
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

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

For the quarterly period ended September 30, 2023

OR

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

For the transition period from ____ to ____

Commission file number 000-21617

ProPhase Labs, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction
of incorporation or organization)

23-2577138

(I.R.S. Employer
Identification No.)

711 Stewart Ave, Suite 200
Garden City, New York

(Address of principal executive office)

11530

(Zip Code)

(215) 345-0919

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Securities Registered Pursuant to Section 12(b) of the Exchange Act:

Title of Each Class	Trading Symbol	Name of Each Exchange on Which Registered
Common Stock, par value \$0.0005	PRPH	Nasdaq Capital Market

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or shorter period that the registration was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a 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.

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input checked="" type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Class	Outstanding November 6, 2023
Common Stock, \$0.0005 par value	18,045,029

ProPhase Labs, Inc. and Subsidiaries
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(in thousands, except share and per share amounts)
(unaudited)

	September 30, 2023	December 31, 2022
ASSETS		
Current assets		
Cash and cash equivalents	\$ 702	\$ 9,109
Marketable securities, available for sale	2,565	8,328
Accounts receivable, net	38,642	37,054
Inventory, net	5,054	3,976
Prepaid expenses and other current assets	2,831	2,366
Total current assets	49,794	60,833
Property, plant and equipment, net	13,163	7,288
Prepaid expenses, net of current portion	832	121
Operating lease right-of-use asset, net	4,680	4,059
Intangible assets, net	13,015	8,475
Goodwill	5,231	5,709
Deferred tax asset	3,832	—
Other assets	1,163	1,163
TOTAL ASSETS	\$ 91,710	\$ 87,648
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 5,467	\$ 5,905
Accrued diagnostic services	241	1,009
Accrued advertising and other allowances	113	99
Finance lease liabilities	1,840	—
Operating lease liabilities	947	301
Deferred revenue	2,447	2,499
Income tax payable	3,309	4,190
Other current liabilities	2,042	2,072
Total current liabilities	16,406	16,075
Non-current liabilities:		
Deferred revenue, net of current portion	796	1,059
Deferred tax liability, net	—	224
Unsecured convertible promissory notes, net	—	2,400
Unsecured convertible promissory notes, net of discount of \$301 and \$0	7,299	—
Due to sellers (see Note 3)	2,000	—
Finance lease liabilities, net of current portion	4,436	—
Operating lease liabilities, net of current portion	4,345	4,259

Total non-current liabilities	18,876	7,942
Total liabilities	35,282	24,017

COMMITMENTS AND CONTINGENCIES

Stockholders' equity

Preferred stock authorized 1,000,000, \$0.0005 par value, no shares issued and outstanding	—	—
Common stock authorized 50,000,000, \$0.0005 par value, 18,045,029 and 16,210,776 shares outstanding, respectively	18	16
Additional paid-in capital	118,132	109,138
Retained earnings	3,722	11,753
Treasury stock, at cost, 18,940,967 and 18,126,970 shares, respectively	(64,000)	(58,033)
Accumulated other comprehensive income	(1,444)	757
Total stockholders' equity	56,428	63,631
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 91,710	\$ 87,648

See accompanying notes to these condensed consolidated financial statements

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)
(in thousands, except per share amounts)
(unaudited)

	For the three months ended		For the nine months ended	
	September 30, 2023	September 30, 2022	September 30, 2023	September 30, 2022
Revenues, net	\$ 8,365	\$ 24,200	\$ 40,885	\$ 100,824
Cost of revenues	6,038	12,227	21,590	41,453
Gross profit	<u>2,327</u>	<u>11,973</u>	<u>19,295</u>	<u>59,371</u>
Operating expenses:				
Diagnostic expenses	132	2,398	1,932	8,869
General and administration	8,245	7,512	26,480	21,643
Research and development	428	110	1,144	174
Total operating expenses	<u>8,805</u>	<u>10,020</u>	<u>29,556</u>	<u>30,686</u>
(Loss) income from operations	<u>(6,478)</u>	<u>1,953</u>	<u>(10,261)</u>	<u>28,685</u>
Interest income, net	1	25	39	123
Interest expense	(275)	(201)	(781)	(635)
Change in fair value of investment securities	—	—	—	(76)
Other income (loss)	(33)	—	(132)	—
(Loss) income from operations before income taxes	<u>(6,785)</u>	<u>1,777</u>	<u>(11,135)</u>	<u>28,097</u>
Income tax benefit (expense)	1,644	(809)	3,104	(7,190)
(Loss) income from operations after income taxes	<u>(5,141)</u>	<u>968</u>	<u>(8,031)</u>	<u>20,907</u>
Net (loss) income	<u>\$ (5,141)</u>	<u>\$ 968</u>	<u>\$ (8,031)</u>	<u>\$ 20,907</u>
Other comprehensive (loss) income:				
Unrealized gain (loss) on marketable debt securities	(2,032)	(51)	(2,201)	(112)
Total comprehensive (loss) income	<u>\$ (7,173)</u>	<u>\$ 917</u>	<u>\$ (10,232)</u>	<u>\$ 20,795</u>
Earnings per share:				
Basic	<u>\$ (0.30)</u>	<u>\$ 0.06</u>	<u>\$ (0.47)</u>	<u>\$ 1.33</u>
Diluted	<u>\$ (0.30)</u>	<u>\$ 0.06</u>	<u>\$ (0.47)</u>	<u>\$ 1.10</u>
Weighted average common shares outstanding:				
Basic	<u>17,175</u>	<u>15,898</u>	<u>16,924</u>	<u>15,712</u>
Diluted	<u>17,175</u>	<u>20,248</u>	<u>16,924</u>	<u>19,504</u>

See accompanying notes to these condensed consolidated financial statements

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Statements of Stockholders' Equity
(in thousands, except share data)
(unaudited)

For the Three Months Ended September 30, 2023

	Common Stock Shares Outstanding	Par Value	Additional Paid in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income	Total
Balance as of July 1, 2023	16,845,029	\$ 17	\$ 113,789	\$ 8,863	\$ (64,000)	\$ 588	\$ 59,257
Issuance of common stock to convert outstanding convertible notes	800,000	1	2,399	—	—	—	2,400
Issuance of common stock upon exercise of warrant	400,000	—	1,200	—	—	—	1,200
Unrealized gain on marketable debt securities	—	—	—	—	—	(2,032)	(2,032)
Stock-based compensation (including \$1,138 in prepaid expense)	—	—	744	—	—	—	744
Net loss	—	—	—	(5,141)	—	—	(5,141)
Balance as of September 30, 2023	18,045,029	\$ 18	\$ 118,132	\$ 3,722	\$ (64,000)	\$ (1,444)	\$ 56,428

For the Three Months Ended September 30, 2022

	Common Stock Shares Outstanding	Par Value	Additional Paid in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance as of July 1, 2022	15,722,827	\$ 16	\$ 106,162	\$ 13,230	\$ (51,015)	\$ (236)	\$ 68,157
Repurchase of common shares	(5,048)	1	—	—	(51)	—	(50)
Treasury shares repurchased to satisfy tax withholding obligations	—	—	—	—	(3,072)	—	(3,072)
Issuance of common shares upon cashless exercise of stock options	308,385	—	—	—	—	—	—
Unrealized loss on marketable debt securities	—	—	—	—	—	(51)	(51)
Stock-based compensation	—	—	1,969	—	—	—	1,969
Net income	—	—	—	968	—	—	968
Balance as of September 30, 2022	16,026,164	\$ 17	\$ 108,131	\$ 14,198	\$ (54,138)	\$ (287)	\$ 67,921

For the Nine Months Ended September 30, 2023

	Common Stock Shares Outstanding	Par Value	Additional Paid in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance as of January 1, 2023	16,210,776	\$ 16	\$ 109,138	\$ 11,753	\$ (58,033)	\$ 757	\$ 63,631
Issuance of common stock in asset acquisition	100,000	1	999	—	—	—	1,000
Repurchases of common shares	(69,628)	—	—	—	(588)	—	(588)
Issuance of common stock to convert outstanding convertible notes	800,000	1	2,399	—	—	—	2,400
Issuance of common stock upon exercise of warrants	400,000	—	1,200	—	—	—	1,200
Issuance of common stock upon stock options cashless exercise	603,881	—	—	—	—	—	—
Issuance of warrants with unsecured promissory note	—	—	398	—	—	—	398
Treasury shares repurchased to satisfy tax withholding obligations	—	—	—	—	(5,379)	—	(5,379)
Unrealized loss on marketable debt securities	—	—	—	—	—	(2,201)	(2,201)
Stock-based compensation (including \$1,138 in prepaid expense)	—	—	3,998	—	—	—	3,998
Net loss	—	—	—	(8,031)	—	—	(8,031)
Balance as of September 30, 2023	18,045,029	\$ 18	\$ 118,132	\$ 3,722	\$ (64,000)	\$ (1,444)	\$ 56,428

For the Nine Months Ended September 30, 2022

	Common Stock Shares Outstanding	Par Value	Additional Paid in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance as of January 1, 2022	15,485,900	\$ 16	\$ 104,552	\$ 2,642	\$ (48,407)	\$ (175)	\$ 58,628
Issuance of common shares for debt conversion	200,000	—	600	—	—	—	600
Treasury shares repurchased to satisfy tax withholding obligations	—	—	—	—	(4,531)	—	(4,531)
Repurchase of common shares	(205,048)	1	—	—	(1,200)	—	(1,199)
Cash dividends	—	—	—	(9,351)	—	—	(9,351)
Unrealized loss on marketable debt securities, net of taxes	—	—	—	—	—	(112)	(112)
Issuance of common shares upon cashless exercise of stock options	545,312	—	—	—	—	—	—
Stock-based compensation	—	—	2,979	—	—	—	2,979
Net income	—	—	—	20,907	—	—	20,907
Balance as of September 30, 2022	16,026,164	\$ 17	\$ 108,131	\$ 14,198	\$ (54,138)	\$ (287)	\$ 67,921

See accompanying notes to these condensed consolidated financial statements

ProPhase Labs, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	For the nine months ended	
	September 30, 2023	September 30, 2022
Cash flows from operating activities		
Net (loss) income	\$ (8,031)	\$ 20,907
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Realized (gain) loss on marketable debt securities	(3)	192
Depreciation and amortization	4,435	3,792
Accretion of debt discount	97	4
Amortization on operating lease right-of-use assets	325	254
Loss on sale of assets	—	14
Stock-based compensation expense	2,860	2,979
Change in fair value of investment securities	—	76
Accounts receivable allowances	718	2,528
Inventory valuation reserve	—	(179)
Bad debt expenses, direct write-off	74	—
Changes in operating assets and liabilities:		
Accounts receivable	(2,380)	(2,652)
Inventory	(1,078)	(133)
Prepaid expenses and other current assets	(938)	643
Deferred tax asset	(4,350)	(1,339)
Other assets	—	(674)
Accounts payable and accrued expenses	(438)	(5,483)
Accrued diagnostic services	(768)	(1,616)
Accrued advertising and other allowances	14	(25)
Deferred revenue	(315)	946
Deferred tax liability	(307)	—
Lease liabilities	(139)	(223)
Income tax payable	(881)	7,029
Other current liabilities	(30)	700
Net cash (used in) provided by operating activities	<u>(11,135)</u>	<u>27,740</u>
Cash flows from investing activities		
Business acquisitions, escrow received	478	—
Business acquisitions, net of cash acquired	(2,904)	—
Purchase of marketable securities	(3,819)	(1,003)
Proceeds from maturities of marketable securities	4,168	—
Proceeds from sales of marketable securities	3,817	5,800
Proceeds from dispositions of property and other assets, net	—	452
Capital expenditures	(1,845)	(2,323)
Net cash (used in) provided by investing activities	<u>(105)</u>	<u>2,926</u>

Cash flows from financing activities

Proceeds from issuance of secured note payable	7,600	—
Proceeds from exercise of warrants	1,200	—
Repurchase of common stock for payment of statutory taxes due on cashless exercise of stock option	(5,379)	(4,530)
Repurchases of common shares	(588)	(1,200)
Repayment of note payable	—	(1,444)
Payment of dividends	—	(9,351)
Net cash provided by (used in) financing activities	2,833	(16,525)
(Decrease) increase in cash and cash equivalents	(8,407)	14,141
Cash and cash equivalents, at the beginning of the period	9,109	8,658
Cash and cash equivalents, at the end of the period	\$ 702	\$ 22,799

Supplemental disclosures:

Cash paid for income taxes	\$ 3,000	\$ 1,500
Interest payment on the promissory notes	\$ 740	\$ 631

Supplemental disclosure of non-cash investing and financing activities:

Stock-based compensation included in prepaid expenses	\$ 1,138	\$ —
Issuance of common shares for debt conversion	\$ 2,400	\$ 600
Net unrealized loss (gain), investments in marketable debt securities	\$ 2,083	\$ (113)
Assets obtained in exchange for new finance lease obligations	\$ 6,201	\$ —
Issuance of warrants with unsecured promissory note	\$ 398	\$ —
Common stock issued in asset acquisition	\$ 1,000	\$ —

See accompanying notes to these condensed consolidated financial statements

Note 1 - Organization and Business

ProPhase Labs, Inc. (“ProPhase”, “we”, “us”, “our” or the “Company”) is a diversified company that offers a range of services including genomics testing, diagnostic testing and contract manufacturing. We are also focused on licensing, developing and commercializing novel drugs, dietary supplements, compounds and diagnostics. We currently conduct our operations through two operating segments: diagnostic services and consumer products.

Until late fiscal year 2020, we were engaged primarily in the research, development, manufacture, distribution, marketing and sale of OTC consumer healthcare products and dietary supplements in the United States. However, commencing in December 2020, we also began offering COVID-19 and prepared to validate other Respiratory Pathogen Panel (“RPP”) molecular tests through our diagnostic services business. In August 2021 we began offering personal genomics products and services and in July 2022 we began focusing on the licensing, development and commercialization of novel drugs, dietary supplements, compounds and diagnostics.

Our wholly owned subsidiary, ProPhase Diagnostics, Inc. (“ProPhase Diagnostics”), which was formed on October 9, 2020, offers a broad array of clinical diagnostic and testing services at its Clinical Laboratory Improvement Amendments (“CLIA”) certified laboratories including polymerase chain reaction (“PCR”) testing for COVID-19. Critical to COVID-19 testing, we provide fast turnaround times for results. We also offer rapid antigen testing for COVID-19. On October 23, 2020, we acquired Confucius Plaza Medical Laboratory Corp. (“CPM”), which included a non-operating but certified 4,000 square foot CLIA accredited laboratory located in Old Bridge, New Jersey. In December 2020, we expanded our diagnostic service business with the build-out of a second, larger CLIA accredited laboratory in Garden City, New York. Operations at this second facility commenced in January 2021.

On August 10, 2021, we acquired Nebula Genomics, Inc. (“Nebula”), a privately owned personal genomics company, through our new wholly owned subsidiary, ProPhase Precision Medicine, Inc. (“ProPhase Precision”) (see Note 3, Business Acquisitions). ProPhase Precision focuses on genomics sequencing technologies, a comprehensive method for analyzing entire genomes, including the genes and chromosomes in DNA. The data obtained from genomic sequencing can be used to help identify inherited disorders and tendencies, help predict disease risk, help identify expected drug response, and characterize genetic mutations, including those that drive cancer progression.

Our wholly owned subsidiary, ProPhase BioPharma, Inc. (“PBIO”) was formed on June 28, 2022, for the licensing, development and commercialization of novel drugs, dietary supplements and compounds beginning with Equivir (dietary supplement) and Equivir G (Rx). In July 2022, PBIO announced a second licensing agreement for two small molecule PIM kinase inhibitors, Linebacker LB-1 and LB-2, with plans to pursue development and commercialization of LB-1 as a cancer co-therapy.

In January 2023, the Company acquired exclusive rights to the BE-Smart Esophageal Pre-Cancer Diagnostic Screening Test and related intellectual property assets.

Our wholly owned subsidiary, Pharmed Manufacturing, Inc. (“PMI”), is a full-service contract manufacturer and private label developer of a broad range of non-GMO, organic and natural-based cough drops and lozenges and OTC drug and dietary supplement products.

We also develop and market dietary supplements under the TK Supplements® brand.

Note 2 - Summary of Significant Accounting Policies

Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and the rules of the Securities and Exchange Commission (“SEC”) applicable to interim financial statements, and therefore do not include all disclosures that might normally be required for financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The accompanying unaudited condensed consolidated financial statements have been prepared by management without audit and should be read in conjunction with our audited consolidated financial statements, including the notes thereto, appearing in our Annual Report on Form 10-K for the fiscal year ended December 31, 2022. In the

opinion of management, all adjustments necessary for a fair presentation of the consolidated financial position, consolidated results of operations and other comprehensive loss and consolidated cash flows, for the periods indicated, have been made. The results of operations for the three and nine months ended September 30, 2023 are not necessarily indicative of operating results that may be achieved over the course of the full year.

Use of Estimates

The preparation of condensed consolidated financial statements and the accompanying notes thereto, in conformity with GAAP, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and reported amounts of revenues and expenses during the respective reporting periods. Examples include revenue recognition and the impact of the variable consideration of diagnostic test reimbursement rates, the provision for uncollectible receivables and billing errors, allowances, slow moving and/or dated inventory and associated provisions, the potential impairment of long-lived assets, stock based compensation valuations, income tax asset valuations and assumptions related to accrued advertising.

Our estimates and assumptions are based on historical experience, current trends and other factors that management believes to be relevant at the time the condensed consolidated financial statements are prepared. Management reviews the accounting policies, assumptions, estimates and judgments on a quarterly basis. Actual results could differ from those estimates.

Fair Value of Financial Instruments

We measure assets and liabilities at fair value based on expected exit price as defined by the authoritative guidance on fair value measurements, which represents the amount that would be received on the sale date of an asset or paid to transfer a liability, as the case may be, in an orderly transaction between market participants. As such, fair value may be based on assumptions that market participants would use in pricing an asset or liability. The authoritative guidance on fair value measurements establishes a consistent framework for measuring fair value on either a recurring or nonrecurring basis whereby inputs, used in valuation techniques, are assigned a hierarchical level.

The following are the hierarchical levels of inputs to measure fair value:

- Level 1: Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2: Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the assets or liabilities; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3: Unobservable inputs reflecting the Company's assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

The carrying amounts of our financial assets and liabilities, such as cash, accounts receivable, accounts payable, and unsecured note payable, approximate their fair values because of the short-term nature of these instruments.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at September 30, 2023 and December 31, 2022.

Corporate bonds: Valued using pricing model maximizing the use of observable inputs for similar securities. This includes basing value on yields currently available on comparable securities of issuers with similar credit ratings.

U.S. government securities: Valued using pricing models maximizing the use of observable inputs for similar securities.

We account for our marketable securities at fair value, with the net unrealized gains or losses of marketable debt securities reported as a component of accumulated other comprehensive income or loss and marketable equity securities change in fair value reported on the condensed consolidated statements of operation and comprehensive income (loss). The components of marketable securities are as follows (in thousands):

	As of September 30, 2023			
	Level 1	Level 2	Level 3	Total
Corporate obligations	\$ —	\$ 2,565	\$ —	\$ 2,565
	\$ —	\$ 2,565	\$ —	\$ 2,565
	As of December 31, 2022			
	Level 1	Level 2	Level 3	Total
U.S. government obligations	\$ —	\$ 1,478	\$ —	\$ 1,478
Corporate obligations	5,496	1,354	—	6,850
	\$ 5,496	\$ 2,832	\$ —	\$ 8,328

There were no transfers of marketable debt securities between Levels 1, 2 or 3 for the three and nine months ended September 30, 2023 and 2022.

Goodwill

Goodwill represents the excess of the fair value of the consideration transferred over the fair value of the underlying identifiable assets and liabilities acquired in a business combination. Goodwill and intangible assets deemed to have an indefinite life are not amortized, but instead are assessed for impairment annually. Additionally, if an event or change in circumstances occurs that would more likely than not reduce the fair value of the reporting unit below its carrying value, we would evaluate goodwill at that time.

During the three and nine months ended September 30, 2023, the Company received \$0.5 million in connection with terms from an escrow agreement from the purchase of Nebula. The receipt of this escrow payment reduced the excess consideration paid for Nebula and was recorded as a reduction of the Goodwill at the time of receipt.

Revenue Recognition

The Company recognizes revenues in accordance with FASB Accounting Standards Codification ("ASC") 606, Revenues from Contracts with Customers. The Company recognizes revenue that represents the transfer of promised goods or services to customers at an amount that reflects the consideration that is expected to be received in exchange for those goods or services. The Company recognizes revenue when performance obligations with our customers have been satisfied. At contract inception, we evaluate the contract to determine if revenue should be recognized using the following five steps: (1) identify the contract with the customer; (2) identify the performance obligations; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations; and (5) recognize revenue when (or as) the entity satisfies a performance obligation.

Income Taxes

The Company recognizes deferred tax liabilities and assets based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities, using enacted tax rates in effect in the years the differences are expected to reverse.

The provision for, or benefit from, income taxes includes deferred taxes resulting from the temporary differences in income for financial and tax purposes using the liability method. Future realization of deferred income tax assets requires sufficient taxable income within the carryback, carryforward period available under tax law. We evaluate, on a quarterly basis whether, based on all available evidence, it is probable that the deferred income tax assets are realizable. Valuation allowances are established when it is more likely than not that the tax benefit of the deferred tax asset will not be realized. The evaluation, as prescribed by ASC 740-10, "Income Taxes," includes the consideration of all available evidence, both positive and negative, regarding historical operating results including recent years with reported losses, the estimated timing of future reversals of existing taxable temporary differences, estimated future taxable income exclusive of reversing temporary differences and carryforwards, and potential tax planning strategies which may be employed to prevent an operating loss or tax credit carryforward from expiring unused.

The Company accounts for uncertainties in income taxes under the provisions of FASB ASC 740-10-05 (the "Subtopic"). The Subtopic clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. The Subtopic prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Subtopic provides guidance on the de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Recently Issued Accounting Standards, Adopted

On January 1, 2023, the Company adopted Accounting Standards Update ("ASU") 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13") ASU 2016-13 requires an impairment model (known as the current expected credit loss ("CECL") model) that is based on expected losses rather than incurred losses. Under the new guidance, each reporting entity should estimate an allowance for expected credit losses, which is intended to result in more timely recognition of losses. This model replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost, accounts receivable and available for sale debt securities and applies to some off-balance sheet credit exposures. In February 2020, the FASB issued ASU 2020-02, Financial Instruments - Credit Losses (Topic 326), which amends the effective date of the original pronouncement for smaller reporting companies. ASU 2016-13 and its amendments will be effective for the Company for interim and annual periods in fiscal years beginning after December 15, 2022. The adoption of ASU 2016-13 did not have a material impact on the Company's consolidated financial statements.

In August 2023, the FASB issued ASU 2023-05, "Business Combinations - Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement." The new guidance applies to the formation of a joint venture and requires a joint venture to initially measure all contributions received upon its formation at fair value. The guidance is intended to reduce diversity in practice and is applicable to joint venture entities with a formation date on or after January 1, 2025 on a prospective basis. The Company currently does not have any transactions that fall under the scope of ASU 2023-05; therefore, the adoption of ASU 2023-05 is not expected to have an impact on the Company's consolidated financial statements.

Note 3 - Asset Acquisition

Stella Diagnostics - Asset Purchase Agreement

On December 15, 2022, the Company entered into an Asset Purchase Agreement (the "Stella Purchase Agreement"), with Stella Diagnostics Inc. ("Stella") and Stella DX, LLC ("Stella DX" and, together with Stella, the "Stella Sellers"), pursuant to which, on January 3, 2023, the Company purchased all of the assets, rights and interests of the Stella Sellers and their affiliates pertaining to the Stella Sellers' BE-Smart Esophageal Pre-Cancer Diagnostic Screening Test and certain clinical assets, including all intellectual property rights (the "Stella Purchased Assets").

As consideration for the Stella Purchased Assets, at closing, the Company (i) paid to the Stella Sellers \$5.5 million in cash, minus (a) the Secured Note Amount of \$0.5 million, (b) the Liability Payoff Amount of \$1.6 million and (c) the

Promissory Note Payoff Amount of \$0.4 million, and (ii) issued to Stella DX 100,000 shares of common stock, par value \$0.0005 per share, of the Company at a value of \$10.00 per share. Total consideration paid was \$4.6 million. The Secured Note Amount of \$0.5 million and the Promissory Note Payoff of \$0.4 million were paid in 2022. The balance of the consideration was paid at closing during the nine months ended September 30, 2023.

In addition to the consideration paid at closing, the Company will issue shares of common stock valued at \$2.0 million (the "Milestone Stock") to the Stella Sellers upon a Commercialization Event (as defined in the Stella Purchase Agreement). The Milestone Stock was recorded at closing as a non-current liability at its fair value of \$2.0 million and will be marked to market until settlement through other income or expense in the consolidated statements of operations. Also, the Company is required to pay to the Stella Sellers for each of the seven calendar years during the seven year period commencing on the first day of the calendar year following the date of the Commercialization Event, a non-refundable, non-creditable royalty of 5% of the Adjusted Gross Margin (as defined in the Stella Purchase Agreement) for such Annual Period.

The asset purchase does not qualify as a business combination under FASB ASC 805, *Business Combinations*, and has therefore been accounted for as an asset acquisition. In connection with the Stella Purchased Assets, the Company incurred \$0.2 million in transaction costs, which were capitalized into the purchase price of the Stella Purchased Assets. The total purchase price for the Stella Purchased Assets was \$ 6.8 million, which was allocated to the proprietary technology intangible asset acquired. The Company is amortizing the acquired intangible asset on a straight-line basis over its estimated useful life of five years.

Note 4 - Intangible Assets, Net

During the nine months ended September 30, 2023, the Company acquired intangible assets of \$6.8 million included with proprietary intellectual property, in connection with the acquisition of the Stella Purchased Assets. See Note 3.

Intangible assets as of September 30, 2023 and December 31, 2022 consisted of the following (in thousands):

	September 30, 2023	December 31, 2022	Estimated Useful Life (in years)
Trade names	\$ 5,550	\$ 5,550	15
Proprietary intellectual property	11,064	4,260	5
Customer relationships	1,180	1,180	1
CLIA license	1,307	1,307	3
	<u>19,101</u>	<u>12,297</u>	
Less: accumulated amortization	(6,086)	(3,822)	
Total intangible assets, net	<u>\$ 13,015</u>	<u>\$ 8,475</u>	

Amortization expense for acquired intangible assets was \$0.8 million and \$0.5 million during the three months ended September 30, 2023 and 2022, respectively. Amortization expense for acquired intangible assets was \$2.3 million and \$2.0 million during the nine months ended September 30, 2023 and 2022, respectively. The estimated future amortization expense of acquired intangible assets as of September 30, 2023 is as follows (in thousands):

Remaining periods in the year ended December 31, 2023	\$ 682
Year ended December 31, 2024	2,583
Year ended December 31, 2025	2,583
Year ended December 31, 2026	2,251
Year ended December 31, 2027	1,731
Thereafter	3,185
	<u>\$ 13,015</u>

Note 5 -Unsecured Promissory Notes Payable

2023 Unsecured Promissory Note Payable

On January 26, 2023, the Company issued an unsecured promissory note (the “2023 Note”) and guaranty for an aggregate principal amount of \$6 million. The 2023 Note is due and payable on January 27, 2026, the third anniversary of the date on which the 2023 Note was funded (the “Closing Date”), and accrues interest at a rate of 10% per year from the Closing Date, payable on a quarterly basis, until the 2023 Note is repaid in full. The Company has the right to prepay the 2023 Note at any time after the Closing Date and prior to the maturity date without premium or penalty upon providing seven days’ written notice to the note holder. Repayment of the 2023 Note has been guaranteed by the Company’s wholly-owned subsidiary, Pharmedoz Manufacturing, Inc. In addition to the 2023 Note, the Company issued warrants to purchase 76,000 shares of the Company’s common stock at an exercise price of \$9.00 for a term of 5 year, vesting immediately. The warrants were valued at \$400,000 fair value, using the Black-Scholes option pricing model to calculate the grant date fair value of the warrants, with the following assumptions: no dividend yield, expected volatility of 81.5%, risk free interest rate of 3.62% and expected warrant life of 5 years. The relative fair value of the warrant was \$380,000 and was recorded as a discount to the note payable in accordance with FASB ASC 835-30-25, *Recognition*, and is being accreted over the term of the note payable for financial statement purposes. As of September 30, 2023, the unpaid principal balance of the 2023 Note was \$7.2 million, net of debt discount of \$0.3 million.

2020 Unsecured Convertible Notes Payable

On September 15, 2020, the Company issued two unsecured, partially convertible, promissory notes (the “September 2020 Notes”) for an aggregate principal amount of \$10 million to two investors (collectively, the “Lenders”).

On February 28, 2022, the Company entered into a letter agreement (the “Letter Agreement”) with one of the Lenders providing for the payoff of its September 2020 Note in the principal amount of \$2,000,000.

Pursuant to the terms of the Letter Agreement, (i) the Lender converted \$600,000 of the principal amount due to him under his September 2020 Note into 200,000 shares of Company common stock (the “Conversion Shares”) at a price of \$3.00 per share as provided for under the terms of the September 2020 Note (the “Conversion”), (ii) the Company paid to the Lender \$1,441,000 in cash, representing \$1,400,000 of the remaining principal under the September 2020 Note following the Conversion plus \$41,000 in accrued and outstanding interest under the September 2020 Note, and (iii) the Company repurchased the Conversion Shares at a price of \$5.75 per share for an aggregate amount of \$1,150,000 (for a total aggregate payment to the Lender of \$2,591,000).

On September 10, 2023, the Lender converted the remaining \$2.4 million principal into 800,000 shares of the Company’s common stock. At September 30, 2023, the September 2020 Note was settled in full.

For the three months ended September 30, 2023 and 2022, interest expense, including accretion of debt discount was \$0.3 million and \$0.2 million, respectively. For the nine months ended September 30, 2023 and 2022, interest expense, including accretion of debt discount was \$0.8 million and \$0.6 million, respectively.

Note 6 - Stockholders’ Equity

Our authorized capital stock consists of 50 million shares of common stock, \$0.0005 par value, and one million shares of preferred stock, \$0.0005 par value.

Preferred Stock

The preferred stock authorized under our certificate of incorporation may be issued from time to time in one or more series. As of September 30, 2023 and December 31, 2022, no shares of preferred stock have been issued.

Common Stock Dividends

No dividends have been declared during the nine months ended September 30, 2023.

On February 14, 2022, the board of directors of the Company declared a special cash dividend of \$0.30 per share on the Company's common stock, paid on March 10, 2022, in the amount of \$4.6 million to holders of record of the Company's common stock on March 1, 2022.

On May 9, 2022, the board of directors of the Company declared a special cash dividend of \$0.30 per share on the Company's common stock, paid on June 4, 2022, in the amount of \$4.7 million to holders of record of the Company's common stock as of May 25, 2022.

Common Stock

Stock Repurchase Program

On March 15, 2023, the Company announced that its board of directors had approved a new stock repurchase program. Under the stock repurchase program, the Company is authorized to repurchase up to \$6.0 million of its outstanding shares of common stock from time to time, over a nine-month period. The number of shares to be repurchased and the timing of the repurchases, if any, will depend on a number of factors, including, but not limited to, price, trading volume and general market conditions, along with the Company's working capital requirements and general business conditions. The board of directors will re-evaluate the program from time to time and may authorize adjustments to its terms.

Following the Commencement Date (as defined in the stock repurchase agreement), and for a period of nine months thereafter, repurchases may be made through open market transactions (based on prevailing market prices), privately negotiated transactions, block trades, or any combination thereof, in accordance with applicable federal securities laws, including Rule 10b-18 of the Securities Exchange Act of 1934, as amended.

There were 69,628 shares repurchased under this new program during the nine months ended September 30, 2023.

On September 8, 2021, the board of directors (the "Board") approved a stock repurchase program under which the Company was authorized to repurchase up to \$0.0 million of its outstanding shares of common stock from time to time, over a nine-month period. This stock repurchase program expired on March 30, 2022. During the nine months ended September 30, 2022, the Company did not make any common shares repurchase under this stock repurchase program.

The 2022 Directors' Equity Compensation Plan

On May 19, 2022, the stockholders of the Company approved the 2022 Directors' Equity Compensation Plan (the "2022 Directors' Plan") at the 2022 Annual Meeting of Stockholders of the Company (the "2022 Annual Meeting"). The 2022 Directors' Plan amended and restated the Company's Amended and Restated 2010 Directors' Equity Compensation Plan and provided for an increase in the number of shares reserved for issuance under the plan by 300,000 shares and for the adjustment of the per share exercise price of stock options granted under the 2022 Plan in the event of any change in the outstanding shares of common stock of the Company as a result of, among other things, any distribution or special dividend to stockholders of shares, cash or other property (other than regular cash dividends).

On June 16, 2023, the stockholders of the Company approved the Amended and Restated 2022 Directors' Equity Compensation Plan (the "Amended 2022 Directors' Plan") at the 2023 Annual Meeting of Stockholders of the Company. The Amended 2022 Directors' Plan provides for an increase in the number of shares reserved for issuance under such plan by 150,000 shares.

As of September 30, 2023, there were 210,000 shares of common stock available to be issued under the 2022 Directors' Plan. There were 20,000 options issued under this plan during the nine months ended September 30, 2023.

The 2010 Directors' Equity Compensation Plan

On May 20, 2021, the stockholders of the Company approved the Amended and Restated 2010 Directors' Equity Compensation Plan (the "Amended 2010 Directors' Plan") at the 2021 Annual Meeting of Stockholders of the Company (the "2021 Annual Meeting"). The Amended 2010 Directors' Plan authorized the issuance of up to 775,000 shares of

common stock. This plan was amended and restated on April 11, 2022 (to become the 2022 Directors' Plan), subject to stockholder approval, which was obtained at the 2022 Annual Meeting.

The 2022 Equity Compensation Plan

On May 19, 2022, the stockholders of the Company approved the 2022 Equity Compensation Plan (the "2022 Plan") at the 2022 Annual Meeting. The 2022 Plan amended and restated the Company's Amended and Restated 2010 Equity Compensation Plan and provided for an increase in the number of shares reserved for issuance under the plan by 1,000,000 shares and for the adjustment of the per share exercise price of stock options granted under the 2022 Plan in the event of any change in the outstanding shares of common stock of the Company as a result of, among other things, any distribution or special dividend to stockholders of shares, cash or other property (other than regular cash dividends).

On June 16, 2023, the stockholders of the Company approved the Amended and Restated 2022 Equity Compensation Plan (the "Amended 2022 Plan") at the 2023 Annual Meeting of Stockholders of the Company. The Amended 2022 Plan provides for an increase in the number of shares reserved for issuance under such plan by 700,000 shares.

As of September 30, 2023, there were 862,035 shares of common stock available to be issued under the 2022 Plan. During the nine months ended September 30, 2023, there were 1,005,000 shares subject to stock options issued under the 2022 Plan.

The 2010 Equity Compensation Plan

On May 20, 2021, the stockholders of the Company approved the Amended and Restated 2010 Equity Compensation Plan (the "Amended 2010 Plan") at the 2021 Annual Meeting. The Amended 2010 Plan authorized the issuance of up to 4,900,000 shares of common stock. This plan was amended and restated on April 11, 2022 (to become the 2022 Plan), subject to stockholder approval, which was obtained at the 2022 Annual Meeting.

The 2018 Stock Incentive Plan

On April 12, 2018, the Company's stockholders approved the 2018 Stock Incentive Plan (the "2018 Stock Plan"). The 2018 Stock Plan provides for the grant of incentive stock options to eligible employees of the Company, and for the grant of non-statutory stock options to eligible employees, directors and consultants. The 2018 Stock Plan provides that the total number of shares that may be issued pursuant to the 2018 Stock Plan is 2,300,000 shares. At April 12, 2018, all 2,300,000 shares had been granted in the form of stock options to Ted Karkus (the "CEO Option"), our Chief Executive Officer.

The 2018 Stock Plan required certain proportionate adjustments to be made to the stock options granted under the 2018 Stock Plan upon the occurrence of certain events, including a special distribution (whether in the form of cash, shares, other securities, or other property) in order to maintain parity. Accordingly, the Compensation Committee of the board of directors, as required by the terms of the 2018 Stock Plan, adjusted the exercise price of the CEO Option in connection with each special cash dividend paid by the Company proportionately to the amount of the dividend paid. The final exercise price of the CEO Option was \$0.60 per share after the latest special cash dividend paid on June 3, 2022.

During the nine months ended September 30, 2023 and 2022, 1,100,000 and 0 stock options were exercised under the 2018 Stock Plan. No share based compensation expense will be recognized in forward periods related to the 2018 Stock Plan.

Inducement Option Awards

There were no issuances of inducements awards during the nine months ended September 30, 2023.

During the nine months ended September 30, 2022, the Company issued an inducement award to a prospective employee to purchase up to 250,000 shares of the Company's common stock at an exercise price of \$13.00, the closing price of the common stock on the date of grant. The award vested 125,000 shares on the date of grant and the remaining portion will vest 25% per year for the next two years. The award expires on the seventh anniversary of the grant date.

All inducement awards have been granted outside of the Company's equity compensation plans.

Summary of all option grants

During the nine months ended September 30, 2023, the Company granted options to purchase 1,125,000 shares of the Company's common stock to various employees and consultants. The options grant date fair value was valued at \$4.1 million, using the Black-Scholes option pricing model to calculate the grant-date fair value of the options with the following assumptions: no dividend yield, expected volatility of 80.0%, risk free interest rate of 3.7% and expected life of 4.7 years. The fair value of stock options for employees are expensed over the vesting term in accordance with the terms of the related stock option agreements and are expensed over the terms of the consulting agreement for consultants.

The following table summarizes stock option activity during the nine months ended September 30, 2023 (in thousands, except per share data).

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Total Intrinsic Value
Outstanding as of January 1, 2023	3,952	\$ 5.25	3.8	\$ 19,103
Granted	1,125	8.65	6.9	—
Cashless exercised	(1,348)	0.98	—	—
Forfeited	(440)	11.10	—	—
Outstanding as of September 30, 2023	<u>3,289</u>	<u>\$ 7.39</u>	<u>5.1</u>	<u>\$ 636</u>
Options vested and exercisable	<u>1,892</u>	<u>\$ 6.70</u>	<u>4.4</u>	<u>\$ 636</u>

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the closing stock price of \$4.37 for the Company's common stock on September 30, 2023.

During the nine months ended September 30, 2023 certain holders of stock options elected to exercise their stock options pursuant to a cashless exercise provision resulting in the net issuance of 603,881 shares of common stock and the return of 744,369 shares to the Company. The Company also made a cash payment of approximately \$5.4 million to repurchase 603,881 shares of treasury stock to satisfy tax withholding obligations related to the cashless exercise of these stock options.

On April 4, 2023, the Company granted, in the aggregate, 550,000 stock options to its CEO and CFO under the 2022 Plan with an exercise price of \$9.00. The options vest over a five-year period in equal annual installments. The estimated fair value of these options at the date of grant was \$2.7 million, which will be expensed over the vesting term.

On April 7, 2023, the Company granted 250,000 stock options to an employee under the 2022 Plan with an exercise price of \$10.00. The options vest 25% on the date of grant with the remaining 75% vesting over a 3-year period in equal annual installments. The incremental fair value resulting from this modification was \$9,000, which will be expensed over the new vesting term.

Stock Warrants

On January 12, 2023, the Company issued warrants to an advisory firm to purchase 50,000 shares of the Company's common stock at an exercise price of \$10.00 for a term of 5 years, vesting immediately. The warrants were valued at 0.3 million fair value, using the Black-Scholes option pricing model to calculate the grant date fair value of the warrants, with the following assumptions: no dividend yield, expected volatility of 80.9%, risk free interest rate of 3.53%

and expected warrant life of 5 years. These warrants will be expensed over the 1 year term of the engagement which ends on December 31, 2023.

On January 27, 2023, the Company issued five-year warrants to purchase 76,000 shares of the Company's common stock with the unsecured promissory note (see Note 5).

On April 6, 2023, the Company issued 250,000 five year warrants to a consultant that vested at the time of grant and an exercise price of \$9.00. The estimated fair value of these options at the date of grant were \$1.4 million, using the Black-Scholes option pricing model to calculate the grant date fair value of the warrants, with the following assumptions: no dividend yield, expected volatility of 80.4%, risk free interest rate of 3.59% and expected warrant life of 5 years. which was initially recognized as a prepaid expense and to be expensed over the term of the consulting agreement. As of September 30, 2023, \$1.1 million was remained in the prepaid expense and other current assets on the condensed consolidated balance sheet.

Between August and September 2023, the Company received \$1.2 million from the exercise of outstanding warrants with an exercise price at \$3.00 per share. The Company issued approximately 400,000 shares of common stock upon these warrant exercises.

The following table summarizes warrant activity during the nine months ended September 30, 2023 (in thousands, except per share data):

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)
Outstanding as of January 1, 2023	855	\$ 8.23	1.9
Granted	376	9.13	4.4
Exercised	\$ (400)	3.00	—
Outstanding as of September 30, 2023	\$ 831	\$ 11.16	2.2
Warrants vested and exercisable	\$ 831	\$ 11.16	2.2

The Company recognized \$0.7 million and \$2.0 million of share-based compensation expense during the three months ended September 30, 2023 and 2022, respectively. The Company recognized \$2.9 million and \$3.0 million of share-based compensation expense during the nine months ended September 30, 2023 and 2022, respectively. The Company will recognize an aggregate of approximately \$6.6 million of remaining share-based compensation expense related to outstanding stock options and warrants over a weighted average period of 4.5 years.

Note 7 – Income Taxes

We recognize tax assets and liabilities for future tax consequences related to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for net operating loss carryforwards. Management evaluated the deferred tax assets for recoverability using a consistent approach that considers the relative impact of negative and positive evidence, including historical profitability and projections of future reversals of temporary differences and future taxable income. We are required to establish a valuation allowance for deferred tax assets if management determines, based on available evidence at the time the determination is made, that it is not more likely than not that some portion or all of the deferred tax assets will be realized. As of September 30, 2023 the Company has net deferred tax liabilities for federal and combined states jurisdictions compared to net deferred tax assets with a full valuation allowance as of December 31, 2022. The decrease in deferred tax assets with a corresponding decrease in valuation allowance against those assets as of September 30, 2023 is primarily due to utilization of net operating losses. The Company has net deferred tax assets in other states jurisdictions where we maintain a full valuation allowance. Judgment is required to estimate forecasted future taxable income, which may be impacted by future business developments, actual results, tax initiatives, legislative, and other economic factors. The Company will continue to monitor income levels and potential changes to its operating and tax model, and other legislative or global developments in its determination.

The Company's effective tax rate for the nine months ended September 30, 2023 is 27.88% and it is primarily driven by federal tax at 21%, state taxes at 2.11%, offset by permanent differences, the R&D credit and state deferred tax benefits.

Note 8 – Commitments and Contingencies

Manufacturing Agreement

The Company and its wholly owned subsidiary, PMI, entered into a manufacturing agreement (the "Manufacturing Agreement") with Mylan Consumer Healthcare Inc. (formerly known as Meda Consumer Healthcare Inc.) ("MCH") and Mylan Inc. (together with MCH, "Mylan" in connection with the asset purchase agreement we entered into with Mylan in 2017. Pursuant to the terms of the Manufacturing Agreement, Mylan (or an affiliate or designee) purchased the inventory of the Company's Cold-EEZE® brand and product line, and PMI agreed to manufacture certain products for Mylan, as described in the Manufacturing Agreement, at prices that reflect current market conditions for such products and include an agreed upon mark-up on our costs. On May 1, 2021, the Manufacturing Agreement was assigned by Mylan to Nurya Brands, Inc. ("Nurya") in connection with Nurya's acquisitions of certain assets from Mylan, including the Cold-EEZE® brand and product line. Unless terminated sooner by the parties, the Manufacturing Agreement was to remain in effect until March 29, 2023. Thereafter, the Manufacturing Agreement could be renewed by Nurya for up to four successive one-year periods by providing notice of its intent to renew not less than 90 days prior to the expiration of the then-current term.

On November 15, 2022, the Company was notified by Nurya of its election to renew the Manufacturing agreement for one year. As a result, the Manufacturing Agreement will remain in effect until March 29, 2024.

License Agreements

Linebacker LB1 and LB2

On July 19, 2022, the Company through its wholly-owned subsidiary ProPhase BioPharma entered into a License Agreement (the "License Agreement") with Global BioLife, Inc. (the "Licensor"), with an effective date of July 18, 2022 (the "Linebacker Effective Date"), pursuant to which it acquired from Licensor a worldwide exclusive right and license under certain patents identified in the License Agreement (the "Licensed Patents") and know-how (collectively, the "Licensed IP") to exploit any compound covered by the Licensed Patents (the "Licensed Compound"), including Linebacker LB1 and LB2, and any product comprising or containing a Licensed Compound ("Licensed Products") in the treatment of cancer, inflammatory diseases or symptoms, memory-related syndromes, diseases or symptoms including dementia and Alzheimer's Disease (the "Field"). Under the terms of the License Agreement, the Licensor reserves the right, solely for itself and for GRDG Sciences, LLC ("GRDG") to use the Licensed Compound and Licensed IP solely for research purposes inside the Field and for any purpose outside the Field.

Under the terms of License Agreement, the Company is required to pay to Licensor a one-time upfront license fee of \$0,000 within 10 days of the Linebacker Effective Date and must pay an additional \$900,000 following the achievement of a first Phase 3 study which may be required by FDA for the first Licensed Product and an additional \$1 million upon the receipt of regulatory approval of a New Drug Application (NDA) for the first Licensed Product.

During the term of the License Agreement, the Company is also required to pay to Licensor 3% royalties on Net Revenue (as defined in the License Agreement) of each Licensed Product, but no less than the minimum royalty of \$250,000 of Net Revenue per year minus any royalty payments for any required third party licenses.

Equivir

In March 2023, we commenced patient enrollment in a randomized, placebo-controlled clinical trial of Equivir to evaluate its effect on upper respiratory tract infections. Vedic Lifesciences, a leading clinical research organization, is contracted to conduct the combination prophylactic and therapeutic study, which will be conducted at 12 sites. We currently anticipate trial completion in the third quarter of 2023 and anticipate launching Equivir (dietary supplement) in the United States toward the end of 2023.

BE-Smart Esophageal Pre-Cancer Diagnostics Screening Test

In March 2023, and in connection with the Asset acquisition of Stella,, we announced a collaboration for the continued development of its BE-Smart Esophageal Pre-Cancer diagnostic screening test. We are pursuing initial commercialization of the BE-Smart test as an LDT (Laboratory Developed Test) and RUO (Research Use Only) for the third quarter of 2023 with full commercialization backed by insurance expected by mid-2024.

In connection with the License Agreements, for the three and nine months ended September 30, 2023, the Company has incurred approximately \$0.4 million and \$1.1 million in general and administrative expenses that are included in the Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) for the three and nine months ended September 30, 2023. No clinical studies have begun under this agreement.

Litigation

In the normal course of our business, we may be named as a defendant in legal proceedings. It is our policy to vigorously defend litigation or to enter into a reasonable settlement where management deems it appropriate.

Note 9 – Leases

Operating Leases

On October 23, 2020, we completed the acquisition of CPM, which included the acquisition of a 4,000 square foot CLIA accredited laboratory located in Old Bridge, New Jersey, which was owned by CPM (which is now known as ProPhase Diagnostics NJ, Inc.). The lease was renewed in February 2023, for an additional 36 months until February 2026. The monthly base rent remains the same at \$5,500 per month. The lease renewal resulted in the recognition of an additional right-of-use asset and operating lease liability of \$170,000, respectively during the nine months ended September 30, 2023.

New York Second Floor Lease

On December 8, 2020, the Company entered into a Lease Agreement (the “NY Second Floor Lease”) with BRG Office L.L.C. and Unit 2 Associates L.L.C. (the “Landlord”), pursuant to which the Company leases certain premises located on the second floor (the “Second Floor Leased Premises”) of 711 Stewart Avenue, Garden City, New York (the “Building”). The Second Floor Leased Premises serve as the Company’s second location and corporate headquarters, offering a wide range of laboratory testing services for diagnosis, screening and evaluation of diseases, including COVID-19 and Respiratory Pathogen Panel Molecular tests.

On June 10, 2022, we entered into a First Amendment to the NY Second Floor Lease (the “Second Floor Lease Amendment”). The Second Floor Lease Amendment amends the NY Second Floor Lease to provide that any uncured default by the Company or any of its affiliate under the NY First Floor Lease (defined below) will constitute a default by the Company under the NY Second Floor Lease.

New York First Floor Lease

On June 10, 2022, the Company entered into a second Lease Agreement (the “NY First Floor Lease”) with Landlord, pursuant to which the Company leases approximately 4,516 sq. feet located on the first floor (the “NY First Floor Leased Premises”) of the Building. As described above, the Company currently leases space on the second floor of the Building. The First Floor Leased Premises will be used to expand the Company’s in-house lab capabilities to include traditional clinical testing across multiple specialty areas and Next Generation Sequencing (NGS) to perform Whole Genome Sequencing (WGS) and an array of genetic diagnostic test offerings for both clinical and research purposes.

The NY First Floor Lease became effective as of June 10, 2022 and will commence upon the date of the Landlord’s substantial completion of certain improvements to the NY First Floor Leased Premises (the “First Floor Commencement Date”), as set forth in the NY First Floor Lease, targeted to be approximately five months from the execution of the NY First Floor Lease. The initial term of the NY First Floor Lease will expire on July 15, 2031, unless sooner terminated as provided in the NY First Floor Lease. During the nine months ended September 30, 2023, the Company recognized additional \$0.8 million right-of-use asset and operating lease liability for the NY First Floor Lease.

At September 30, 2023 and December 31, 2022, the Company had operating lease liabilities for the New York and New Jersey leases of approximately \$5.3 million and \$4.6 million, respectively, and right of use assets of approximately \$4.7 million and \$4.1 million, respectively, which were included in the condensed consolidated balance sheet.

Finance Leases

On April 19, 2023, the Company entered into a master lease agreement for a laboratory equipment (the "First Equipment Lease") with a vendor. The First Equipment Lease has a 5-year term and is recognized as a finance lease under ASC 842. The present value of the minimum future obligations of \$1.5 million was calculated based on an interest rate of 8.0%, which was recognized in finance lease liabilities in the condensed consolidated balance sheet.

On July 21, 2023, the Company entered into a master lease agreement for a laboratory equipment (the "Second Equipment Lease") with a vendor. The Second Equipment Lease has a 4-year term and is recognized as a finance lease under ASC 842. The present value of the minimum future obligations of \$5.1 million was calculated based on an interest rate of 7.4%, which was recognized in finance lease liabilities in the condensed consolidated balance sheet.

On September 26, 2023, the Company entered into a master lease agreement for a laboratory equipment (the "Third Equipment Lease") with a vendor. The Third Equipment Lease has a 3-year term starting on the commencement date. The commencement date is when the equipment is shipped and installed, then the Company will provide Final Acceptance Certificate to the vendor. As of September 30, 2023, the commencement date was not established, therefore, there was no fixed assets or finance lease liability recognized in the condensed consolidated balance sheet.

Depreciation and interest expense related to the Equipment Lease was \$440,000 and \$510,000 for the three and nine months ended September 30, 2023, respectively.

The following summarizes quantitative information about our operating and finance leases (amounts in thousands):

	For the three months ended		For the nine months ended	
	September 30, 2023	September 30, 2022	September 30, 2023	September 30, 2022
Operating leases:				
Operating lease cost	\$ 215	\$ 204	\$ 717	\$ 612
Total operating lease expense	\$ 215	\$ 204	\$ 717	\$ 612
Finance leases:				
Interest lease cost	\$ 122	\$ —	\$ 142	\$ —
Depreciation expense	318	—	368	—
Total finance lease expense	\$ 440	\$ —	\$ 510	\$ —

Other information related to the Company's leases is shown below (dollar amounts in thousands):

	For the nine months ended	
	September 30, 2023	September 30, 2022
Operating cash flows used in operating leases	\$ (606)	\$ (580)
	September 30, 2023	December 31, 2022
Weighted-average remaining lease term – operating leases (in years)	7.7	8.5
Weighted-average remaining lease term – finance leases (in years)	4.0	—
Weighted-average discount rate – operating leases	10 %	10 %
Weighted-average discount rate – finance leases	8 %	—
Finance lease asset (1)	\$ 6,201	—

(1) As of September 30, 2023, the Company had recorded accumulated depreciation of approximately \$368,000 for the finance lease asset. Finance lease assets are recorded within property and equipment, net on the Company's condensed consolidated balance sheets.

Minimum lease payments over the remaining lease periods as of September 30, 2023 are as follows (amounts in thousands):

	Operating Lease	Finance Lease	Total
Remaining periods in the year ended December 31, 2023	\$ 232	\$ 460	\$ 692
Year Ended December 31, 2024	953	1,840	2,793
Year Ended December 31, 2025	977	1,840	2,817
Year Ended December 31, 2026	941	1,840	2,781
Year Ended December 31, 2027	955	1,188	2,143
Thereafter	3,649	122	3,771
Total lease payments	7,707	7,290	14,997
Less present value discount	(2,415)	(1,014)	(3,429)
Total	\$ 5,292	\$ 6,276	\$ 11,568

Note 10 - Segment Information

The Company has identified two operating segments, diagnostic services and consumer products, based on the manner in which the Company's CEO as CODM assesses performance and allocates resources across the organization. The operating segments are organized in a manner that depicts the difference in revenue generating synergies that include the separate processes, profit generation and growth of each segment. The diagnostic services segment provides COVID-19 diagnostic information services to a broad range of customers in the United States, including health plans, third party payers and government organizations. The consumer products segment is engaged in the research, development, manufacture, distribution, marketing and sale of OTC consumer healthcare products and dietary supplements in the United States and also provides personal genomics products and services. The unallocated corporate expenses mainly included professional fees associated with the public company.

The following table is a summary of segment information for three and nine months ended September 30, 2023 and 2022 (amounts in thousands):

	For the three months ended		For the nine months ended	
	September 30, 2023	September 30, 2022	September 30, 2023	September 30, 2022
Net revenues				
Diagnostic services	\$ 2,491	\$ 20,541	\$ 24,849	\$ 91,613
Consumer products	5,874	3,659	16,036	9,211
Consolidated net revenue	8,365	24,200	40,885	100,824
Cost of revenue				
Diagnostic services	1,798	8,452	10,812	33,558
Consumer products	4,240	3,775	10,778	7,895
Consolidated cost of revenue	6,038	12,227	21,590	41,453
Depreciation and amortization expense				
Diagnostic services	1,916	584	3,059	1,755
Consumer products	655	435	1,266	1,637
Total Depreciation and amortization expense	2,571	1,019	4,325	3,392
Operating and other expenses				
	6,541	9,176	26,105	27,882
Income (loss) from operations, before income taxes				
Diagnostic services	(2,512)	6,776	4,902	39,671
Consumer products	(1,384)	(3,214)	(874)	(5,390)
Unallocated corporate	(2,889)	(1,785)	(15,163)	(6,184)
Total (loss) income from operations, before income taxes	(6,785)	1,777	(11,135)	28,097
Income tax benefit (expense)	1,644	(809)	3,104	(7,190)
Total (loss) income from operations, after income taxes	(5,141)	968	(8,031)	20,907
Net (loss) income	\$ (5,141)	\$ 968	\$ (8,031)	\$ 20,907

The following table is a summary of segment information as of September 30, 2023 and December 31, 2022 (amounts in thousands):

	September 30, 2023	December 31, 2022
ASSETS		
Diagnostic services	\$ 46,496	\$ 50,832
Consumer products	41,423	22,080
Unallocated corporate	3,791	14,736
Total assets	<u>\$ 91,710</u>	<u>\$ 87,648</u>

Note 11 - Earnings Per Share

Basic earnings per share ("EPS") excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or otherwise result in the issuance of common stock that shared in the earnings of the entity. Diluted EPS also utilizes the treasury stock method which prescribes a theoretical buy back of shares from the theoretical proceeds of all options outstanding during the period, and the if-converted method for convertible debt.

The following is a reconciliation of the weighted average number of common shares outstanding used in calculating basic and diluted net loss per share (in thousands):

	For the three months ended		For the nine months ended	
	September 30, 2023	September 30, 2022	September 30, 2023	September 30, 2022
Net (loss) income - basic	\$ (5,141)	\$ 968	\$ (8,031)	\$ 20,907
Interest on unsecured convertible promissory note	—	201	—	635
Net (loss) income - diluted	\$ (5,141)	\$ 1,169	\$ (8,031)	\$ 21,542
Weighted average shares outstanding - basic	17,175	15,898	16,924	15,712
Diluted shares- Stock Options	—	2,453	—	1,925
Diluted shares- Stock Warrants	—	1,097	—	1,067
Unsecured convertible promissory note	—	800	—	800
Weighted average shares outstanding - diluted	17,175	20,248	16,924	19,504

The following table represents the number of securities excluded from the income per share computation as a result of their anti-dilutive effect (in thousands):

Anti-dilutive securities	For the three months ended		For the nine months ended	
	September 30, 2023	September 30, 2022	September 30, 2023	September 30, 2022
Common stock purchase warrants	831	455	831	455
Stock Options	3,289	370	3,289	610
Anti-dilutive securities	4,120	825	4,120	1,065

Note 12 - Subsequent Events

The Company has evaluated subsequent events through November 13, 2023, which is the date the consolidated financial statements were available to be issued. There were no subsequent events that required adjustment to or disclosure in the condensed consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis should be read in conjunction with our interim unaudited condensed consolidated financial statements and related notes included in this Quarterly Report on Form 10-Q ("Quarterly Report") and the audited financial statements and notes thereto as of and for the year ended December 31, 2022 and the related Management's Discussion and Analysis of Financial Condition and Results of Operations, both of which are contained in our Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on March 29, 2023 (the "2022 Annual Report"). As used in this Quarterly Report, unless the context suggests otherwise, "we," "us," "our," or "ProPhase" refer to ProPhase Labs, Inc. and its subsidiaries, unless the context otherwise requires.

Forward-Looking Statements

This Quarterly Report contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These forward-looking statements relate to future events or our future financial performance. Forward-looking statements typically are identified by use of terms such as "anticipate", "believe", "plan", "expect", "intend", "may", "will", "should", "estimate", "predict", "potential", "continue" and similar words although some forward-looking statements are expressed differently. This Quarterly Report may also contain forward-looking statements attributable to third parties relating to their estimates regarding the growth of our markets.

You are cautioned that forward-looking statements are not guarantees of performance and are subject to known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance, achievements or prospects to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements. Many of these factors are beyond our ability to predict.

Such risks and uncertainties include, but are not limited to:

- our ability to manage our growth successfully and to compete effectively;
- potential disruptions to our supply chain, increases in the price of testing supplies, equipment and raw materials need for our businesses, or the adulteration of key testing materials and raw materials needed for our businesses;
- potential product liability claims;
- our ability to secure additional capital, when needed to support our businesses;
- our dependence on key personnel and our ability to attract, retain and motivate our key employees;
- our ability to generate revenue and sufficient profits from Respiratory Pathogen Panel ("RPP") Molecular tests if and when demand for COVID-19 testing becomes no longer necessary;
- Our ability to collect payment for the tests we deliver and to comply with complex billing requirements;
- Our dependence on our largest diagnostic services customers;
- Our ability to successfully offer, perform and generate revenues from our personal genomics businesses;
- Potential disruptions in our ability to manufacture our products and those of others;
- Seasonal fluctuations in demand for the products and services we provide;
- Risks related to the initiation, cost, timing, progress and results of current and future research and development programs, preclinical studies and clinical trials and our ability to obtain and maintain regulatory approvals;
- Our ability to successfully develop and commercialize our existing products and any new products;

- Our ability to protect our proprietary rights;
- Our ability to comply with complex regulatory requirements applicable to our businesses;
- Our dependence on third parties to provide services critical to our businesses; and
- General economic conditions, including rising inflation and interest rates.

Given the risks and uncertainties surrounding forward-looking statements, you should not place undue reliance on these statements. You should also consider carefully the statements we make under other sections of this Quarterly Report and in our 2022 Annual Report, as well as in other documents we file from time to time with the SEC that address additional risks that could cause our actual results to differ from those set forth in any forward-looking statements. Our forward-looking statements speak only as the date of this Quarterly Report. We undertake no obligation to publicly update or review any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by law.

General

We are a diversified company that offers a range of services including genomics testing, diagnostic testing and contract manufacturing. We are also focused on licensing, developing and commercializing novel drugs, dietary supplements, compounds and diagnostics.

We conduct our operations through two operating segments: diagnostic services and consumer products.

Until late fiscal year 2020, we were engaged primarily in the research, development, manufacture, distribution, marketing and sale of OTC consumer healthcare products and dietary supplements in the United States. This includes the development and marketing of dietary supplements under the TK Supplements® brand. However, commencing in December 2020, we also began offering COVID-19 and were prepared to validate other RPP Molecular tests through our diagnostic service business. In August 2021 we began offering personal genomics products and services and in July 2022 we began focusing on the licensing, development and commercialization of novel drugs, dietary supplements, compounds and diagnostics.

Our wholly owned subsidiary, ProPhase Diagnostics, Inc. (“ProPhase Diagnostics”), which was formed on October 9, 2020, offers a broad array of clinical diagnostic and testing services at its Clinical Laboratory Improvement Amendments (“CLIA”) certified laboratories including polymerase chain reaction (“PCR”) testing for COVID-19. Critical to COVID-19 testing, we provide fast turnaround times for results. We also offer best-in-class rapid antigen testing for COVID-19. On October 23, 2020, we completed the acquisition of all of the issued and outstanding shares of capital stock of Confucius Plaza Medical Laboratory Corp. (“CPM”), which owned a 4,000 square foot CLIA accredited laboratory located in Old Bridge, New Jersey for approximately \$2.5 million. In December 2020, we expanded our diagnostic service business with the build-out of a second, larger CLIA accredited laboratory in Garden City, New York. Operations at this second facility commenced in January 2021.

On August 10, 2021, we acquired Nebula Genomics, Inc. (“Nebula”), a privately owned personal genomics company, through our new wholly owned subsidiary, ProPhase Precision Medicine Inc. (“ProPhase Precision”). ProPhase Precision focuses on genomics sequencing technologies, a comprehensive method for analyzing entire genomes, including the genes and chromosomes in DNA. The data obtained from genomic sequencing can be used to help identify inherited disorders and tendencies, help predict disease risk, help identify expected drug response, and characterize genetic mutations, including those that drive cancer progression.

Our wholly owned subsidiary, ProPhase BioPharma, Inc. (“PBIO”) was formed on June 28, 2022, for the licensing, development and commercialization of novel drugs, dietary supplements and compounds, beginning with Equivir and Equivir G. PBIO announced a second licensing agreement for two small molecule PIM kinase inhibitors, Linebacker LB-1 and LB-2, in July 2022, with plans to pursue development and commercialization of LB-1 as a cancer co-therapy.

In January 2023, we acquired exclusive rights to the BE-Smart Esophageal Pre-Cancer Diagnostic Screening Test and related intellectual property assets.

Our wholly owned subsidiary, Pharmed Manufacturing, Inc. (“PMI”), is a full-service contract manufacturer and private label developer of a broad range of non-GMO, organic and natural-based cough drops and lozenges and OTC drug and dietary supplement products.

Our diagnostic service business is and will continue to be impacted by the level of demand for COVID-19 and other diagnostic testing, how long this demand persists, the price we are able to receive for performing our testing services, our ability to collect payment or reimbursement for our testing services, as well as the availability of COVID-19 testing from other laboratories and the period of time for which we are able to serve as an authorized laboratory offering COVID-19 testing under various Emergency Use Authorizations.

Our personal genomics business is and will continue to be impacted by demand for our genetic sequencing products and services, our marketing and service capabilities, and our ability to comply with applicable regulatory requirements.

Our consumer sales are and will continue to be impacted by (i) the timing of acceptance of our TK Supplement® consumer products in the marketplace, and (ii) fluctuations in the timing of purchase and the ultimate level of demand for the OTC healthcare and cold remedy products that we manufacture, which is largely a function of the timing, length and severity of each cold season. Generally, a cold season is defined as the period from September to March when the incidence of the common cold rises as a result of the change in weather and other factors. We generally experience in the first, third and fourth quarter higher levels of net revenues from our contract manufacturing business. Revenues are generally at their lowest levels in the second quarter when customer demand generally declines.

In addition, we continue to actively pursue acquisition opportunities for other companies, technologies and products within and outside the consumer products industry.

Results of Operations

Three Months Ended September 30, 2023 as Compared to the Three Months Ended September 30, 2022

Net revenue for the three months ended September 30, 2023 was \$8.4 million as compared to \$24.2 million for the three months ended September 30, 2022. The decrease in net revenue was the result of a \$18.0 million decrease in net revenue from diagnostic services, partially offset by a \$2.2 million increase in consumer products. The decrease in net revenue for diagnostic services was due to decreased COVID-19 testing volumes compared to the 2022 period as a result of the Omicron variant, which emerged in early 2022. Overall diagnostic testing volume decreased from 113,000 tests in the three months ended September 30, 2022 to 13,000 tests in the three months ended September 30, 2023.

Cost of revenues for the three months ended September 30, 2023 was \$6.0 million, comprised of \$1.8 million for diagnostic services and \$4.2 million for consumer products. Cost of revenues for the three months ended September 30, 2022 were \$12.2 million, comprised of \$8.5 million for diagnostic services and \$3.8 million for consumer products. The decrease in cost of revenues for diagnostic services between the two comparable periods was due to the reduction in COVID-19 testing volumes.

We realized a gross profit of \$2.3 million for the three months ended September 30, 2023 as compared to \$12.0 million for the three months ended September 30, 2022. The decrease of \$9.6 million was comprised of a decrease of \$11.4 million in diagnostic services, partially offset by an increase of \$1.7 million in consumer products. For the three months ended September 30, 2023 and 2022 we realized an overall gross margin of 27.8% and 49.5%, respectively. Gross margin for diagnostic services was 27.8% and 58.9% in the three months ended September 30, 2023 and 2022, respectively. Gross margin for consumer products was 27.8% and (3.2)% in the three months ended September 30, 2023 and 2022, respectively. Gross margin for consumer products have historically been influenced by fluctuations in quarter-to-quarter production volume, fixed production costs and related overhead absorption, raw ingredient costs, inventory mark to market write-downs and timing of shipments to customers.

Diagnostic services costs for the three months ended September 30, 2023 were \$0.1 million compared to \$2.4 million for the three months ended September 30, 2022. The decrease of \$2.3 million was due to decreased COVID-19 testing volumes during the three months ended September 30, 2023 compared to the three months ended September 30, 2022 as a result of the Omicron variant, which emerged in early 2022.

General and administration expenses for the three months ended September 30, 2023 were \$8.2 million as compared to \$7.5 million for the three months ended September 30, 2022. The increase of \$0.7 million in general and administration expenses was principally related to an increase in personnel expenses, marketing and professional fees associated with the Company's strategic initiatives.

Research and development costs for the three months ended September 30, 2023 were \$0.4 million as compared to \$0.1 million for the three months ended September 30, 2022. The increase in research and development costs for the three months ended September 30, 2023 as compared to the three months ended September 30, 2022 was principally due to increased activities at ProPhase BioPharma. These activities include product research and field testing.

Interest and other income for the three months ended September 30, 2023 was \$1,000 as compared to \$25,000 for the comparable period in 2022. Interest expense for the three months ended September 30, 2023 was \$0.3 million compared to \$0.2 million for the three months ended September 30, 2022.

As a result of the effects described above, net loss for the three months ended September 30, 2023 was \$(5.1) million, or \$(0.30) per share, as compared to a net income of \$1.0 million, or \$0.06 per share, for the three months ended September 30, 2022. Diluted (loss) earnings per share for the three months ended September 30, 2023 and 2022 were \$(0.30) and \$0.06, respectively.

Nine Months Ended September 30, 2023 as Compared to the Nine Months Ended September 30, 2022

For the nine months ended September 30, 2023, net revenue was \$40.9 million as compared to \$100.8 million for the nine months ended September 30, 2022. The decrease in net revenue was the result of a \$66.8 million decrease in net revenue from diagnostic services, partially offset by a \$6.9 million increase in consumer products. The decrease in net revenue for diagnostic services was due to decreased COVID-19 testing volumes compared to the 2022 period as a result of the Omicron variant, which emerged in early 2022. Overall diagnostic testing volume decreased from 634,000 tests for the nine months ended September 30, 2022 to 259,000 tests in the nine months ended September 30, 2023, of which 54.9% were reimbursed by the HRSA uninsured program for the nine months ended September 30, 2022, and none were reimbursed from the HRSA uninsured program during the nine months ended September 30, 2023.

Cost of revenues for the nine months ended September 30, 2023 were \$21.6 million, comprised of \$10.8 million for diagnostic services and \$10.8 million for consumer products. Cost of revenues for the nine months ended September 30, 2022 were \$41.5 million, comprised of \$33.6 million for diagnostic services and \$7.9 million for consumer products. The decrease in cost of revenues for diagnostic services between the two comparable periods was due to the reduction in COVID-19 testing volumes.

We realized a gross profit of \$19.3 million for the nine months ended September 30, 2023 as compared to \$59.4 million for the nine months ended September 30, 2022. The decrease of \$40.1 million was comprised of a decrease of \$44.0 million in diagnostic services, partially offset by an increase of \$3.9 million in consumer products. For the nine months ended September 30, 2023 and 2022 we realized an overall gross margin of 47.2% and 58.9%, respectively. Gross margin for diagnostic services was 56.5% and 63.4% in the nine months ended September 30, 2023 and 2022, respectively. Gross margin for consumer products was 32.8% and 14.3% in the nine months ended September 30, 2023 and 2022, respectively. Gross margin for consumer products have historically been influenced by fluctuations in quarter-to-quarter production volume, fixed production costs and related overhead absorption, raw ingredient costs, inventory mark to market write-downs and timing of shipments to customers.

Diagnostic services costs for the nine months ended September 30, 2023 were \$1.9 million compared to \$8.9 million for the nine months ended September 30, 2022. The decrease of \$7.0 million was due to decreased COVID-19 testing volumes in during the nine months ended September 30, 2023 compared to the comparable period in 2022 as a result of the Omicron variant, which emerged in early 2022.

General and administration expenses for the nine months ended September 30, 2023 were \$26.5 million as compared to \$21.6 million for the nine months ended September 30, 2022. The increase of \$4.9 million in general and administration expenses was principally related to an increase in personnel expenses, marketing and professional fees associated with the Company's strategic initiatives.

Research and development costs for the nine months ended September 30, 2023 were \$1.1 million as compared to \$174,000 for the nine months ended September 30, 2022. The increase in research and development costs for the nine three

months ended September 30, 2023 as compared to the nine months ended September 30, 2022 was principally due to increased activities at ProPhase BioPharma. These activities include product research and field testing.

Interest and other income for the nine months ended September 30, 2023 was \$39,000 as compared to \$123,000 for the comparable period in 2022. The decrease in interest income for the nine months ended September 30, 2023 as compared to the nine months ended September 30, 2022 was principally due to the lower account balance of our investment account that bears interest.

Interest expense for the nine months ended September 30, 2023 was \$781,000 compared to \$635,000 for the nine months ended September 30, 2022. The increase in interest expense for the nine months ended September 30, 2023 as compared to the nine months ended September 30, 2022 was principally due to higher balance of our outstanding debt that bears interest.

As a result of the effects described above, net loss for the nine months ended September 30, 2023 was \$(8.0) million, or \$(0.47) per share, as compared to a net income of \$20.9 million, or \$1.33 per share, for the nine months ended September 30, 2022. Diluted (loss) earnings per share for the nine months ended September 30, 2023 and 2022 were \$(0.47) and \$1.10, respectively.

Non-GAAP Financial Measures and Reconciliation

In an effort to provide investors with additional information regarding our results of operations as determined by generally accepted accounting principles in the United States of America ("GAAP"), we disclose certain non-GAAP financial measures. The primary non-GAAP financial measures we disclose are EBITDA and Adjusted EBITDA.

We define EBITDA as net income (loss) before net interest expense, income taxes, depreciation and amortization. Adjusted EBITDA further adjusts EBITDA by excluding acquisition costs, other non-cash items, and other unusual or non-recurring charges (as described in the table below).

Non-GAAP financial measures should not be considered as a substitute for, or superior to, measures of financial performance prepared in accordance with GAAP. These non-GAAP financial measures do not reflect a comprehensive system of accounting, differ from GAAP measures with the same names and may differ from non-GAAP financial measures with the same or similar names that are used by other companies. We compute non-GAAP financial measures using the same consistent method from quarter to quarter and year to year. We may consider whether other significant items that arise in the future should be excluded from the non-GAAP financial measures.

We use EBITDA and Adjusted EBITDA internally to evaluate and manage the Company's operations because we believe they provide useful supplemental information regarding the Company's ongoing economic performance. We believe that these non-GAAP financial measures provide meaningful supplemental information regarding our operating results primarily because they exclude amounts that are not considered part of ongoing operating results when planning and forecasting and when assessing the performance of the organization. In addition, we believe that non-GAAP financial information is used by analysts and others in the investment community to analyze our historical results and in providing estimates of future performance and that failure to report these non-GAAP measures could result in confusion among analysts and others and create a misplaced perception that our results have underperformed or exceeded expectations.

The following table sets forth the reconciliations of EBITDA and Adjusted EBITDA excluding other costs to the most comparable GAAP financial measures (in thousands):

	For the three months ended		For the nine months ended	
	September 30, 2023	September 30, 2022	September 30, 2023	September 30, 2022
GAAP net (loss) income ⁽¹⁾	\$ (5,141)	\$ 968	\$ (8,031)	\$ 20,907
Interest, net	274	176	742	512
Income tax (benefit) expense	(1,644)	809	(3,104)	7,190
Depreciation and amortization	3,143	2,352	4,435	3,601
EBITDA	(3,368)	4,305	(5,958)	32,210
Share-based compensation expense	744	1,969	3,998	2,979
Non-cash rent expense ⁽²⁾	99	22	111	32
Bad debt expense	—	—	74	250
Adjusted EBITDA	\$ (2,525)	\$ 6,296	\$ (1,775)	\$ 35,471

⁽¹⁾ We believe that net income (loss) is the financial measure calculated and presented in accordance with GAAP that is most directly comparable to EBITDA and Adjusted EBITDA. EBITDA and Adjusted EBITDA measure the Company's operating performance without regard to certain expenses. EBITDA and Adjusted EBITDA are not presentations made in accordance with GAAP and the Company's computation of EBITDA and Adjusted EBITDA may vary from others in the industry. EBITDA and Adjusted EBITDA have important limitations as analytical tools and should not be considered in isolation or as substitutes for analysis of the Company's results as reported under GAAP.

⁽²⁾ The non-cash portion of rent, which reflects the extent to which our GAAP rent expense recognized exceeds (or is less than) our cash rent payments. For newer leases, our rent expense recognized typically exceeds our cash rent payments, while for more mature leases, rent expense recognized is typically less than our cash rent payments.

Liquidity and Capital Resources

Our aggregate cash, cash equivalents and marketable securities available for sale as of September 30, 2023 were \$3.3 million as compared to \$17.4 million at December 31, 2022. Our working capital was \$33.4 million and \$44.8 million as of September 30, 2023 and December 31, 2022, respectively. The decrease of \$14.2 million in our cash and cash equivalents for the nine months ended September 30, 2023 was principally due to (a) the proceeds from the sale of marketable debt securities of \$3.8 million, (b) the proceeds from the maturities of marketable debt securities of \$4.2 million, (c) the proceeds for issuance of notes payable of \$7.6 million, and (d) the proceeds from warrant exercise of \$1.2 million, offset by (i) \$11.1 million cash used in operating activities, (ii) the asset purchase of Stella of \$2.9 million, (iii) repurchase of common shares for payment of statutory taxes due on cashless exercise of options for \$5.4 million, (iv) repurchase of common shares for \$0.6 million, (v) purchase marketable debt securities of \$3.8 million, and (vi) capital expenditures of \$1.8 million.

To date the principal sources of capital to fund our operations have been from diagnostic services, genomics sequencing, product sales, net proceeds from the offering of equity securities, and issuances of promissory notes. Based on management's current business plans, the Company estimates it will have enough cash and liquidity to finance its operating requirements for at least 12 months from the date of filing these unaudited condensed consolidated financial statements. However, due to the nature of early-stage ventures and accounts receivables collections, there are inherent uncertainties associated with managements' business plan and cash flow projections, particularly if the Company is unable to grow its lines of business or collect on its accounts receivables in a timely manner or at all. If we were to experience a cash shortfall, we believe our access to existing and other financing sources and the established relationships with our investment banks will enable us to continue to meet our obligations and fund ongoing operations.

COVID-19

The COVID-19 pandemic has not had a material adverse impact on our business to date. We experienced higher than normal net revenue for the year ended December 31, 2021 and nine months ended September 30, 2022, primarily as a

result of revenue from our diagnostic services business, which offers COVID-19 testing. There can be no assurance that demand for our COVID-19 testing services will continue to exist in the future due to the widespread and effective vaccination of a majority of Americans against COVID-19 and successful containment efforts. If there is no demand for our COVID-19 testing services, and we are unable to generate sufficient profits from other RPP Molecular tests, our business could be materially adversely affected.

There are still numerous uncertainties associated with the COVID-19 pandemic, including the ability of vaccines and other protective measures to protect against new strains of the virus, people's willingness to receive a vaccine, possible resurgences of the coronavirus and/or new strains of the virus, the extent and duration of protective and preventative measures that may be adopted by local, state and/or the federal government in the future as a result of future outbreaks, including business closures, the ongoing impact of COVID-19 on the U.S. and world economy and consumer confidence, and various other uncertainties all of which could negatively impact our Company as a whole.

The COVID-19 pandemic has had a negative impact on the global capital markets and economies worldwide and could ultimately have a material adverse impact on our ability to raise capital needed to develop and commercialize products.

HRSA Funding

In March 2020, the Coronavirus Aid, Relief, and Economic Security Act was enacted, providing for reimbursement to healthcare providers for COVID-19 tests provided to uninsured individuals, subject to continued available funding. Approximately 54.9% of our diagnostic services revenue for the nine months ended September 30, 2022, was generated from this program for the uninsured. None of our diagnostic revenues for the nine months ended September 30, 2023 was generated from this program for the uninsured. On March 22, 2022, the HRSA uninsured program stopped accepting claims for COVID-19 testing and treatment due to lack of sufficient funds. Despite requests from the Acting Director of the Office of Management and Budget and the White House Coordinator for COVID-19 Response for additional emergency funding for the uninsured program, emergency funding has not been allocated to the HRSA uninsured program. We continue to perform testing for uninsured persons and are incurring the accompanying costs.

On January 30, 2023, the Administration announced that effective May 11, 2023, the federal Public Health Emergency would expire related to the COVID-19 pandemic. This expiration changes regulatory guidelines around COVID-19 testing including billing codes and reimbursement rates of in and out of network laboratories. While the Company is still assessing the impact this may have on our operations and financial performance, it could impact our ability to collect insurance reimbursements and could negatively impact revenues in future periods.

At-the-Market Facility

On December 28, 2021, we entered into a Sales Agreement (the "Sales Agreement") with ThinkEquity LLC (the "Sales Agent"), pursuant to which we may offer and sell, from time to time through the Sales Agent, shares of our common stock having an aggregate offering price of up to \$100,000,000, subject to the terms and conditions of the Sales Agreement. We are not obligated to make any sales of shares under the Sales Agreement.

We will pay the Sales Agent a fixed commission rate of 2.0% of the aggregate gross proceeds from the sale of any shares pursuant to the Sales Agreement and have agreed to provide the Sales Agent with customary indemnification and contribution rights. We also agreed to reimburse the actual out-of-pocket accountable expenses of the Sales Agent up to \$60,000 (of which a \$25,000 advance was paid on December 7, 2021).

Additionally, we will pay to H.C. Wainwright & Co. ("Wainwright"), a fee equal to 1.0% of the gross proceeds of the sales price of all the shares sold under the Sales Agreement, pursuant to a separate financial services agreement with Wainwright. Wainwright is not a sales agent under the Sales Agreement.

As of September 30, 2023, we have not sold any shares under the Sales Agreement.

Impact of Inflation

We are subject to normal inflationary trends and anticipate that any increased costs for our contract manufacturing and retail operations would be passed on to our customers; however, any increased costs related to diagnostic services would be absorbed by the Company. Inflation has not had a material effect on our business.

Critical Accounting Policies and Estimates

Our significant accounting policies are described in Note 2 of the Notes to Condensed Consolidated Financial Statements included under Item 8 of this Part II. However, certain accounting policies are deemed “critical”, as they require management’s highest degree of judgment, estimates and assumptions. These accounting policies, estimates and disclosures have been discussed with the Audit Committee of our Board of Directors. A discussion of our critical accounting policies and estimates, the judgments and uncertainties affecting their application and the likelihood that materially different amounts would be reported under different conditions or using different assumptions are as follows:

Use of Estimates

The preparation of condensed consolidated financial statements and the accompanying notes thereto, in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and reported amounts of revenues and expenses during the respective reporting periods. Examples include revenue recognition and the estimation of the variable consideration associated with the diagnostic reimbursement rates, the provision for bad debt and billing discrepancies, sales returns and allowances, inventory obsolescence, useful lives of property and equipment, impairment of goodwill, intangibles and property and equipment, income tax valuations and assumptions related to accrued advertising. The estimates and assumptions are based on historical experience, current trends and other factors that management believes to be relevant at the time the condensed consolidated financial statements are prepared. Management reviews the accounting policies, assumptions, estimates and judgments on a quarterly basis. Actual results could differ from those estimates.

Revenue Recognition and Accounts Receivables

We generate revenue principally through four types of revenue streams: diagnostic services, contract manufacturing, genomic products and services, and retail and other. The process for estimating revenues and the ultimate collection of receivables involves assumptions and judgments.

Revenue from our diagnostic services is recognized when the lab test is complete, and the diagnostic test result is provided to the customer. Revenue from our genomics services is recognized when the sequencing report is provided to the customer. Revenue from our consumer products is recognized when the shipments to contract manufacturing and retailer customers are recognized at the time ownership is transferred to the customer. We bill the providers at standard price and take into consideration for negotiated discounts and an anticipated reimbursement remittance adjustments based on the payer portfolio, when revenue is recorded. We use the most expected value method to estimate the transaction price for reimbursements that may vary from the standard price.

We carry our accounts receivable at cost less an allowance for doubtful accounts. Allowances for doubtful accounts are based upon our judgment regarding collectability. On a periodic basis, we evaluate our receivables and establish an allowance for doubtful accounts, based on a history of past write-offs, collections, current credit conditions or generally accepted future trends in the industry and/or local economy. Accounts are written off as uncollectible at the time we determine that collections are unlikely. The reserve is not intended to address return activity or disputed balances with ongoing customers, as this should be addressed in a reserve for credit memos with a corresponding charge to revenue.

Goodwill and Long-lived Assets

We review our goodwill at least annually for impairment as well as the carrying value of goodwill and our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be fully recoverable. When it is determined that the carrying amount of long-lived assets or goodwill is impaired, impairment is measured by comparing an asset’s estimated fair value to its carrying value. The determination of fair value is based on quoted market prices in active markets, if available, or independent appraisals; sales price negotiations; or projected future cash flows discounted at a rate determined by management to be commensurate with our business risk.

The estimation of fair value utilizing discounted forecasted cash flows includes significant judgments regarding assumptions of revenue, operating and marketing costs; selling and administrative expenses; interest rates; property and equipment additions and retirements; and industry competition, general economic and business conditions, among other factors.

Income Taxes

Accounting for income taxes requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities. These deferred taxes are measured by applying the provisions of tax laws in effect at the balance sheet date, including the impact of the Tax Cuts and Jobs Act ("TCJA") enacted on December 22, 2017. The TCJA made broad and significant changes to the U.S. tax code that affects the year ended December 31, 2017, including, but not limited to, a change in the federal rate from 35% to 21% effective January 1, 2018.

We recognize in income the effect of a change in tax rates on deferred tax assets and liabilities in the period that includes the TCJA enactment date. We utilize the asset and liability approach which requires the recognition of deferred tax assets and liabilities for the future tax consequences of events that have been recognized in our financial statements or tax returns. In estimating future tax consequences, we generally consider all expected future events other than enactments of changes in the tax law or rates. Until sufficient taxable income to offset the temporary timing differences attributable to operations and the tax deductions attributable to option, warrant and stock activities are assured, a valuation allowance equaling the total net current and non-current deferred tax asset is being provided.

Inventories

Inventory is valued at the lower of cost, determined on a first-in, first-out basis ("FIFO"), or net realizable value. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on current and anticipated customer demand, production and laboratory requirements.

Recently Issued Accounting Standards, Adopted

On January 1, 2023, the Company adopted ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). ASU 2016-13 requires an impairment model (known as the current expected credit loss ("CECL") model) that is based on expected losses rather than incurred losses. Under the new guidance, each reporting entity should estimate an allowance for expected credit losses, which is intended to result in more timely recognition of losses. This model replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost, accounts receivable and available for sale debt securities and applies to some off-balance sheet credit exposures. In February 2020, the FASB issued ASU 2020-02, Financial Instruments - Credit Losses (Topic 326), which amends the effective date of the original pronouncement for smaller reporting companies. ASU 2016-13 and its amendments will be effective for the Company for interim and annual periods in fiscal years beginning after December 15, 2022. The adoption of ASU 2016-13 did not have a material impact on the Company's consolidated financial statements.

In August 2023, the FASB issued ASU 2023-05, "Business Combinations - Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement." The new guidance applies to the formation of a joint venture and requires a joint venture to initially measure all contributions received upon its formation at fair value. The guidance is intended to reduce diversity in practice and is applicable to joint venture entities with a formation date on or after January 1, 2025 on a prospective basis. The Company currently does not have any transactions that fall under the scope of ASU 2023-05; therefore, the adoption of ASU 2023-05 is not expected to have an impact on the Company's consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Like virtually all commercial enterprises, we can be exposed to the risk ("market risk") that the cash flows to be received or paid relating to certain financial instruments could change as a result of changes in interest rate, exchange rates, commodity prices, equity prices and other market changes.

Our operations are not subject to risks of material foreign currency fluctuations, nor do we use derivative financial instruments in our investment practices. We place our marketable investments in instruments that meet high credit quality

standards. We do not expect material losses with respect to our investment portfolio or excessive exposure to market risks associated with interest rates. The impact on our results of one percentage point change in short-term interest rates would not have a material impact on our future earnings, fair value, or cash flows related to investments in cash equivalents or interest-earning marketable securities.

Current economic conditions may cause a decline in business and consumer spending which could adversely affect our business and financial performance including the collection of accounts receivables, notes receivable, realization of inventory and recoverability of assets. In addition, our business and financial performance may be adversely affected by current and future economic conditions, including a reduction in the availability of credit, financial market volatility and recession.

Except for the broad effects of COVID-19 including its negative impact on the global economy and major financial markets, there have been no material changes to our market risk exposures since December 31, 2022.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in our reports filed with or submitted to the SEC under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including our principal executive officer and principal financial and accounting officer, to allow timely decisions regarding required disclosure.

We carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of September 30, 2023. This evaluation was carried out under the supervision and with the participation of our principal executive officer and principal financial and accounting officer. Based on that review, our management, including our principal executive officer and principal financial and accounting officer, concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of September 30, 2023.

Changes in Internal Control Over Financial Reporting

Except as described above, no change in internal control over financial reporting occurred during the most recent quarter with respect to our operations, which materially affected, or is reasonable likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we have been and may again become involved in legal proceedings arising in the ordinary course of business. There are no material updates to the matters previously disclosed in Item 1, "Legal Proceedings" to our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2023, except as provided below. We are not presently a party to any other material litigation.

Our wholly-owned subsidiary, TK Supplements, Inc., is the defendant in *Aviles v. TK Supplements, Inc.*, a purported class action pending in the Superior Court for the State of California, County of Los Angeles. In the complaint that was filed on April 27, 2023, the plaintiff alleges that TK Supplements falsely advertised its Legendz XL male enhancement supplement in violation of California's Consumer Legal Remedies Act. The plaintiff is seeking certification of a class of California purchasers; actual, statutory and punitive damages; an award of attorneys' fees and costs; and all other relief at law or in equity as may be proper. TK Supplements, Inc., filed a demurrer and motion to strike the plaintiff's complaint, which resulted in the plaintiff filing an amended complaint making similar allegations. We believe the lawsuit and the allegations contained therein are without merit. We intend to file another demurrer and vigorously defend against the litigation.

Item 1A. Risk Factors.

Factors that could cause our actual results to differ materially from those in this Quarterly Report are any of the risks described in our Annual Report on Form 10-K filed with the SEC on March 29, 2023. Any of these factors could result in a significant or material adverse effect on our results of operations or financial condition. Additional risk factors not presently known to us or that we currently deem immaterial may also impair our business or results of operations.

As of the date of this Quarterly Report on Form 10-Q, there have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K filed with the SEC on March 29, 2023, except as provided below. In addition, we may disclose changes to such factors or disclose additional factors from time to time in our future filings with the SEC.

Billing and collections processing for our diagnostic tests is complex and time-consuming, and any delay in transmitting and collecting claims could have an adverse effect on our revenue.

Billing for our diagnostic tests is complex, time-consuming and expensive. Depending on the billing arrangement and applicable law, we may bill different parties for our tests. This includes billing customers directly, as in the case of our hospital and other medical institution customers, as well as billing through Medicare, Medicaid, insurance companies and patients, all of which may have different billing requirements. We may face increased risk in our collection efforts due to the complexities of these billing requirements, including long collection cycles and lower collection rates, which could adversely affect our business, results of operations and financial condition.

Several factors make this billing process complex, including:

- contractual restrictions in our customer contracts that may limit our ability to utilize certain third-party billing service providers;
- differences between the list price for our tests and the reimbursement rates of payors;
- compliance with complex federal and state regulations related to billing government healthcare programs, including Medicare and Medicaid;
- disputes among payors as to which party is responsible for payment;
- disputes with payors regarding the amount due;
- differences in coverage among payors and the effect of patient co-payments or co-insurance;
- differences in information and billing requirements among payors;
- incorrect or missing billing or insurance information; and
- the resources required to manage the billing and claims appeals process.

In addition, the expiration of the federal Public Health Emergency on May 11, 2023 changed regulatory guidelines around COVID-19 testing including billing codes and reimbursement rates of in and out of network laboratories.

We have developed internal systems and procedures to handle these billing and collections functions, but we must continue to make significant efforts and expend substantial resources to further develop our systems and procedures to handle these aspects of our business, which could become increasingly important as we focus on increasing test volumes and establishing coverage and reimbursement policies with third-party payors. As a result, these billing complexities, along with the related uncertainty in obtaining payment for our tests, could negatively affect our revenue and cash flow, our ability to achieve or sustain profitability and the consistency and comparability of our results of operations. In addition, if claims for our tests are not submitted to payors on a timely basis, if we are required to switch to a different provider to handle our processing and collections functions, our revenue and our business could be adversely affected.

Failure to accurately bill for testing services, or to comply with applicable laws relating to government health care programs, could have a material adverse effect on our business.

Billing for diagnostic services is complex and subject to extensive and non-uniform rules and administrative requirements. Depending on the billing arrangement and applicable law, we bill various payers, such as patients, insurance companies, government groups, Medicare and Medicaid. Effective November 2021, billing for diagnostic services is performed internally by our billing department. Failure to accurately bill for our services could have a material adverse effect on our business. For example, certain billing claims for our diagnostic services are taking longer to process and complete because of incorrect patient or insurance information. We have engaged a third-party biller to assist with such claims; however, there is no guarantee that we and our third-party biller will be successful in collecting payments from the services we provided.

In addition, failure to comply with applicable laws relating to billing government health care programs may result in various consequences, including the return of overpayments, civil and criminal fines and penalties, exclusion from participation in government health care programs and the loss of various licenses, certificates and authorizations necessary to operate our business, as well as incur additional liabilities from third-party claims, all of which could have a material adverse effect on our business. Certain violations of these laws may also provide the basis for a civil remedy under the federal False Claims Act, including fines and damages of up to three times the amount claimed. The *qui tam* provisions of the federal False Claims Act and similar provisions in certain state false claims acts allow private individuals to bring lawsuits against health care companies on behalf of the government. Although we believe we are compliant, in all material respects, with applicable laws and regulations, there can be no assurance that a regulatory agency or tribunal would not reach a different conclusion. The federal and state governments have substantial leverage in negotiating settlements since the amount of potential damages and fines far exceeds the rates at which services will be reimbursed, and the government has the remedy of excluding a non-compliant provider from participation in the Medicare and Medicaid programs. We expect that federal and state governments continue aggressive enforcement efforts against perceived health care fraud. Legislative provisions relating to health care fraud and abuse provide government enforcement personnel with substantial funding, powers, penalties and remedies to pursue suspected cases of fraud and abuse.

Our ability to achieve or sustain profitability depends on our collection of payment for the tests we deliver, which we may not be able to do successfully.

Our customer base for our COVID-19 and influenza tests is principally comprised of governmental bodies, municipalities, and large corporations who pay us directly or through third-party payors. In March 2020, the Coronavirus Aid, Relief, and Economic Security Act was enacted, providing for reimbursement to healthcare providers for COVID-19 tests provided to uninsured individuals, subject to continued available funding. On March 22, 2022, HRSA uninsured program stopped accepting claims for COVID-19 testing and treatment due to the lack of sufficient funds. Despite requests from the Acting Director of the Office of Management and Budget and the White House Coordinator for COVID-19 Response for additional emergency funding for the uninsured program, emergency funding has not been allocated to the HRSA uninsured program. We continue to perform limited testing for uninsured persons and are incurring the accompanying costs. Approximately 31.5% and 0% of our diagnostic services revenue for the year ended December 31, 2022 and for the nine months ended September 30, 2023, respectively, was generated from this program for the uninsured.

Further, healthcare policy changes that influence the way healthcare is financed or other changes in the market that impact payment rates by institutional or non-institutional customers could also affect our collection rates. If we are unable to convince customers of the value and benefit provided by our tests, these customers may slow, or stop altogether, their purchases of these tests. Our collection risks also include the potential for default or bankruptcy by the party responsible for payment and other risks associated with payment collection generally. Any inability to maintain our past payment collection levels could cause our revenue and ability to achieve profitability to decline and adversely affect our business, prospects and financial condition.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On August 15, 2023, the Company issued 200,000 shares of the Company's common stock upon the exercise of 200,000 warrants at an exercise price of \$3.00 per share.

On September 10, 2023, the Company issued 200,000 shares of the Company's common stock upon the exercise of 200,000 warrants at an exercise price of \$3.00 per share.

On September 10, 2023, the Company issued 800,000 shares to a note holder upon conversion of \$2.4 million outstanding note at a conversion price of \$3.00 per share pursuant to the original term of the note agreement.

The shares issued upon the exercise of the warrants and upon conversion of the note were issued in reliance on the exemption from registration provided by Section 4(a)(2) of the Securities Act and Regulation D promulgated thereunder and have not been registered under the Securities Act, and may not be offered or sold in the United States absent registration with the SEC or an applicable exemption from such registration requirements.

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1)
July 1, 2023 through July 31, 2023	—	\$ —	—	\$ 5,411,119
August 1, 2023 through August 31, 2023	—	—	—	5,411,119
September 1, 2023 through September 30, 2023	—	—	—	5,411,119
Total	—	\$ —	—	\$ 5,411,119

There was no other purchases of equity securities for the three months ended September 30, 2023.

Item 3. Defaults Upon Senior Securities.

None

Item 4. Mine Safety Disclosures.

Not applicable

Item 5. Other Information.

None

Item 6. Exhibits

Exhibit No.	Description
3.1	<u>Certificate of Incorporation of the Company, (incorporated by reference to Exhibit 3.3 of the Current Report on Form 8-K (File No. 000-21617) filed on June 19, 2015)</u>
3.2	<u>Amended and Restated Bylaws of Prophase Labs, Inc. (incorporated by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K (File No. 000-21617) filed on June 20, 2023)</u>
31.1	Certification by the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification by the Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification by the Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS#	Inline XBRL Instance Document
101.SCH#	Inline XBRL Taxonomy Extension Schema Document
101.CAL#	Inline XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF#	Inline XBRL Taxonomy Extension Definition Linkbase Document
101.LAB#	Inline XBRL Taxonomy Extension Label Linkbase Document
101.PRE#	Inline XBRL Taxonomy Extension Presentation Linkbase Document
104	Cover Page Interactive Data File (embedded within the Inline XBRL document)

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.

ProPhase Labs, Inc.

By: /s/ Ted Karkus
Ted Karkus
Chairman of the Board and Chief Executive Officer (Principal Executive Officer)

Date: November 13, 2023

By: /s/ Robert A Morse Jr.
Robert A. Morse Jr.
Chief Financial Officer (Principal Accounting and Financial Officer)

Date: November 13, 2023

**OFFICER'S CERTIFICATION PURSUANT TO
RULE 13a-14(a)/15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Ted Karkus, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of ProPhase Labs, Inc.;
2. Based on my knowledge, this Quarterly 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 Quarterly Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly 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 Quarterly 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 Rule 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 Quarterly 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 Quarterly 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 (or persons performing the equivalent functions):
 - (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: November 13, 2023

By: /s/ Ted Karkus
Ted Karkus
Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)

**OFFICER'S CERTIFICATION PURSUANT TO
RULE 13a-14(a)/15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Robert Morse, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of ProPhase Labs, Inc.;
2. Based on my knowledge, this Quarterly 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 Quarterly Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly 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 Quarterly 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 Rule 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 Quarterly 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 Quarterly 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 (or persons performing the equivalent functions):
 - (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: November 13, 2023

By: /s/ Robert Morse

Robert Morse

Chief Accounting Officer (Principal Accounting and Financial Officer)

PROPHASE LABS, INC.
CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(b) OF THE SECURITIES EXCHANGE ACT OF 1934
AND 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Ted Karkus, Chief Executive Officer of ProPhase Labs, Inc., a Delaware corporation (the “Registrant”), in connection with the Registrant’s Quarterly Report on Form 10-Q for the period ended September 30, 2023, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), do hereby represent, warrant and certify, in compliance with Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Ted Karkus

Ted Karkus

Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)

November 13, 2023

PROPHASE LABS, INC.
CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(b) OF THE SECURITIES EXCHANGE ACT OF 1934
AND 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Robert Morse, Chief Financial Officer of ProPhase Labs, Inc., a Delaware corporation (the "Registrant"), in connection with the Registrant's Quarterly Report on Form 10-Q for the period ended September 30, 2023, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), do hereby represent, warrant and certify, in compliance with Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Robert Morse

Robert Morse

Chief Accounting Officer (Principal Accounting and Financial Officer)

November 13, 2023