

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

**FORM 10-Q**

*(Mark One)*

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

For the quarterly period ended March 31, 2020

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 0-21617

**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.)

621 N. Shady Retreat Road, Doylestown, Pennsylvania

(Address of principal executive office)

18901

(Zip Code)

(215) 345-0919

(Registrant's telephone number, including area code)

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

<u>Title of Each Class</u>	<u>Trading Symbol</u>	<u>Name of Each Exchange on Which Registered</u>
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 definition of "large accelerated filer", "accelerated filer", "non-accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer   
Emerging growth company

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

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

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

<u>Class</u>	<u>Outstanding at May 12, 2020</u>
Common Stock, \$0.0005 par value	11,591,648

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)

	March 31, 2020 <u>(Unaudited)</u>	December 31, 2019
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 697	\$ 434
Marketable debt securities, available for sale	840	926
Escrow receivable	4,812	4,812
Accounts receivable, net	1,213	2,010
Inventory	1,703	1,459
Prepaid expenses and other current assets	240	304
Total current assets	<u>9,505</u>	<u>9,945</u>
Property, plant and equipment, net of accumulated depreciation of \$6,295 and \$6,252, respectively	2,363	2,329
<b>TOTAL ASSETS</b>	<b><u>\$ 11,868</u></b>	<b><u>\$ 12,274</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable	\$ 695	\$ 432
Accrued advertising and other allowances	92	92
Other current liabilities	338	409
Total current liabilities	<u>1,125</u>	<u>933</u>
Non-current liabilities:		
Deferred revenue, net of current portion	112	110
Total non-current liabilities	<u>112</u>	<u>110</u>
Total liabilities	<u>1,237</u>	<u>1,043</u>
<b>COMMITMENTS AND CONTINGENCIES</b>		
	-	-
Stockholders' equity		
Preferred stock authorized 1,000,000, \$.0005 par value, no shares issued	-	-
Common stock authorized 50,000,000, \$.0005 par value, issued 28,233,961 and 28,225,615 shares, respectively	14	14
Additional paid-in capital	60,413	60,215
Accumulated deficit	(2,315)	(1,506)
Treasury stock, at cost, 16,652,022 and 16,652,022 shares	(47,490)	(47,490)
Accumulated comprehensive income (loss)	9	(2)
Total stockholders' equity	<u>10,631</u>	<u>11,231</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b><u>\$ 11,868</u></b>	<b><u>\$ 12,274</u></b>

See accompanying notes to condensed consolidated financial statements

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

	<b>For the Three Months Ended</b>	
	<b>March 31, 2020</b>	<b>March 31, 2019</b>
Net sales	\$ 1,888	\$ 2,318
Cost of sales	1,473	1,798
Gross profit	415	520
Operating expenses:		
Sales and marketing	170	266
Administration	998	1,204
Research and development	59	94
Total operating expenses	1,227	1,564
Loss from operations	(812)	(1,044)
Interest income, net	3	31
<b>Net loss</b>	<b>\$ (809)</b>	<b>\$ (1,013)</b>
Other comprehensive income:		
Unrealized gain on marketable debt securities	11	15
Total comprehensive loss	\$ (798)	\$ (998)
Basic and diluted loss per share:	\$ (0.07)	\$ (0.09)
Weighted average common shares outstanding:		
Basic and diluted	11,582	11,557

See accompanying notes to condensed consolidated financial statements

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

	Common Stock Shares Outstanding, Net of Shares of Treasury Stock	Par Value	Additional Paid in Capital	Accumulated Deficit	Accumulated Comprehensive Income (Loss)	Treasury Stock	Total
<b>Balance as of January 1, 2020</b>	11,573,593	\$ 14	\$ 60,215	\$ (1,506)	\$ (2)	\$ (47,490)	\$ 11,231
Unrealized gain on marketable debt securities, net of realized losses of \$3, net of taxes	-	-	-	-	11	-	11
Stock-based compensation	8,346	-	198	-	-	-	198
Net loss	-	-	-	(809)	-	-	(809)
<b>Balance as of March 31, 2020</b>	<u>11,581,939</u>	<u>\$ 14</u>	<u>\$ 60,413</u>	<u>\$ (2,315)</u>	<u>\$ 9</u>	<u>\$ (47,490)</u>	<u>\$ 10,631</u>
	Common Stock Shares Outstanding, Net of Shares of Treasury Stock	Par Value	Additional Paid in Capital	Retained Earnings	Accumulated Comprehensive Loss	Treasury Stock	Total
<b>Balance as of January 1, 2019</b>	11,549,519	\$ 14	\$ 59,471	\$ 4,533	\$ (24)	\$ (47,490)	\$ 16,504
Unrealized gain on marketable debt securities, net of realized losses of \$3, net of taxes	-	-	-	-	15	-	15
Stock-based compensation	7,166	-	196	-	-	-	196
Net loss	-	-	-	(1,013)	-	-	(1,013)
<b>Balance as of March 31, 2019</b>	<u>11,556,685</u>	<u>\$ 14</u>	<u>\$ 59,667</u>	<u>\$ 3,520</u>	<u>\$ (9)</u>	<u>\$ (47,490)</u>	<u>\$ 15,702</u>

See accompanying notes to condensed consolidated financial statements

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

	<b>For the Three Months Ended</b>	
	<b>March 31, 2020</b>	<b>March 31, 2019</b>
<b>Cash flows from operating activities</b>		
Net loss	\$ (809)	\$ (1,013)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Realized loss on marketable debt securities	3	3
Depreciation and amortization	82	101
Lower of cost or net realizable value inventory adjustment	12	-
Stock-based compensation expense	198	196
Changes in operating assets and liabilities:		
Accounts receivable	797	2,180
Inventory	(256)	292
Prepaid and other assets	64	78
Accounts payable and accrued expenses	263	(179)
Other current liabilities	(69)	(255)
Net cash provided by operating activities	<u>285</u>	<u>1,403</u>
<b>Cash flows from investing activities</b>		
Purchase of marketable securities	(706)	-
Proceeds from sale of marketable debt securities	800	2,470
Capital expenditures	(116)	(48)
Net cash provided by (used in) investing activities	<u>(22)</u>	<u>2,422</u>
<b>Cash flows from financing activities</b>		
Payment of dividends	-	(2,929)
Net cash used in financing activities	<u>-</u>	<u>(2,929)</u>
Increase in cash and cash equivalents	263	896
Cash and cash equivalents, at the beginning of the period	434	1,554
<b>Cash and cash equivalents, at the end of the period</b>	<u>\$ 697</u>	<u>\$ 2,450</u>
<b>Supplemental disclosure of non-cash investing and financing activities:</b>		
Net unrealized gain, investments in marketable debt securities	<u>\$ 11</u>	<u>\$ 15</u>

See accompanying notes to condensed consolidated financial statements

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

**Note 1 – Organization and Business**

ProPhase Labs, Inc. (“we”, “us” or the “Company”) was initially organized as a corporation in Nevada in July 1989. Effective June 18, 2015, we changed our state of incorporation from the State of Nevada to the State of Delaware. We are a manufacturing and marketing company with deep experience with OTC consumer healthcare products and dietary supplements. We are engaged 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.

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.

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

We use a December 31 year-end for financial reporting purposes. References herein to “Fiscal 2020” shall mean the fiscal year ended December 31, 2020 and references to other “fiscal” years shall mean the year, which ended on December 31 of the year indicated. The term “we”, “us” or the “Company” as used herein also refer, where appropriate, to the Company, together with its subsidiaries unless the context otherwise requires.

**Note 2 – Summary of Significant Accounting Policies**

For the three months ended March 31, 2020 and 2019, our revenues have come principally from our OTC healthcare and dietary supplement contract manufacturing business and sales to retail customers of dietary supplement product.

***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, 2019. In the opinion of management, all adjustments necessary for a fair presentation of the consolidated financial position, consolidated results of operations and consolidated cash flows, for the periods indicated, have been made. The results of operations for the three months ended March 31, 2020 are not necessarily indicative of operating results that may be achieved over the course of the full year.

***Product Innovation, Seasonality of the Business and Liquidity***

Our net sales are derived principally from our contract manufacturing of OTC healthcare and our dietary supplement products sold in the United States. In addition, we are engaged in market activities for our TK Supplements® product line of dietary supplements.

Our sales are influenced by and subject to (i) the timing of acceptance of our TK Supplements® 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 for others, which are 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 consequence of the change in weather and other factors. We generally experience in the first, third and fourth quarter higher levels of net sales from our contract manufacturing of OTC healthcare and cold remedy products. Revenues are generally at their lowest levels in the second quarter when customer demand generally declines.

As a consequence of the timing of acceptance of our TK Supplements® products in the marketplace and the seasonality of our business, we realize variations in operating results and demand for working capital from quarter to quarter. As of March 31, 2020, we had working capital of approximately \$8.4 million, including \$0.8 million in marketable securities available for sale. We believe our current working capital at March 31, 2020 is at an acceptable and adequate level to support our business for at least the next twelve months.

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

Based on the Company's current assessment, the Company does not expect any material impact on its long-term liquidity due to the COVID-19 pandemic. However, the Company will continue to assess the effect of the pandemic on its operations. The extent to which the COVID-19 pandemic will impact the Company's business and operations will depend on future developments that are highly uncertain and cannot be predicted with confidence at this time, such as the ultimate geographic spread of the disease, the duration of the outbreak, the duration and effect of business disruptions and the short-term effects and ultimate effectiveness of the travel restrictions, quarantines, social distancing requirements and business closures in the United States and other countries to contain and treat the disease. While the potential economic impact caused by, and the duration of, COVID-19 may be difficult to assess or predict, a widespread pandemic such as COVID-19 could result in significant disruption of global financial markets, reducing the Company's ability to access capital, which could in the future negatively affect the Company's liquidity. In addition, a recession or market correction resulting from the spread of COVID-19 could materially affect the Company's business and the value of its common stock.

***Use of Estimates***

The preparation of financial statements and the accompanying notes thereto, in conformity with generally accepted accounting principles in the United States of America ("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 financial statements and reported amounts of revenues and expenses during the respective reporting periods. Examples include the provision for bad debt, sales returns and allowances, inventory obsolescence, useful lives of property and equipment, impairment of property and equipment, income tax valuations and assumptions related to accrued advertising. When providing for the appropriate sales returns, allowances, cash discounts and cooperative incentive promotion costs ("sales allowances"), we apply a uniform and consistent method for making certain assumptions for estimating these provisions. These estimates and assumptions are based on historical experience, current trends and other factors that management believes to be relevant at the time the financial statements are prepared. Management reviews its accounting policies, assumptions, estimates and judgments on a quarterly basis. Actual results could differ from those estimates.

***Cash and Cash Equivalents***

We consider all highly liquid investments with a maturity of three months or less at the time of purchase to be cash equivalents. Cash equivalents include cash on hand and monies invested in money market funds. The carrying amount approximates the fair market value due to the short-term maturity of these investments.

***Marketable Debt Securities***

We have classified our investments in marketable debt securities as available-for-sale and as a current asset. Our investments in marketable debt securities are carried at fair value, with unrealized gains and losses included as a separate component of stockholders' equity. Realized gains and losses from our marketable debt securities are recorded as interest income (expense). We initiated short term investments in marketable debt securities, which carry maturity dates between one and three years from date of purchase with interest rates of 1.875% - 2.750% during the first quarter of Fiscal 2020. For the three months ended March 31, 2020, we reported unrealized gains of \$11,000 and an accumulated unrealized income of \$9,000. Unrealized gains and losses are classified as other comprehensive income (loss) and the cost is determined on a specific identification basis. The following is a summary of the components of our marketable debt securities and the underlying fair value input level tier hierarchy (see long-lived assets below) (in thousands):

	<b>As of March 31, 2020</b>		
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Fair Value</b>
U.S. government obligations	\$ 829	\$ 11	\$ 840
	<b>As of December 31, 2019</b>		
	<b>Amortized Cost</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
U.S. government obligations	\$ 125	\$ -	\$ 125
Corporate obligations	803	(2)	801
	<u>\$ 928</u>	<u>\$ (2)</u>	<u>\$ 926</u>



**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

We believe that the unrealized gains or losses generally are the result of a change in the risk premiums required by market participants rather than an adverse change in cash flows or a fundamental weakness in the credit quality of the issuer or underlying assets.

**Inventory**

Inventory is valued at the lower of cost, determined on a first-in, first-out basis (FIFO), or net realizable value. Inventory items are analyzed to determine cost and the net realizable value and appropriate valuation adjustments are established. At March 31, 2020 and March 31, 2019, the financial statements include non-cash adjustments to adjust inventory for excess, obsolete or short-dated shelf-life inventory by \$12,000 and \$10,000 respectively. The components of inventory are as follows (in thousands):

	March 31, 2020	December 31, 2019
Raw materials	\$ 993	\$ 1,024
Work in process	463	299
Finished goods	247	136
	\$ 1,703	\$ 1,459

**Property, Plant and Equipment**

Property, plant and equipment are recorded at cost. We use the straight-line method in computing depreciation for financial reporting purposes. Depreciation expense is computed in accordance with the following ranges of estimated asset lives: building and improvements –ten to thirty-nine years; machinery and equipment – three to seven years; computer equipment and software – three to five years; and furniture and fixtures – five years. We have reviewed our property, plant and equipment for the three months ended March 31, 2020 and 2019 and concluded there were no impairments or changes in useful lives.

**Concentration of Risks**

Future revenues, costs, margins and profits will continue to be influenced by our ability to maintain our manufacturing availability and capacity together with our marketing and distribution capabilities and the regulatory requirements associated with the development of OTC consumer healthcare products, dietary supplements and other remedies in order to compete on a national level and/or international level.

Our business is subject to federal and state laws and regulations adopted for the health and safety of users of our products. The manufacturing and distribution of OTC healthcare and dietary supplement products are subject to regulations by various federal, state and local agencies, including the Food and Drug Administration (“FDA”) and, as applicable, the Homeopathic Pharmacopoeia of the United States.

Financial instruments that potentially subject us to significant concentrations of credit risk consist principally of cash investments, marketable securities, and trade accounts receivable. Our marketable securities are fixed income investments, which are highly liquid and can be readily purchased or sold through established markets.

We maintain cash and cash equivalents with certain major financial institutions. As of March 31, 2020, our cash and cash equivalents balance was \$0.7 million and our bank balance was \$0.8 million. Of the total bank balance, \$0.3 million was covered by federal depository insurance and \$0.5 million was uninsured at March 31, 2020.

Trade accounts receivable potentially subject us to credit concentrations from time-to-time as a consequence of the timing, payment pattern and ultimate purchase volumes or shipping schedules with our customers. We extend credit to our customers based upon an evaluation of the customer’s financial condition and credit history and generally we do not require collateral. Our customers include consumer products companies and large national chain, regional, specialty and local retail stores. These credit concentrations may impact our overall exposure to credit risk, either positively or negatively, in that our customers may be similarly affected by changes in economic, regulatory or other conditions that may impact the timing and collectability of amounts due to us. As a consequence of an evaluation of our customer’s financial condition, payment patterns, balance due to us and other factors, we did not offset our account receivable with an allowance for bad debt at March 31, 2020 and December 31, 2019.

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

**Long-lived Assets**

We review the carrying value of our long-lived assets with definite lives whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. When indicators of impairment exist, we determine whether the estimated undiscounted sum of the future cash flows of such assets is less than their carrying amounts. If less, an impairment loss is recognized in the amount, if any, by which the carrying amount of such assets exceeds their respective fair values. 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; industry competition; and general economic and business conditions, among other factors.

**Fair Value of Financial Instruments**

Fair value is based on the prices that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, a three-tier fair value hierarchy prioritizes the inputs used to measure fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

Cash and cash equivalents, marketable securities, accounts receivable, assets held for sale, accounts payable, and accrued expenses are reflected in the consolidated financial statements at carrying value which approximates fair value. We account for our marketable securities at fair value, with the net unrealized gains or losses reported as a component of accumulated other comprehensive income or loss. The components of marketable debt securities are as follows (in thousands):

	<b>As of March 31, 2020</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Marketable debt securities				
U.S. government obligations	\$ -	\$ 840	\$ -	\$ 840
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	<b>As of December 31, 2019</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Marketable debt securities				
U.S. government obligations	\$ -	\$ 125	\$ -	\$ 125
Corporate obligations	-	801	-	801
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

There were no transfers of marketable debt securities between Levels 1, 2 or 3 for the three months ended March 31, 2020.

**Revenue Recognition**

We recognize revenue that represents the transfer of promised goods or services to customers at an amount that reflects the consideration which is expected to be received in exchange for those goods or services. We recognize revenue when performance obligations with our customers have been satisfied. At contract inception, 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.

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

*Performance Obligations*

We generate sales principally through two types of customers, contract manufacturing and retail customers. Sales from product shipments to contract manufacturing and retailer customers are recognized at the time ownership is transferred to the customer. Net sales from OTC healthcare contract manufacturing and retail dietary supplement product customers were \$1.7 million and \$0.2 million, respectively, for the three months ended March 31, 2020 and \$2.1 million and \$0.2 million, respectively, for the three months ended March 31, 2019. Revenue from retailer customers is reduced for trade promotions, estimated sales returns, cash discounts and other allowances in the same period as the related sales are recorded. No such allowance is applicable to our contract manufacturing customers. We make estimates of potential future product returns and other allowances related to current period revenue. We analyze historical returns, current trends, and changes in customer and consumer demand when evaluating the adequacy of the sales returns and other allowances.

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer and is the unit of account in accordance with ASC 606. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. The combined duties and responsibilities within each contract will be considered one single performance obligation under ASC 606 as these items would not be separately identifiable from each other promise in the contract and we provide a significant service of integrating the duties with other promises in the contracts.

*Transaction Price*

The transaction price is fixed based upon either (i) a combined Master Agreement and each related purchase order, or (ii) if there is no Master Agreement, the price per the individual purchase order received from each customer. The customers are invoiced at an agreed upon contractual price for each unit ordered and delivered by the Company and the R&D services are invoiced at the time the performance is completed.

The Company does not collect sales tax or other similar taxes from customers. As such, there is no effect on the measurement of the transaction price.

*Recognize Revenue When the Company Satisfies a Performance Obligation*

Performance obligations related to contract manufacturing and sales to retail customers are satisfied at a point in time when the goods are shipped to the customer as (i) we have transferred control of the assets to the customers upon shipping, and (ii) the customer obtains title and assumes the risks and rewards of ownership after the goods are shipped.

We do not accept returns from our contract manufacturing customers. Our return policy for retailer customers accommodates returns for (i) discontinued products, (ii) store closings and (iii) products that have reached or exceeded their designated expiration date. We do not impose a period of time within which products must be returned. All requests for product returns must be submitted to us for pre-approval. The main components of our returns policy are: (i) we will accept returns that are due to damaged product that is un-saleable and such return request activity falls within an acceptable range, (ii) we will accept returns for products that have reached or exceeded designated expiration dates and (iii) we will accept returns in the event that we discontinue a product provided that the customer will have the right to return only such items that it purchased directly from us. We will not accept return requests pertaining to customer inventory "Overstocking" or "Resets". We will accept return requests for only products in its intended package configuration. We reserve the right to terminate shipment of product to customers who have made unauthorized deductions contrary to our return policy or pursue other methods of reimbursement. We compensate the customer for authorized returns by means of a credit applied to amounts owed or to be owed and in the case of discontinued product only, also by way of an exchange. We do not have any significant product exchange history.

We continue to recognize revenue from contract manufacturing and retail customers at a point in time as we have an enforceable right to payment for goods as products are shipped to customers.

Accrued advertising and other allowances from continuing operations as of March 31, 2020 included (i) \$46,000 for estimated returns which is reported as a liability and (ii) \$22,000 for cooperative and incentive promotion costs which is also reported as a liability. Accrued advertising and other allowances from discontinued operations as of March 31, 2020 included (i) \$134,000 for estimated returns, which is reported as a reduction to account receivables, and (ii) \$69,000 for cooperative incentive promotion costs, which is reported as accrued advertising and other allowances under current liabilities. As of December 31, 2019, accrued advertising and other allowances from continuing operations included (i) \$37,000 for estimated returns which is reported as a liability and (ii) \$92,000 for cooperative and incentive promotion costs which is also reported as a liability. Accrued advertising and other allowances from discontinued operations as of December 31, 2019 included (i) \$132,000 for estimated returns, which is reported as a reduction to account receivables, and (ii) \$76,000 for cooperative incentive promotion costs, which is reported as accrued advertising and other allowances under current liabilities.

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

As of March 31, 2020, we have deferred revenue of \$205,000 in relation to Research and Development (“R&D”) stability and release testing programs. As of December 31, 2019, deferred revenue was \$214,000. Deferred revenues primarily consist of amounts that have been billed to or received from customers in advance of revenue recognition and prepayments received from customers in advance for implementation, maintenance and other services, as well as initial subscription fees. We recognize deferred revenues as revenues when the services are performed and the corresponding revenue recognition criteria are met. Customer prepayments are generally applied against invoices issued to customers when services are performed and billed.

The following table disaggregates the Company’s deferred revenue expected by recognition period (in thousands):

Recognition Period	<b>Deferred Revenue</b>	
	March 31, 2020	December 31, 2019
0-12 Months	\$ 93	\$ 104
13-24 Months	33	49
Over 24 Months	79	61
<b>Total</b>	<b>\$ 205</b>	<b>\$ 214</b>

*Disaggregation of Revenue*

We disaggregate revenue from contracts with customers into two categories: contract manufacturing and retail customers. We determined that disaggregating revenue into these categories achieves the disclosure objective to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

The following table disaggregates the Company’s revenue by revenue source for the three months ended March 31, 2020 and 2019 (in thousands):

Revenue by Customer Type	<b>For the Three Months Ended</b>	
	March 31, 2020	March 31, 2019
Contract manufacturing	\$ 1,723	\$ 2,124
Retail and others	165	194
<b>Total revenue</b>	<b>\$ 1,888</b>	<b>\$ 2,318</b>

*Sales Tax Exclusion from the Transaction Price*

We exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the Company from the customer.

*Shipping and Handling Activities*

We account for shipping and handling activities that we perform as activities to fulfill the promise to transfer the good.

*Advertising and Incentive Promotions*

Advertising and incentive promotion costs are expensed within the period in which they are utilized. Advertising and incentive promotion expense is comprised of (i) media advertising, presented as part of sales and marketing expense, (ii) cooperative incentive promotions and coupon program expenses, which are accounted for as part of net sales, and (iii) free product, which is accounted for as part of cost of sales. Advertising and incentive promotion expenses (i) incurred from continuing operations for the three months ended March 31, 2020 and 2019 were \$47,000 and \$27,000, respectively.

*Share-Based Compensation*

We recognize all share-based payments to employees and directors, including grants of stock options, as compensation expense in the financial statements based on their fair values. Fair values of stock options are determined through the use of the Black-Scholes option pricing model. The compensation cost is recognized as an expense over the requisite service period of the award, which usually coincides with the vesting period. We account for forfeitures as they occur.

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
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Stock and stock options for the purchase of our common stock, \$0.0005 par value (“Common Stock”), have been granted to both employees and non-employees pursuant to the terms of certain agreements and stock option plans (see Note 5). Stock options are exercisable during a period determined by us, but in no event later than ten years from the date granted. For the three months ended March 31, 2020 and 2019, we charged to operations \$198,000 and \$196,000, respectively, for share-based compensation expense for the aggregate fair value of stock grants issued and vested stock options earned.

***Research and Development***

R&D costs are charged to operations in the period incurred R&D costs incurred for the three months ended March 31, 2020 and 2019 from continuing operations were \$59,000 and \$94,000, respectively. R&D costs are principally related to personnel expenses and new product development initiatives and costs associated with our OTC health care products, dietary supplements and other remedies.

***Income Taxes***

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 deferred tax asset is being provided.

We utilize a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than fifty percent likely of being realized upon ultimate settlement. Any interest or penalties related to income taxes will be recorded as interest or administrative expense, respectively.

As a result of our losses from continuing operations, we have recorded a full valuation allowance against a net deferred tax asset. Additionally, we have not recorded a liability for unrecognized tax benefit.

***Recently Issued Accounting Standards, Not Yet Adopted***

In September 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326). The ASU sets forth a “current expected credit loss” (CECL) model which requires the Company to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost 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 Company is currently assessing the impact of the adoption of this ASU on its financial statements.

In December 2019, the FASB issued ASU No. 2019-12, “Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes (“ASU 2019-12”), which is intended to simplify various aspects related to accounting for income taxes. ASU 2019-12 removes certain exceptions to the general principles in Topic 740 and also clarifies and amends existing guidance to improve consistent application. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020, with early adoption permitted. The Company is currently evaluating the impact of this standard on its consolidated financial statements and related disclosures.

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

**Note 3 – Property, Plant and Equipment**

The components of property and equipment are as follows (in thousands):

	March 31, 2020	December 31, 2019	Estimated Useful Life
Land	\$ 504	\$ 504	
Building improvements	3,113	3,113	10-39 years
Machinery	4,376	4,285	3-7 years
Computer equipment	458	472	3-5 years
Furniture and fixtures	207	207	5 years
	8,658	8,581	
Less: accumulated depreciation	(6,295)	(6,251)	
Total property, plant and equipment, net	\$ 2,363	\$ 2,329	

Depreciation expense incurred for the three months ended March 31, 2020 and 2019 was \$82,000 and \$101,000, respectively. During the three months ended March 31, 2020, we wrote off fully depreciated assets and accumulated depreciation totaling \$38,000.

**Note 4 – Transactions Affecting 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").

**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 March 31, 2020 and December 31, 2019, no shares of Preferred Stock have been issued.

**Common Stock Dividend**

On December 24, 2018, the Board declared a special cash dividend of \$0.25 per share on the Company's Common Stock resulting in \$2.9 million payable on January 24, 2019 to holders of record of the Company's Common Stock on January 10, 2019. On January 24, 2019, the Company paid an aggregate of \$2.9 million to the Company's stockholders entitled to receive such dividend.

**The 2010 Directors' Equity Compensation Plan**

On May 5, 2010, our stockholders approved the 2010 Directors' Equity Compensation Plan which, has been subsequently amended and restated by our stockholders (the "2010 Directors' Plan"). A primary purpose of the 2010 Directors' Plan is to provide us with the ability to pay all or a portion of the fees of directors in stock instead of cash. The 2010 Directors' Plan provides that the total number of shares of Common Stock that may be issued under the 2010 Directors' Plan is equal to 675,000 shares.

During the three months ended March 31, 2020, 8,346 shares of Common Stock were granted to our directors under the 2010 Directors' Plan. We recorded \$17,000 of director fees during the three months ended March 31, 2020 in connection with these grants, which represented the fair value of the shares calculated based on the average closing price of the Company's shares of Common Stock for the last five trading days of the quarter in which the Board fee was earned.

During the three months ended March 31, 2019, 7,166 shares of Common Stock were granted to our directors under the 2010 Directors' Plan. We recorded \$23,000 of director fees during the three months ended March 31, 2019 in connection with these grants, which represented the fair value of the shares calculated based on the average closing price of the Company's shares of Common Stock for the last five trading days of the quarter in which the Board fee was earned.

At March 31, 2020, there were 350,440 shares of Common Stock that may be issued pursuant to the terms of the 2010 Directors' Plan.

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
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**The 2010 Equity Compensation Plan**

On May 5, 2010, our stockholders approved the 2010 Equity Compensation Plan, which was subsequently amended and restated by our stockholders (the “2010 Plan”). The 2010 Plan provides that the total number of shares of Common Stock that may be issued under the 2010 Plan is 3.9 million shares.

No options were granted under the 2010 Plan for the three months ended March 31, 2020 and 2019. In addition, no stock options were exercised during the three months ended March 31, 2020 and 2019.

As of March 31, 2020, there were 782,000 options outstanding and 528,659 options available to be issued pursuant to the terms of the 2010 Plan. We will recognize approximately \$350,000 of share-based compensation expense over a weighted average period of 1.8 years.

**The 2018 Stock Incentive Plan**

On April 12, 2018, our stockholders approved the 2018 Stock Incentive Plan (the “2018 Stock Plan”). At April 12, 2018, all 2.3 million shares available for issuance under the 2018 Stock Plan have been granted in the form of stock options at an initial exercise price of \$3.00 per share, which is exercisable in 36 monthly installments to Ted Karkus (the “CEO Option”), our Chief Executive Officer and no stock options have been exercised under the 2018 Stock Plan.

The 2018 Plan requires 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 terms of the CEO Option, such that the exercise price of the CEO Option was reduced from \$3.00 per share to \$2.00 per share, effective as of September 5, 2018, the date the special \$1.00 special cash dividend was paid to the Company’s stockholders. The exercise price of the CEO Option was further reduced from \$2.00 to \$1.75 per share, effective as of January 24, 2019, the date the \$0.25 special cash dividend was paid to the Company’s stockholders. The exercise price of the CEO Option was further reduced from \$1.75 to \$1.50 per share, effective as of December 12, 2019, the date another \$0.25 special cash dividend was paid to Company’s stockholders. We will recognize approximately \$447,000 of share-based compensation expense over a weighted average period of 0.9 years.

The following table summarizes stock options activity during the three months ended March 31, 2020 for both the 2010 Plan and 2018 Stock Plan (in thousands, except per share data):

	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Contractual Life (in years)</u>	<u>Total Intrinsic Value</u>
Outstanding as of January 1, 2020	3,082	\$ 1.67	3.7	\$ 1,085
Granted	-	-	-	-
Forfeited/expired	-	-	-	-
Outstanding as of March 31, 2020	<u>3,082</u>	<u>\$ 1.67</u>	<u>3.4</u>	<u>\$ 900</u>
Options vested and exercisable	1,848	\$ 1.58	3.1	\$ 626

**Note 5 – Defined Contribution Plans**

We maintain the ProPhase Labs, Inc. 401(k) Savings and Retirement Plan, a defined contribution plan for our employees. Our contributions to the plan are based on the amount of the employee plan contributions and compensation. Our contributions to the plan in the three months ended March 31, 2020 and 2019 were \$16,000 and \$21,000, respectively.

**Note 6 – Other Current Liabilities**

The following table sets forth the components of other current liabilities at March 31, 2020 and December 31, 2019, respectively, (in thousands):

	March 31, 2020	December 31, 2019
Accrued expenses	\$ 122	\$ 218
Accrued benefits	14	25
Accrued payroll	88	57
Accrued vacation	20	5
Sales tax payable	1	-
Deferred revenue	93	104
Total other current liabilities	<u>\$ 338</u>	<u>\$ 409</u>

**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

**Note 7— Commitments and Contingencies**

Escrow Receivable

We have indemnification obligations to Mylan Consumer Healthcare Inc. (formerly known as Meda Consumer Healthcare Inc.) (“MCH”) and Mylan Inc. (together with MCH, “Mylan”) under the asset purchase agreement pursuant to which we sold the Cold-EEZE<sup>®</sup> business to Mylan, that may require us to make future payments to Mylan and other related persons for any damages incurred by Mylan or such related persons as a result of any breaches of our representations, warranties, covenants or agreements contained in the asset purchase agreement, or arising from the Retained Liabilities (as such term is defined in the asset purchase agreement) or certain third party claims specified in the asset purchase agreement. Generally, our representations and warranties survive for a period of 24 months from the closing date, which was March 29, 2017, other than certain fundamental representations which survive until the expiration of the applicable statute of limitations. There is a limited indemnification cap with respect to a majority of the Company’s indemnification obligations under the asset purchase agreement with the exception of claims for actual fraud, the breach of any fundamental representations and certain other items, which have a larger indemnification cap (i.e., the purchase price).

Pursuant to the terms of the asset purchase agreement, we, Mylan, and an escrow agent entered into an Escrow Agreement at closing, pursuant to which Mylan deposited \$5 million of the aggregate purchase price for the Cold-EEZE<sup>®</sup> business into an escrow account established with the Escrow Agent in order to satisfy, in whole or in part, certain of our indemnity obligations under the asset purchase agreement.

The terms of the Escrow Agreement provide that if, as of September 29, 2018, there were funds remaining in the escrow account, then the escrow account would be reduced by the difference, if a positive number, of (i) \$2.5 million minus (ii) the aggregate amount of all escrow claims asserted by Mylan prior to this date that had either been paid out of the escrow account or were pending as of such date, and, within two business days of such date, the Escrow Agent would disburse such difference, if a positive number, to us. In addition, within two business days of March 29, 2019, the Escrow Agent was required to release any funds remaining in the escrow account to us minus any amounts being reserved for escrow claims asserted by Mylan prior to such date. Upon the resolution of any pending escrow claims, the Escrow Agent would then, within two business days of receipt of joint instructions or a final order from a court (as described in the Escrow Agreement) disburse such reserved amount to the parties entitled to such funds. As described below, in August 2018, Mylan asserted an indemnification claim against us, for a yet to be determined amount. Accordingly, the distributions were not released to us on September 29, 2018 or March 29, 2019.

On May 31, 2018, we received notice of a claim for \$800,000 in losses against the escrow amount. We resolved this claim pursuant to a settlement agreement, effective October 16, 2018, pursuant to which \$160,000 of the funds held in escrow were released to Mylan. This expense is reflected in discontinued operations in the third quarter of 2018.

On August 2, 2018, we received notice of an indemnification claim from Mylan in relation to certain product advertising claims brought against Mylan related to certain Cold-EEZE<sup>®</sup> products. Pursuant to the terms of the asset purchase agreement, we elected to assume the defense of these claims on behalf of Mylan, which we disputed and vigorously contested. Although we believe these claims are without merit, we have negotiated a settlement with the plaintiffs.

As described in Part I, Item 1, Note 10 “Subsequent Events,” on May 4, 2020, the final pending claim against the Company’s escrow account with Mylan was resolved and, as a consequence, the Escrow Agent released all funds from the escrow account to the Company on May 7, 2020, in the amount of \$4.8 million.

Manufacturing Agreement

In connection with the asset purchase agreement, the Company and its wholly-owned subsidiary, PMI, entered into a manufacturing agreement (the “Manufacturing Agreement”) with Mylan. Pursuant to the terms of the Manufacturing Agreement, Mylan (or an affiliate or designee) purchased the inventory of the Company’s Cold-EEZE<sup>®</sup> brand and product line, and PMI will 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. Unless terminated sooner by the parties, the Manufacturing Agreement will remain in effect until March 29, 2022. Thereafter, the Manufacturing Agreement may be renewed by Mylan for up to five 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.



**ProPhase Labs, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
(unaudited)

Future Obligations:

We have estimated future minimum obligations for an executive's employment agreement over the next five years, including the remainder of Fiscal 2020, as follows (in thousands):

	<b>Employment Contracts</b>
2020	\$ 94
2021	595
2022	675
2023	675
2024	675
Total	\$ 2,714

Other Litigation

In the normal course of our business, we are named as a defendant in legal proceedings. It is our policy to vigorously defend litigation and/or enter into settlements of claims where management deems appropriate.

On November 12, 2019, an action was filed in the United States District Court for the Eastern District of Texas against TK Supplements, Inc., one of our wholly-owned subsidiaries ("TK Sub"), asserting two class claims and alleging that, by sending plaintiff text messages to his cellular telephone number without his prior express consent and notwithstanding its listing on the Do No Call Registry, TK Sub violated the Telephone Consumer Protection Act, 47 U.S.C. § 227(b)(3)(B) and 47 U.S.C. § 227(c) (5). Plaintiff seeks to represent a class of (i) all residents within the United States to whom TK Sub or its agents sent text messages to the person's cellular telephone number in the past four years and (ii) all residents within the United States to whom TK Sub or its agents placed two or more telemarketing phone calls to the person's residential telephone number that was listed on the Do Not Call Registry in the past four years. On January 8, 2020, TK Supplements filed its Answer and Defenses to the Complaint. We intend to defend this matter vigorously.

**Note 8 – Loss Per Share**

Basic loss per share for continuing and discontinued operations are computed by dividing the respective net loss attributable to common stockholders by the weighted-average number of shares of our Common Stock outstanding for the period. Diluted loss per share reflects the potential dilution that could occur if securities or other contracts to issue Common Stock were exercised or converted into Common Stock or resulted in the issuance of Common Stock that shared in the earnings of the entity. Diluted loss per share also utilize the treasury stock method which prescribes a theoretical buy-back of shares from the theoretical proceeds of all options and warrants outstanding during the period. Options and warrants outstanding to acquire shares of our Common Stock at March 31, 2020 and 2019 were 3,082,000 and 2,950,000, respectively.

For the three months ended March 31, 2020, dilutive loss per share were the same as basic earnings per share due to the exclusion of Common Stock in the form of stock options ("Common Stock Equivalents"), which in a net loss position would have an anti-dilutive effect on loss per share. For the three months ended March 31, 2020, there were 3,082,000 potential dilutive Common Stock Equivalents that were excluded from the loss per share computation as a consequence of their anti-dilutive effect. For the three months ended March 31, 2019, there were 2,950,000 potential dilutive Common Stock Equivalents that were excluded from the loss per share computation as a consequence of their anti-dilutive effect.

**Note 9 – Significant Customers**

Revenue for the three months ended March 31, 2020 and 2019 was \$1.9 million and \$2.3 million, respectively. Three third-party contract manufacturing customers accounted for 48.6% and 18% and 17.3%, respectively, of our revenue from continuing operations for the three months ended March 31, 2020. Three third-party contract manufacturing customers accounted for 45.7%, 23.9% and 12.3%, respectively, of our revenue from continuing operations for the three months ended March 31, 2019. The loss of sales to any of these large third-party contract manufacturing customers could have a material adverse effect on our business operations and financial condition.

We are subject to account receivable credit concentrations from time-to-time as a consequence of the timing, payment pattern and ultimate purchase volumes or shipping schedules with our customers. These concentrations may impact our overall exposure to credit risk, either positively or negatively, in that our customers may be similarly affected by changes in economic, regulatory or other conditions that may impact the timing and collectability of amounts due to us. Four customers represented 49%, 18%, 12%, and 11% of our total trade receivable balances at March 31, 2020 and three customers represented 70%, 14% and 11% of our total trade receivable balances at December 31, 2019.

**Note 10 – Subsequent Event**

*Settlement and Release of Escrow Receivable*

On May 4, 2020, the final pending claim against the Company's escrow account with Mylan was resolved and, as a consequence, the Escrow Agent released all funds from the escrow account to the Company on May 7, 2020, in the amount of \$4.8 million.

*Receipt of Loan under the Paycheck Protection Program*

On May 3, 2020, the Company entered into a promissory note and agreement (the "Note") with Wells Fargo, N.A. for an aggregate principal amount of \$295,250 (the "Loan"), pursuant to the Paycheck Protection Program under the recently enacted Coronavirus Aid, Relief, and Economic Security Act.

The Loan matures two years from the disbursement date and bears interest at a rate of 1.000% per annum, with the first six months of interest deferred. Principal and interest are payable monthly commencing six months after the disbursement date and may be prepaid by the Company at any time prior to maturity with no prepayment penalties. We did not provide any collateral or guarantees for the Loan, nor did we pay any facility charge to obtain the Loan.

## 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 financial statements and related notes included in this Quarterly Report on Form 10-Q ("Quarterly Report") and the audited condensed financial statements and notes thereto as of and for the year ended December 31, 2019 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 26, 2020 (the "2019 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 and involve known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance or achievements 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. Given the risks and uncertainties surrounding forward-looking statements, you should not place undue reliance on these statements. 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 contain forward-looking statements attributable to third parties relating to their estimates regarding the growth of our markets. You are cautioned that such forward-looking statements are not guarantees of future performance and that all forward-looking statements address matters that involve risk and uncertainties, and that there are many important risks, uncertainties and other factors that could cause our actual results, levels of activity, performance, achievements and prospects, as well as those of the markets we serve, to differ materially from the forward-looking statements contained in this Quarterly Report.

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

- Our ability to successfully manage the demand, supply, and operational challenges associated with the effects of the novel coronavirus (COVID-19) pandemic and its effects on the global economy generally.
- Our history of losses;
- Our dependence on our largest manufacturing customers;
- Potential disruptions in our ability to manufacture our products and those of others or our access to raw materials;
- Seasonal fluctuations in demand for the products we manufacture at our manufacturing facility;
- Our ability to successfully develop and commercialize our existing products and any new products;
- Our ability to secure additional capital, when needed, to support our product development and commercialization programs;
- Our ability to compete effectively, including our ability to maintain and increase our markets and/or market share in the markets in which we do business;
- Our ability to protect our proprietary rights;
- The general financial and economic uncertainty, fluctuations in consumer confidence and the strength of the United States economy, and their impacts on our business including demand for our products;
- Our continued ability to comply with regulations relating to our current products and those we manufacture for others, any new products we develop, including our ability to effectively respond to changes in laws and regulations or the interpretation thereof including changing market rules and evolving federal, state and regional laws and regulations; and
- Our ability to attract, retain and motivate our key employees.

You should also consider carefully the statements we make under other sections of this Quarterly Report and in our 2019 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 manufacturing and marketing company with deep experience with OTC consumer healthcare products and dietary supplements. We are engaged 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.

Our wholly-owned subsidiary, Pharnaloz 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.

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

## **Financial Condition and Results of Operations Results for the Three Months Ended March 31, 2020 as Compared to the Three Months Ended March 31, 2019**

For the three months ended March 31, 2020, net sales were \$1.9 million as compared to \$2.3 million for the three months ended March 31, 2019. The decrease in net sales from period to period was principally due to a decrease in contract manufacturing net sales as a result of the timing and demand of third-party customers.

Cost of sales for the three months ended March 31, 2020 were \$1.5 million as compared to \$1.8 million for the three months ended March 31, 2019. For the three months ended March 31, 2020 and 2019, we realized a gross margin of 22.0% and 22.4%, respectively. The decrease of 0.4% in gross margin from the prior period is principally due to fluctuations in our product mix shipped and pricing fluctuations from period to period. Gross margins are generally 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.

Sales and marketing expense for the three months ended March 31, 2020 was \$170,000 as compared to \$266,000 for the three months ended March 31, 2019. The decrease of \$96,000 in sales and marketing expense for the three months ended March 31, 2020 as compared to the three months ended March 31, 2019 was principally due to reduction of TK product launch costs that are no longer significant.

Administration expenses for the three months ended March 31, 2020 were \$1 million as compared to \$1.2 million for the three months ended March 31, 2019. The decrease of \$0.2 million in administrative expenses for the three months ended March 31, 2020 as compared to the three months ended March 31, 2019 was principally due to a decrease in professional fees.

Research and development costs during the three months ended March 31, 2020 were \$59,000, as compared to \$94,000 for the three months ended March 31, 2019. The decrease of \$35,000 in research and development costs for the three months ended March 31, 2020 as compared to the three months ended March 31, 2019 was principally due to the timing of product research expenses in the current period.

Interest and other income for the three months ended March 31, 2020 and 2019 was \$3,000 and \$31,000, respectively. The decrease in interest income for the three months ended March 31, 2020 as compared to March 31, 2019 was principally due to less interest earned on our investment account in the current period due to decline in the overall investment balance.

As a consequence of the effects of the above, the net loss for the three months ended March 31, 2020 was approximately \$0.8 million, or (\$0.07) per share, as compared to the net loss for the three months ended March 31, 2019 of \$1.0 million, or (\$0.09) per share.

## **Liquidity and Capital Resources**

Our aggregate cash and cash equivalents and marketable debt securities as of March 31, 2020 were \$1.5 million as compared to \$1.4 million at December 31, 2019. Our working capital was \$8.4 million and \$9.0 million as of March 31, 2020 and December 31, 2019, respectively. The increase of \$0.1 million in our cash and cash equivalents and marketable debt securities balance for the three months ended March 31, 2020 was principally due to an increase in cash provided by operating activities.

## General

We believe our current working capital is an acceptable and adequate level of working capital to support our business for at least the next twelve months.

As described in Part I, Item 1, Note 10 “Subsequent Events,” on May 4, 2020, the final pending claim against the Company’s escrow account with Mylan was resolved and, as a consequence, the Escrow Agent released all funds from the escrow account to the Company on May 7, 2020, in the amount of \$4.8 million.

In addition, to help ensure adequate liquidity in light of the uncertainties posed by the COVID-19 pandemic, on May 3, 2020, we entered into a promissory note and agreement (the “Note”) with Wells Fargo, N.A. for an aggregate principal amount of \$295,250 (the “Loan”), pursuant to the Paycheck Protection Program under the recently enacted Coronavirus Aid, Relief, and Economic Security Act.

The Loan matures two years from the disbursement date and bears interest at a rate of 1.000% per annum, with the first six months of interest deferred. Principal and interest are payable monthly commencing six months after the disbursement date and may be prepaid by the Company at any time prior to maturity with no prepayment penalties. We did not provide any collateral or guarantees for the Loan, nor did we pay any facility charge to obtain the Loan.

Pursuant to the terms of the Note, all or a portion of the Loan may be forgiven to the extent the proceeds are used for payroll costs, including payments required to continue group health care benefits, and certain rent, utility, and mortgage interest expenses (collectively, “Qualifying Expenses”). The Company intends to the Loan for Qualifying Expenses. However, no assurance can be provided that the Company will obtain forgiveness of the Loan in whole or in part.

Management is not aware of any other trends, events or uncertainties that have or are reasonably likely to have a material negative impact upon our (i) short-term or long-term liquidity, or (ii) net sales or income from operations. Any challenge to our patent or trademark rights could have a material adverse effect on our future; however, we are not aware of any condition that would make such an event probable. Our business is subject to seasonal variations thereby impacting our liquidity and working capital during the course of our fiscal year.

To the extent that we do not generate sufficient cash from operations, our cash balances will decline. We may also use our cash to explore and/or acquire new product technologies, applications, product line extensions, new contract manufacturing applications and other new product opportunities. In the event that our available cash is insufficient to support such initiatives, we may need to incur indebtedness or issue Common Stock to finance plans for growth. Volatility in the credit markets and the liquidity of major financial institutions may have an adverse effect on our ability to fund our business strategy through borrowings, under either existing or newly created instruments in the public or private markets on terms that we believe to be reasonable, if at all.

### **Off-Balance Sheet Arrangements**

It is not our usual business practice to enter into off-balance sheet arrangements such as guarantees on loans and financial commitments and retained interests in assets transferred to an unconsolidated entity for securitization purposes. We have no off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### **Impact of Inflation**

We are subject to normal inflationary trends and anticipate that any increased costs would be passed on to our customers. Inflation has not had a material effect on our business.

### **Critical Accounting Policies and Estimates**

The condensed consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”), which require the use of estimates, judgments and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities at the date of the financial statements, and the reported amounts of expenses in the periods presented. We believe that the accounting estimates employed are appropriate and resulting balances are reasonable; however, due to inherent uncertainties in making estimates, actual results could differ from the original estimates, requiring adjustments to these balances in future periods. The critical accounting estimates that affect the consolidated financial statements and the judgments and assumptions used are consistent with those described under Part II, Item 7 of the 2019 Annual Report.

### **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, 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, 2019.

#### **Item 4. Controls and Procedures.**

##### Disclosure Controls and Procedures

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 March 31, 2020. This evaluation was carried out under the supervision and with the participation of our Principal Executive Officer and Principal Financial and Accounting Officer. Based upon that evaluation, our Principal Executive Officer and Principal Financial and Accounting Officer concluded that our disclosure controls and procedures were effective as of March 31, 2020.

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.

##### Changes in Internal Control Over Financial Reporting

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.**

In the normal course of our business, we are named as a defendant in legal proceedings. It is our policy to vigorously defend litigation and/or enter into settlements of claims where management deems appropriate.

On November 12, 2019, an action was filed in the United States District Court for the Eastern District of Texas against TK Supplements, Inc., one of our wholly-owned subsidiaries ("TK Sub"), asserting two class claims and alleging that, by sending plaintiff text messages to his cellular telephone number without his prior express consent and notwithstanding its listing on the Do No Call Registry, TK Sub violated the Telephone Consumer Protection Act, 47 U.S.C. § 227(b)(3)(B) and 47 U.S.C. § 227(c) (5). Plaintiff seeks to represent a class of (i) all residents within the United States to whom TK Sub or its agents sent text messages to the person's cellular telephone number in the past four years and (ii) all residents within the United States to whom TK Sub or its agents placed two or more telemarketing phone calls to the person's residential telephone number that was listed on the Do Not Call Registry in the past four years. On January 8, 2020, TK Supplements filed its Answer and Defenses to the Complaint. We intend to defend this matter vigorously.

#### **Item 1A. Risk Factors.**

There have been no material changes to the risks described in Item 1A. Risk Factors of the 2019 Annual Report.

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

None

#### **Item 3. Defaults Upon Senior Securities.**

None

#### **Item 4. Mine Safety Disclosures.**

Not applicable

**Item 5. Other Information.**

None

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
31.1	<a href="#"><u>Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u></a>
31.2	<a href="#"><u>Certification by the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u></a>
32.1	<a href="#"><u>Certification by the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u></a>
32.2	<a href="#"><u>Certification by the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u></a>
101.INS#	XBRL Instance Document
101.SCH#	XBRL Taxonomy Extension Schema Document
101.CAL#	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF#	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB#	XBRL Taxonomy Extension Label Linkbase Document
101.PRE#	XBRL Taxonomy Extension Presentation Linkbase 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: May 12, 2020

By: /s/ Monica Brady  
Monica Brady  
Chief Financial Officer  
(Principal Financial Officer)

Date: May 12, 2020

**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: May 12, 2020

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

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

I, Monica Brady, 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: May 12, 2020

By: /s/ Monica Brady  
Monica Brady  
Chief Financial Officer  
(Principal Financial Officer)

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**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 March 31, 2020, 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*

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Ted Karkus  
Chairman of the Board and Chief Executive Officer  
(Principal Executive Officer)  
May 12, 2020

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**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, Monica Brady, 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 March 31, 2020, 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/ Monica Brady*

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Monica Brady  
Chief Financial Officer  
(Principal Financial Officer)  
May 12, 2020

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