the three-month period ended June 30, 2017 from $3,046 during the same period in 2016. The increase is primarily a result of higher compensation partially offset by lower professional fees.

Our effective tax rate for the three months ended June 30, 2017 was 43.6% compared to an effective tax rate of 27.2% in the same period last year. We reported net income of $1,036 or $0.06 per basic and diluted common share for the three-month period ended June 30, 2017 compared to net income of $2,107 or $0.13 per basic and diluted common share in the same period in 2016.

First Six Months of Fiscal 2016

Year to date net sales increased by $149, or approximately 0.2%, to $63,850 during the six-month period ended June 30, 2017 from $63,701 during the same six-month period in 2016. Sales of private label products and our new cupped kefir contributed to a 1% volume gain that was partially offset by higher trade promotion in 2017.

Gross profit as a percent of net sales decreased to 27.8% from 28.9% in the same period last year. The lower gross profit percent reflects higher milk costs and increased trade promotion partially offset by lower delivery costs.

Selling expenses increased by $1,211 or 18.8% to $7,638 during the first six months of 2017 from $6,427 in the first six months of 2016. As a percentage of net sales, selling expenses increased to 12.0% compared to 10.1% in the same period last year.

Our effective tax rate for the six months ended June 30, 2017 was 43.1% compared to an effective tax rate of 31.3% in the same period last year. We reported net income of $1,160 or $0.07 per basic and diluted common share for the six-month period ended June 30, 2017 compared to net income of $3,062 or $0.19 per basic and diluted common share in the same period in 2016.

Balance Sheet

Cash and cash equivalents increased $0.5 million to $9.3 million during the six months ended June 30, 2017. As of June 30, 2017, the Company had outstanding borrowings of approximately $6.7 million, of which $3.4 becomes due in May of 2018. The Company had additional borrowing capacity of $5 million under its line of credit as of June 30, 2017.

About Lifeway Foods, Inc.

Lifeway Foods, Inc. (LWAY), recently named one of Forbes' Best Small Companies, is America's leading supplier of the probiotic, fermented beverage known as kefir. In addition to its line of drinkable kefir, the company also produces frozen kefir, specialty cheeses and a ProBugs line for kids. Lifeway's tart and tangy cultured dairy products are available throughout the United States and on a small, but growing basis in Canada, Latin America, Ireland, and the United Kingdom. Learn how Lifeway is good for more than just you at www.lifewaykefir.com.

Forward-Looking Statements

All statements in this release (and oral statements made regarding the subjects of this release) contains "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995 regarding, among other things, future operating and financial performance, product development, market position, business strategy and objectives. These statements use words, and variations of words, such as "will," "expect," "next," "project," "potential," "continue," "expand," and "grow." Other examples of forward looking statements may include, but are not limited to, (i) statements of Company plans and objectives, including the introduction of new products, or estimates or predictions of actions by customers or suppliers, (ii) statements of future economic performance, and (III) statements of assumptions underlying other statements and statements about Lifeway or its business. You are cautioned not to rely on these forward-looking statements. These statements are based on current expectations of future events and thus are inherently subject to uncertainty. If underlying assumptions prove inaccurate or known or unknown risks or uncertainties materialize, actual results could vary materially from Lifeway's expectations and projections. These risks, uncertainties, and other factors 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; and customer acceptance of products and services. A further list and description of these risks, uncertainties, and other factors can be found in Lifeway's Annual Report on Form 10-K for the fiscal year ended December 31, 2016, and the Company's subsequent filings with the SEC. Copies of these filings are available online at https://www.sec.gov, http://lifewaykefir.com/investor-relations/, or on request from Lifeway. Information in this release is as of the dates and time periods indicated herein, and Lifeway does not undertake to update any of the information contained in these materials, except as required by law. Accordingly, YOU SHOULD NOT RELY ON THE ACCURACY OF ANY OF THE STATEMENTS OR OTHER INFORMATION CONTAINED IN ANY ARCHIVED PRESS RELEASE.

Contact:

Lifeway Foods, Inc.
Phone: 847-967-1010
Email: info@Lifeway.net

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
June 30, 2017 and December 31, 2016
(In thousands)

	June 30, 2017 (Unaudited)	December 31, 2016
Current assets		
Cash and cash equivalents	9,349	8,812
Accounts receivable, net of allowance for doubtful accounts and discounts and allowances of $1,500 and $1,600 at June 30, 2017 and December 31, 2016 respectively	10,388	9,594
Inventories, net	8,097	8,042
Prepaid expenses and other current assets	1,285	785
Refundable income taxes	342	309
Total current assets	**29,461**	**27,542**
Property, plant and equipment, net	**23,010**	**21,832**
Intangible assets		
Goodwill and other indefinite-lived intangibles	14,068	14,068
Other intangible assets, net	1,311	1,647
Total intangible assets	**15,379**	**15,715**
Other Assets	125	125
Total assets	**67,975**	**65,214**
Current liabilities		
Current maturities of notes payable	3,419	840
Accounts payable	6,285	5,718
Accrued expenses	3,813	2,169
Accrued income taxes	75	654
Total current liabilities	**13,592**	**9,381**
Notes payable	**3,280**	**6,279**
Deferred income taxes, net	**1,192**	**1,192**
Other long-term liabilities	**351**	**–**

Total liabilities	**18,415**	**16,852**
Stockholders' equity		
Common stock, no par value; 40,000,000 shares authorized; 17,274 shares issued; 16,154 outstanding	6,509	6,509
Paid-in-capital	2,236	2,198
Treasury stock, at cost	(10,340)	(10,340)
Retained earnings	51,155	49,995
Total stockholders' equity	**49,560**	**48,362**
Total liabilities and stockholders' equity	**67,975**	**65,214**

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Income and Comprehensive Income
For the three and six months ended June 30, 2017 and 2016
(Unaudited)
(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	**2016**	**2017**	**2016**
Net sales	**$ 31,733**	**$ 31,131**	**$ 63,850**	**$ 63,701**
Cost of goods sold	21,857	20,763	44,931	44,002
Depreciation expense	597	633	1,183	1,264
Total cost of goods sold	22,454	21,396	46,114	45,266
Gross profit	**9,279**	**9,735**	**17,736**	**18,435**
Selling expense	3,400	3,463	7,638	6,427
General and administrative expense	3,813	3,046	7,598	6,992
Amortization expense	168	177	336	353
Total operating expenses	**7,381**	**6,686**	**15,572**	**13,772**
Income from operations	**1,898**	**3,049**	**2,164**	**4,663**
Other income (expense):				
Interest expense	(61)	(47)	(118)	(105)
Loss on sale of investments, net reclassified from OCI	–	(15)	–	(27)
Loss on sale of equipment	–	(151)	(5)	(151)
Other income, net	–	60	–	77
Total other income (expense)	(61)	(153)	(123)	(206)
Income before provision for income taxes	**1,837**	**2,896**	**2,041**	**4,457**
Provision for income taxes	801	789	881	1,395
Net income	**$ 1,036**	**$ 2,107**	**$ 1,160**	**$ 3,062**
Earnings per common share:				
Basic	$ 0.06	$ 0.13	$ 0.07	$ 0.19
Diluted	$ 0.06	$ 0.13	$ 0.07	$ 0.19
Weighted average common shares:				

Basic	16,154	16,149	16,154	16,169
Diluted	16,203	16,149	16,211	16,169

COMPREHENSIVE INCOME				
Net income	**$ 1,036**	**$ 2,107**	**$ 1,160**	**$ 3,062**
Other comprehensive income (loss), net of tax:				
Unrealized gains on investments, net of taxes	–	12	–	56
Reclassifications to earnings:				
Realized gains on investments, net of taxes	–	24	–	17
Comprehensive income	**$ 1,036**	**$ 2,143**	**$ 1,160**	**$ 3,135**

LIFEWAY FOODS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the six months ended June 30, 2017 and 2016
(Unaudited)
(In thousands)

	2017	2016
Cash flows from operating activities:		
Net Income	1,160	3,062
Adjustments to reconcile net income to operating cash flow:		
Depreciation and amortization	1,519	1,617
Loss on sale of investments, net	–	27
Reserve for inventory obsolescence	131	–
Stock-based compensation	775	42
Loss on sale of property and equipment	5	151
(Increase) decrease in operating assets:		
Accounts receivable	(793)	(502)
Inventories	(185)	(1,649)
Refundable income taxes	(33)	(70)
Prepaid expenses and other current assets	(500)	(448)
Increase (decrease) in operating liabilities:		
Accounts payable	564	(1,710)
Accrued expenses	1,259	765
Accrued income taxes	(579)	576
Net cash provided by operating activities	**3,323**	**1,861**
Cash flows from investing activities:		
Purchases of investments	–	(479)
Proceeds from sale of investments	–	1,024
Redemption of certificates of deposits	–	513
Purchases of property and equipment	(2,400)	(1,382)
Proceeds from sale of property and equipment	34	39
Net cash used in investing activities	**(2,366)**	**(285)**
Cash flows from financing activities:		
Purchase of treasury stock	–	(738)
Repayment of notes payable	(420)	(420)
Net cash used in financing activities	**(420)**	**(1,158)**
Net increase in cash and cash equivalents	**537**	**418**
Cash and cash equivalents at the beginning of the period	8,812	5,646
Cash and cash equivalents at the end of the period	**$ 9,349**	**$ 6,064**

Supplemental cash flow information:		
Cash paid for income taxes, net of refunds	$ 1,493	$ 886
Cash paid for interest	$ 118	$ 105