FORM 10-Q

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

(Mark One)

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

For the quarterly period ended June 30, 2011

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)

Nevada	23-2577138
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

621 North Shady Retreat Road, Doylestown, Pennsylvania 18901
(Address of principal executive office) (Zip Code)

(215) 345-0919
(Registrant's telephone number, including area code)

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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 at August 12, 2011
Common Stock, $0.0005 par value	15,281,146

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)

	June 30, 2011	December 31, 2010
ASSETS		
Cash and cash equivalents (Note 2)	$ 8,743	$ 8,232
Accounts receivable, net of doubtful accounts of $10 and $13 respectively (Note 2)	1,162	4,821
Inventory, net (Note 2)	1,594	1,682
Prepaid expenses and other current assets	298	883
Assets held for sale (Note 2)	-	138
Total current assets	11,797	15,756
Intangible asset, licensed technology (Note 3)	3,577	3,577
Property, plant and equipment, net of accumulated depreciation of $3,583 and $3,389, respectively (Note 2)	2,372	2,362
	$ 17,746	$ 21,695
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Accounts payable	$ 131	$ 489
Accrued royalties (Note 4)	3,524	3,524
Accrued advertising and other allowances	1,802	3,524
Other current liabilities	331	698
Total current liabilities	5,788	8,235
Commitments and contingencies (Note 4)	-	-
STOCKHOLDERS' EQUITY:		
Common Stock, $.0005 par value; authorized 50,000,000; issued: 19,862,869 and 19,353,672 shares, respectively (Note 5)	10	10
Additional paid-in-capital	41,112	40,627
Accumulated deficit	(3,976)	(1,989)
Treasury stock, at cost, 4,646,053 and 4,646,053 shares, respectively	(25,188)	(25,188)
Total stockholders' equity	11,958	13,460
	$ 17,746	$ 21,695

See accompanying notes to condensed consolidated financial statements

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

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Net sales (Note 2)	$ 1,744	$ 1,131	$ 4,910	$ 3,107
Cost of sales (Note 2)	848	660	2,020	1,466
Gross profit	896	471	2,890	1,641
Operating expenses:				
Sales and marketing	663	780	2,218	1,514
Administration	1,040	1,819	2,285	3,231
Research and development	176	150	395	238
	1,879	2,749	4,898	4,983
Loss from operations	(983)	(2,278)	(2,008)	(3,342)
Interest and other income	9	24	21	26
Loss before income taxes	(974)	(2,254)	(1,987)	(3,316)
Income tax (benefit) (Note 6)	-	-	-	-
Net loss	$ (974)	$ (2,254)	$ (1,987)	$ (3,316)
Basic and diluted loss per share:				
Loss from operations	$ (0.06)	$ (0.15)	$ (0.13)	$ (0.24)
Net loss	$ (0.06)	$ (0.15)	$ (0.13)	$ (0.24)
Weighted average common shares outstanding:				
Basic and diluted	14,990	14,593	14,864	13,896

See accompanying notes to condensed consolidated financial statements

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

	Common Stock Shares	Par Value	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total
Balance at December 31, 2010	14,707,619	$ 10	$ 40,627	$ (1,989)	$ (25,188)	$ 13,460
Net loss		-	-	(1,987)	-	(1,987)
Share-based compensation expense		-	60	-	-	60
Common stock granted pursuant to employment agreements	444,347	-	344	-	-	344
Common stock granted pursuant to a compensation plan	64,850	-	81	-	-	81
Balance at June 30, 2011	15,216,816	$ 10	$ 41,112	$ (3,976)	$ (25,188)	$ 11,958

See accompanying notes to condensed consolidated financial statements

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

	Six Months Ended	
	June 30, 2011	June 30, 2010
Cash Flows from operating activities:		
Net loss	$ (1,987)	$ (3,316)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	194	167
Share-based compensation expense	191	35
Gain on sale of asset	(28)	-
Sales discounts and provision for bad debts	(54)	(105)
Inventory valuation provision	(20)	(823)
Changes in operating assets and liabilities:		
Accounts receivable	3,713	2,849
Inventory	108	1,075
Accounts payable	(358)	(476)
Accrued advertising and other allowances	(1,722)	(255)
Other operating assets and liabilities, net	512	194
Net cash provided by (used in) operating activities	549	(655)
Cash flows from investing activities:		
Capital expenditures	(204)	(116)
Proceeds from the sale of fixed assets	166	-
Acquisition of product license	-	(1,000)
Net cash flows used in investing activities	(38)	(1,116)
Cash flows from financing activities:		
Proceeds from exercise of stock options	-	133
Net cash provided by financing activities	-	133
Net increase (decrease) in cash and cash equivalents	511	(1,638)
Cash and cash equivalents at beginning of period	8,232	12,801
Cash and cash equivalents at end of period	$ 8,743	$ 11,163
Supplemental disclosures of cash flow information:		
Income taxes paid	$ -	$ -
Common stock issued to Phosphagenics Limited pursuant to a product license agreement	$ -	$ 2,577

See accompanying notes to condensed consolidated financial statements

Note 1 – Organization and Business

ProPhase Labs, Inc. (“we”, “us” or the “Company”), organized under the laws of the State of Nevada, is a manufacturer, marketer and distributor of a diversified range of homeopathic and health products that are offered to the general public. We are also engaged in the research and development of potential over-the-counter (“OTC”) drug, natural base health products along with supplements, personal care and cosmeceutical products.

Our primary business is currently the manufacture, distribution, marketing and sale of OTC cold remedy products to consumers through national chain, regional, specialty and local retail stores. One of our principal products is Cold-EEZE®, a zinc gluconate glycine product proven in clinical studies to reduce the duration and severity of the common cold symptoms by nearly half. Cold-EEZE® is an established product in the health care and cold remedy market. For the three and six months ended June 30, 2011 and 2010, our revenues from continuing operations have come principally from our OTC cold remedy products.

On March 22, 2010, the Company, Phosphagenics Limited (“PSI Parent”), an Australian corporation, Phosphagenics Inc. (“PSI”), a Delaware corporation and subsidiary of PSI Parent, and Phusion Laboratories, LLC (the “Joint Venture”), a Delaware limited liability company, entered into a Limited Liability Company Agreement (the “LLC Agreement”) of the Joint Venture and additional related agreements for the purpose of developing and commercializing, for worldwide distribution and sale, a wide range of non-prescription remedies using PSI Parent’s proprietary patented TPM™ technology (“TPM”). TPM facilitates the delivery and depth of penetration of active molecules in pharmaceutical, nutraceutical, and other products. Pursuant to the LLC Agreement, we and PSI each own a 50% membership interest in the Joint Venture (see Note 3).

We use a December 31 year-end for financial reporting purposes. References herein to the fiscal year ended December 31, 2011 shall be the term “Fiscal 2011” 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.

Our balance sheet at December 31, 2010 has been reclassified to conform to our current period ended June 30, 2011 presentation.

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 within 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 generally accepted accounting principles. The accompanying unaudited condensed consolidated financial statements have been prepared by management without audit and should be read in conjunction with our consolidated financial statements, including the notes thereto, appearing in our Annual Report on Form 10-K for the year ended December 31, 2010. 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 and six months ended June 30, 2011 are not necessarily indicative of operating results that may be achieved over the course of the full year.

Note 2 – Summary of Significant Accounting Policies - continued

Seasonality of the Business

Our net sales are derived principally from our OTC cold remedy products. Currently, our sales are influenced by and subject to fluctuations in the timing of purchase and the ultimate level of demand for our products which are a function of the timing, length and severity of each cold season. Generally, a cold season is defined as the period of 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 fourth quarter higher levels of net sales along with a corresponding increase in marketing and advertising expenditures designed to promote our products during the cold season. Revenues and related marketing costs are generally at their lowest levels in the second quarter when consumer demand generally declines and retail customers balance their inventory positions as cold season consumer demand subsides. We track health and wellness trends and develop retail promotional strategies to align our production scheduling, inventory management and marketing programs to optimize consumer purchases.

Use of Estimates

The preparation of financial statements and the accompanying notes thereto, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect our reported amounts of assets and liabilities, 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 and intangible assets, impairment of property and equipment and intangible assets, income tax valuations and assumptions related to accrued advertising. 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 the accounting policies, assumptions, estimates and judgments on a quarterly basis. Actual results could differ from those estimates.

Our primary product, Cold-EEZEÒ, utilizes a proprietary zinc formulation which has been clinically proven to reduce the severity and duration of common cold symptoms. Factors considered in estimating the appropriate sales returns and allowances for this product include it being (i) a unique product with limited competitors, (ii) competitively priced, (iii) promoted, (iv) unaffected for remaining shelf-life as there is no product expiration date and (v) monitored for inventory levels at major customers and third-party consumption data. In addition to Cold-EEZE®, we market and distribute Kids-EEZE® Chest Relief, Kids-EEZE® Cough Cold and Kids-EEZE® Allergy children OTC cold remedies (“Kids-EEZE® Products”). We introduced Kids-EEZE® Chest Relief in Fiscal 2008 and expanded the product line to include Kids-EEZE® Cough Cold and Kids-EEZE® Allergy in Fiscal 2010. We also manufacture, market and distribute an organic cough drop and a Vitamin C supplement (“Organix”). Each of the Kids-EEZE® Products and Organix® products do carry shelf-life expiration dates for which we aggregate such new product market experience data and update its sales returns and allowances estimates accordingly. Sales allowances estimates are tracked at the specific customer and product line levels and are tested on an annual historical basis, and reviewed quarterly. Additionally, we monitor current developments by customer, market conditions and any other occurrences that could affect the expected provisions relative to net sales for the period presented.

Cash Equivalents

We consider all highly liquid investments with an initial 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.

Note 2 – Summary of Significant Accounting Policies - continued

Inventory Valuation

Inventory is valued at the lower of cost, determined on a first-in, first-out basis ("FIFO"), or market. Inventory items are analyzed to determine cost and the market value and, if appropriate, an inventory write-down to market (adjusted basis) is charged to operations in the applicable period. At June 30, 2011 and December 31, 2010, inventory included raw material, work in progress and packaging amounts of $592,000 and $742,000, respectively, and finished goods of $1.0 million and $940,000, respectively.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. We use a combination of straight-line and accelerated methods in computing depreciation for financial reporting purposes. Depreciation expense is computed in accordance with the following ranges of estimated asset lives: building and improvements - twenty to thirty-nine years; machinery and equipment - three to seven years; computer software - three years; and furniture and fixtures – five years.

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 drug, personal care or other products in order to continue 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. Our OTC cold remedyproducts 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 and trade accounts receivable.

We maintain cash and cash equivalents with certain major financial institutions. As of June 30, 2011, our cash balance was $8.7 million and bank balance was $9.1 million. Of the total bank balance, $902,000 was covered by federal depository insurance and $8.2 million was uninsured.

Trade accounts receivable potentially subjects 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 broad range of customers includes many large wholesalers, mass merchandisers and multi-outlet pharmacy and chain drug 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. Customers comprising the five largest accounts receivable balances represented approximately 47% and 51% of total trade receivable balances at June 30, 2011 and December 31, 2010, respectively.

Note 2 – Summary of Significant Accounting Policies - continued

Our revenues are principally generated from the sale of OTC cold remedy products which represented approximately 94% and 95% of total revenues for the six months ended June 30, 2011 and 2010, respectively. A significant portion of our business is highly seasonal, which causes major variations in operating results from quarter to quarter. The third and fourth quarters generally represent the largest sales volume for the OTC cold remedy products. For the three and six months ended June 30, 2011 and 2010, effectively all of our net sales were related to domestic markets.

Long-lived Assets

We review our 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 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.

The fair value of the reported *Assets Held For Sale* at December 31, 2010 of $138,000 was arrived at through bids generated from interested third party purchasers and guidance from a third party real estate advisor thereby relating to Level 3 fair value hierarchy. In February 2011, we derived net proceeds from the sale of these assets of $166,000.

Fair Value of Financial Instruments

We categorize our financial instruments into a three-level fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument.

Financial assets recorded at fair value on our consolidated balance sheets are categorized as either (i) Level 1: unadjusted quoted prices for identical assets in an active market, (ii) Level 2: quoted prices in markets that are not active or inputs that are observable either directly or indirectly for substantially the full-term of the asset or (iii) Level 3: prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement.

Note 2 – Summary of Significant Accounting Policies - continued

Cash and cash equivalents, accounts receivable and accounts payable are reflected in the Condensed Consolidated Financial Statements at carrying value which approximates fair value because of the short-term maturity of these instruments. Determination of fair value of related party payables, if any, is not practicable due to their related party nature.

Revenue Recognition

Sales are recognized at the time ownership is transferred to the customer. Revenue is reduced for trade promotions, estimated sales returns, cash discounts and other allowances in the same period as the related sales are recorded. 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.

We do not impose a period of time within which product may 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 only accept return requests for product 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.

As of June 30, 2011 and December 31, 2010, we included a provision for sales allowances of $54,000 and $106,000, respectively, which are reported as a reduction to account receivables. We also included an estimate of the uncollectability of our accounts receivable as an allowance for doubtful accounts of $10,000 and $13,000 as of June 30, 2011 and December 31, 2010, respectively. Additionally, accrued advertising and other allowances as of June 30, 2011 include $1.1 million for estimated future sales returns, $537,000 for cooperative incentive promotion costs and $159,000 for certain other advertising and marketing promotions. As of December 31, 2010 accrued advertising and other allowances included $1.5 million for estimated future sales returns, $1.2 million for cooperative incentive promotion costs and $828,000 for certain other advertising and marketing promotions.

Shipping and Handling

Product sales carry shipping and handling charges to the purchaser, included as part of the invoiced price, which is classified as revenue. In all cases, costs related to this revenue are recorded in cost of sales.

Stock 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.

Note 2 – Summary of Significant Accounting Policies - continued

Stock options for purchase of our common stock, $0.0005 par value, ("Common Stock") have been granted to both employees and non-employees. 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 June 30, 2011 and 2010, we charged to operations an aggregate of $107,000 and $13,000, respectively, for share-based compensation expense for the grant of stock and stock options pursuant to our stock option plans and certain employment arrangements (see Note 5). For the six months ended June 30, 2011 and 2010, we charged to operations an aggregate of $191,000 and $35,000, respectively, for share-based compensation expense for the grant of stock and stock options pursuant to our stock option plans and certain employment arrangements

Variable Interest Entity

The Joint Venture, of which we own a 50% membership interest since March 22, 2010, qualifies as a variable interest entities ("VIE") and we have consolidated the Joint Venture beginning with the quarter ended March 31, 2010 (see Note 3).

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 media advertising, presented as part of sales and marketing expense, cooperative incentive promotions and coupon program expenses, which are accounted for as part of net sales, and free product, which is accounted for as part of cost of sales. Advertising and incentive promotion costs incurred for the three months ended June 30, 2011 and 2010 were $555,000 and $633,000, respectively. Advertising and incentive promotion costs incurred for the six months ended June 30, 2011 and 2010 were $2.2 million and $1.4 million, respectively. Included in prepaid expenses and other current assets was zero and $189,000 at June 30, 2011 and December 31, 2010, respectively, relating to prepaid advertising and promotion expense.

Research and Development

Research and development costs are charged to operations in the period incurred. Research and development costs for the three months ended June 30, 2011 and 2010 were $176,000 and $150,000, respectively. Research and development costs for the six months ended June 30, 2011 and 2010 were $395,000 and $238,000, respectively. Research and development costs are principally related to new product development initiatives and costs associated with our OTC cold remedy products.

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 (see Note 6).

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 uncertain tax positions will be recorded as interest or administrative expense, respectively.

Note 2 – Summary of Significant Accounting Policies - continued

As a result of our continuing tax losses, we have recorded a full valuation allowance against a net deferred tax asset. Additionally, we have not recorded a liability for unrecognized tax benefits. The tax years 2004 through 2010 remain open to examination by the major taxing jurisdictions to which we are subject.

Recently Issued Accounting Standards

In November 2008, the SEC issued for comment a proposed roadmap regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board ("IASB"). The proposed roadmap has since been superseded by an SEC work plan and no date is currently proposed that we could be required to prepare financial statements in accordance with IFRS. The SEC has targeted late 2011 to make a determination regarding the mandatory adoption of IFRS. We are currently assessing the impact that this potential change would have on our consolidated financial statements and we will continue to monitor the development of the potential implementation of IFRS.

In June 2011, the Financial Accounting Standards Board issued Accounting Standards Update No. 2011-05, "Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income," ("ASU 2011-05") which amends current comprehensive income guidance. This accounting update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. Instead, comprehensive income must be presented in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. ASU 2011-05 will be effective for fiscal periods beginning after December 15, 2011 with early adoption permitted. The adoption of ASU 2011-05 will not have a material impact on our consolidated financial position, results of operations or cash flows.

Note 3 – Investment in Phusion Laboratories, LLC.

On March 22, 2010, the Company, PSI Parent, PSI and the Joint Venture entered into the LLC Agreement of the Joint Venture and additional related agreements for the purpose of developing and commercializing, for worldwide distribution and sale, a wide range of non-prescription remedies using PSI Parent's proprietary patented TPM.

In connection with the LLC Agreement, PSI Parent granted to us, pursuant to the terms of a License Agreement, dated March 22, 2010 (the "Original License Agreement"), (i) an exclusive, royalty-free, world-wide (subject to certain limitations), paid-up license to exploit OTC drugs and certain other products that embody certain of PSI Parent's TPM-related patents and related know-how (collectively, the "PSI Technology") and (ii) a non-exclusive, royalty-free, world-wide (subject to certain limitations), paid-up license to exploit certain compounds that embody the PSI Technology for use in a product combining one or more of such compounds with an OTC drug or in a product that is part of a regimen that includes the application of an OTC drug.

Note 3 – Investment in Phusion Laboratories, LLC. – continued

Pursuant to the Original License Agreement, we issued 1,440,000 shares of our Common Stock having an aggregate value of approximately $2.6 million to PSI Parent (such shares, the "PSI Shares"), and made a one-time payment to PSI Parent of $1.0 million. PSI Parent has agreed, pursuant to a Share Transfer Restriction Agreement, dated March 22, 2010 (the "Share Transfer Restriction Agreement"), between us and PSI Parent, that, with certain exceptions, it will not sell or otherwise dispose of any of the PSI Shares prior to June 1, 2012. The PSI Shares were issued pursuant to an exemption from registration under the Securities Act, by virtue of Section 4(2) of the Securities Act and by virtue of Rule 506 of Regulation D under the Securities Act. Such sale and issuance did not involve any public offering and was made without general solicitation or advertising. Additionally, PSI Parent represented to us, among other things, that PSI Parent is not a US Person (as defined in Regulation S under the Securities Act), that PSI Parent is an accredited investor with access to all relevant information necessary to evaluate its investment and that the PSI Shares were being acquired for investment purposes only.

In accordance with a Contribution Agreement, dated March 22, 2010 (the "Contribution Agreement"), by and among us, PSI Parent, PSI, and the Joint Venture, we transferred, conveyed and assigned to the Joint Venture all of our rights, title and interest in, to and under the Original License Agreement, and the Joint Venture assumed, and undertook to pay, discharge and perform when due, all of our liabilities and obligations under and arising pursuant to the Original License Agreement (such actions, collectively, the "Assignment and Assumption").

Pursuant to the Contribution Agreement and in order to reflect the Assignment and Assumption, we, PSI Parent and the Joint Venture entered into an Amended and Restated License Agreement, dated March 22, 2010 (the "Amended License Agreement"), which amends and restates the Original License Agreement to reflect that the Joint Venture is the licensee thereunder and which otherwise contains substantially the same terms as the Original License Agreement. The Joint Venture has the right to grant one or more sub-licenses of the rights granted under the Amended License Agreement to one or more third parties for reasonable consideration in any part of the applicable territory. The Amended License Agreement provides that PSI Parent shall not, directly or through third parties, exploit the covered intellectual property during the term thereof, subject to certain limitations. The Amended License Agreement will remain in effect until the expiration of the last to expire of the patents included within the PSI Technology or any extensions thereof. Either party may terminate the Amended License Agreement upon written notice to the other party in the event of certain events involving bankruptcy or insolvency. The Amended License Agreement also contains, among other things, provisions concerning the treatment of confidential information, the ownership of intellectual property and indemnification obligations.

Pursuant to the LLC Agreement, we and PSI each own a 50% membership interest in the Joint Venture. PSI Parent will conduct and oversee much of the product development, formulation, testing and other research and development needed by the Joint Venture, and we will oversee much of the production, distribution, sales and marketing. The LLC Agreement provides that each member may be required, from time to time and subject to certain limitations, to make capital contributions to the Joint Venture to fund its operations, in accordance with agreed upon budgets for products to be developed. Specifically we contributed in Fiscal 2010 $500,000 in cash as initial capital and we are committed to fund up to $2.0 million, subject to agreed upon budgets (which have not been established to date), toward the initial development and marketing costs of new products for the Joint Venture. The newly formed Joint Venture has not engaged in any financial transactions, other than organizational expenses and general market and product analysis. At June 30, 2011, cash and equivalents includes $425,000 which is expected to be used by the Joint Venture to fund future product development initiatives currently under consideration by PSI Parent, PSI and us.

The Joint Venture is managed by a four-person Board of Managers, with two managers appointed by each member. The LLC Agreement contains other normally found terms in such arrangements, including provisions relating to governance of the Joint Venture, indemnification obligations of the Joint Venture, allocation of profits and losses, the distribution of funds to the members and restrictions on transfer of a member's interest.

Note 3 – Investment in Phusion Laboratories, LLC. – continued

Our initial determination is that the Joint Venture qualifies as a VIE and that we are the primary beneficiary. As a consequence, we have consolidated the Joint Venture financial statements beginning with the quarter ended March 31, 2010. Since inception and including the six months ended June 30, 2011, the newly formed Joint Venture has not engaged in any financial transactions, other than certain organizational expenses and general market and product analysis, as formal operations are not expected to commence until later in Fiscal 2011. Furthermore, the liabilities and other obligations incurred, if any, by the Joint Venture is without recourse to us and do not create a claim on our general assets. At June 30, 2011, we have recorded the $3.6 million payment representing the estimated fair value to acquire the product license as an intangible asset. We currently estimate the expected useful life of the product license to be approximately 11 years which we will begin amortizing the cost of intangible asset once production commercialization is completed with PSI Parent and the OTC drug products begin to ship to our retail customers. As of June 30, 2011, we have not established a formal commercialization program timeline for any specific OTC drug covered under the product license but we do not project that any OTC drug products will be available for shipment within the next twelve months.

Note 4 – Commitments and Contingencies

We have maintained a separate representation and distribution agreement relating to the development of the zinc gluconate glycine product formulation. In return for exclusive distribution rights, we agreed to pay the developer a 3% royalty and a 2% consulting fee based on sales collected, less certain deductions, throughout the term of this agreement, which expired in May 2007. However, we and the developer are in litigation and as such no potential offset from such litigation for these fees have been recorded. The amount accrued for this expense at each of June 30, 2011 and December 31, 2010 is $3.5 million.

We have estimated future obligations over the next five years, including the remainder of Fiscal 2011, as follows (in thousands):

Fiscal Year	Employment Contracts	Total
2011	$ 538	$ 538
2012	1,075	1,075
2013	-	-
2014	-	-
2015		
Total	$ 1,613	$ 1,613

Note 5 – Transactions Affecting Stockholders' Equity

Stockholder Rights Plan

On September 8, 1998, our Board of Directors declared a dividend distribution of Common Stock Purchase Rights (each individually, a "Right" and collectively, the "Rights") payable to the stockholders of record on September 25, 1998, thereby creating a Stockholder Rights Plan (the "Rights Agreement"). The Plan was amended effective May 23, 2008 ("First Amendment") and further amended effective August 18, 2009 ("Second Amendment"). The Rights Agreement, as amended, provides that each Right entitles the stockholder of record to purchase from the Company that number of common shares having a combined market value equal to two times the Rights exercise price of $45. The Rights are not exercisable until the distribution date, which will be the earlier of a public announcement that a person or group of affiliated or associated persons has acquired 15% or more of the outstanding common shares, or the announcement of an intention by a similarly constituted party to make a tender or exchange offer resulting in the ownership of 15% or more of the outstanding common shares. The dividend has the effect of giving the stockholder a 50% discount on the share's current market value for exercising such right. In the event of a cashless exercise of the Right, and the acquirer has acquired less than 50% beneficial ownership of the Company, a stockholder may exchange one Right for one common share of the Company. The Rights Agreement, as amended, includes a provision pursuant to which our Board of Directors may exempt from the provisions of the Rights Agreement an offer for all outstanding shares of our Common Stock that the directors determine to be fair and not inadequate and to otherwise be in the best interests of the Company and its stockholders, after receiving advice from one or more investment banking firms. The expiration date of the Rights Agreement, as amended, is September 25, 2018.

Equity Compensation Plans

Our shareholders have approved and we maintain three different equity compensation plans, (i) the 1997 Option Plan, as amended, (the "1997 Plan"), (ii) the 2010 Equity Compensation Plan, as amended, (the "2010 Plan") and (iii) the 2010 Directors Equity Compensation Plan (the "Directors' Plan"), together known as our "Equity Compensation Plans".

The 1997 Plan, which was amended in 2005, provided for the granting of up to 4.5 million shares of Common Stock. Under the 1997 Plan, we were permitted to grant options to employees, officers or directors of the Company at variable percentages of the market value of stock at the date of grant. No incentive stock option could be exercisable more than ten years after the date of grant or five years after the date of grant where the individual owns more than ten percent of the total combined voting power of all classes of stock. At December 31, 2009, we are precluded from issuing any additional options or grants in the future under the 1997 Plan pursuant to the terms of the plan document. Options previously granted continue to be available for exercise at any time prior to such options' respective expiration dates, but in no event later than ten years from the date granted. At June 30, 2011, there are 207,250 options outstanding under the 1997 Plan with various expiration dates ranging from October 2011 through December 2015, depending upon the date of grant.

The 2010 Plan provides that the total number of shares of Common Stock, as adjusted, that may be issued is equal to an aggregate of 1.8 million shares. All of our employees, including employees who are officers or members of the Board are eligible to participate in the 2010 Plan. Consultants and advisors who perform services for us are also eligible to participate in the 2010 Plan.

Note 5 – Transactions Affecting Stockholders' Equity – continued

Stock Options and Stock Grants Pursuant to Equity Compensation Plans

On April 21, 2011, the Compensation Committee of the Board of Directors approved an amendment to Chief Executive Officer Ted Karkus' employment agreement, dated August 19, 2009 (the "**Amendment**") to lower his annual salary by $150,000 (or $12,500 per month) in exchange for a grant of restricted stock equal in value to the salary reduction. Pursuant to the Amendment, Mr. Karkus' annual base salary was decreased from $750,000 per year to $600,000 per year, effective May 1, 2011 thru July 15, 2012, which is the end of the term of his employment agreement, as amended. As a consequence of the Amendment, a restricted stock grant under the 2010 Plan equal to $12,500 of shares per month thru the end of the term (14.5 months). The restricted stock grant was made in an upfront grant of 161,830 shares, subject to certain future vesting conditions, at a value of $181,000 as of the grant date. The grant was made on April 21, 2011, and the amount of the shares issued was calculated based on the average closing price of our Common Stock for the last five (5) trading days prior to and including the issuance date of April 21, 2011. For the three months ended June 30, 2011, we have charged to operations $25,000 as share-based compensation expense for the restricted stock grant and we have unrecognized compensation expense of $156,000 at June 30, 2011 that will be charged to operations in equal monthly installments of $12,500 over the remaining vesting period ending July 15, 2012.

In addition, on April 21, 2011, the Compensation Committee of the Board of Directors granted Mr. Karkus 133,928 shares of Common Stock under the 2010 Plan as payment for his Fiscal 2010 bonus. Mr. Karkus agreed to accept his Fiscal 2010 cash bonus of $150,000 in shares of our Common Stock. Furthermore, Mr. Karkus agreed to convert into shares of our Common Stock $144,000 of deferred cash compensation owed to him thru April 2011, resulting in an issuance of 128,571 shares under the 2010 Plan. The amount of these shares issued to Mr. Karkus was calculated based on the average closing price of the Company's shares for the last five (5) trading days prior to and including the issuance dates of April 21, 2011. Furthermore in May 2011, we granted to certain employees 100,000 options to acquire our Common Stock under the 2010 Plan that vest over a four year period and at carry an exercise price of $1.08 per share.

At June 30, 2011, there are 1,077,000 options outstanding and subject to vesting over a three to six year period under the 2010 Plan. At June 30, 2011, 44,250 of such options have vested and 1,032,750 options are subject to vesting. At June 30, 2011, there are 298,671 shares available for future grant under the 2010 Plan. For the three months and six months ended June 30, 2011, we charged to operations $30,000 and $60,000, respectively, for share-based compensation expense relating to stock options. At June 30, 2011, the unrecognized share-based compensation expense related to stock options granted but not vested was approximately $586,000 which will be recognized over a weighted average period of approximately 4.6 years.

The 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 restricted 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 250,000. For the three months and six months ended June 30, 2011, we issued 32,560 and 64,850 shares, respectively, of our Common Stock valued at $40,000 and $81,000, respectively, for share-based director compensation expense. There was no share-based compensation expense related to the 2010 Directors' Plan for the six month ended June 30, 2010. At June 30, 2011, there are 117,525 shares available for future grant under the 2010 Directors' Plan.

Note 5 – Transactions Affecting Stockholders' Equity – continued

Stock Option Exercise and Other Grants

During the six months ended June 30, 2011 no options were exercised. For the six months ended June 30, 2010, we derived net proceeds of $133,000 as a consequence of the exercise of options to acquire 130,500 shares of our Common Stock.

Pursuant to the terms of Mr. Cuddihy's, our Chief Operating Officer and Chief Financial Officer, employment agreement, Mr. Cuddihy receives an annual grant of shares of Common Stock that is equal to $50,000, payable quarterly, promptly following the close of each quarter. For the three months ended June 30, 2011 and 2010, Mr. Cuddihy earned 15,170 and 9,045 shares, respectively, valued each at $12,500 as share-based compensation. For the six months ended June 30, 2011 and 2010, Mr. Cuddihy earned 25,220, and 15,295 shares, respectively, valued each at $25,000 as share-based compensation.

Note 6 – 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.

Certain exercises of options and warrants, and restricted stock issued for services that became unrestricted resulted in reductions to taxes currently payable and a corresponding increase to additional-paid-in-capital for prior years. In addition, certain tax benefits for option and warrant exercises totaling $6.9 million are deferred and will be credited to additional-paid-in-capital when our net operating loss carry-forward attributable to these exercises are utilized. Consequently, these net operating loss carryforward will not be available to offset our current income tax expense. As of December 31, 2010, we had net operating loss carry-forwards of approximately $28.7 million for federal purposes that will expire beginning in Fiscal 2018 through 2030. Additionally, there are net operating loss carry-forwards of $19.9 million for state purposes that will expire beginning Fiscal 2018 through 2030. 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, we have recorded a full valuation allowance equaling the total deferred tax asset at June 30, 2011 and December 31, 2010. As of June 30, 2011 and December 31, 2010, we have no unrecognized tax benefits.

The major jurisdiction for which we file income tax returns is the United States. The Internal Revenue Service ("IRS") has examined our tax year ended September 30, 2005 and has made no changes to the filed tax returns. The tax years 2006 and forward remain open to examination by the IRS. The tax years 2004 and forward remain open to examination by the various state taxing authorities to which we are subject.

Note 7 – Earnings (Loss) Per Share

Basic earnings per share is computed by dividing net income or loss to common stockholders by the weighted-average number of shares of our Common Stock outstanding for the period. Diluted earnings 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 earnings per share also utilizes 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 June 30, 2011 and 2010 were 1,284,250 and 453,250, respectively.

For the three and six months ended June 30, 2011 and 2010 dilutive earnings per share is the same as basic earnings per share due to (i) the inclusion of Common Stock, in the form of stock options and warrants ("Common Stock Equivalents"), would have an anti-dilutive effect on the loss per share or (ii) there were no Common Stock Equivalents for the respective period. For the three months ended June 30, 2011 and 2010, there were zero and 4,109 Common Stock Equivalents, respectively, which were in the money, that were excluded from the earnings per share computation. For the six months ended June 30, 2011 and 2010, there were 150,224 and 4,814 Common Stock Equivalents, respectively, which were in the money, that were excluded from the earnings per share computation.

A reconciliation of the applicable numerators and denominators of the income statement periods presented, as reflected in the results of continuing operations, is as follows (in thousands, except per share amounts):

	Three Months Ended June 30, 2011			Three Months Ended June 30, 2010			Six Months Ended June 30, 2011			Six Months Ended June 30, 2010		
	Income	Shares	EPS	Loss	Shares	EPS	Income	Shares	EPS	Loss	Shares	EPS
Basic loss per share	$ (974)	14,990	$ (0.06)	$ (2,254)	14,593	$ (0.15)	$ (1,987)	14,864	$ (0.13)	$ (3,316)	13,896	$ (0.24)
Dilutives:												
Options/Warrants	-	-	-	-	-	-	-	-	-	-	-	-
Diluted loss per share	$ (974)	14,990	$ (0.06)	$ (2,254)	14,593	$ (0.15)	$ (1,987)	14,864	$ (0.13)	$ (3,316)	13,896	$ (0.24)

Item 2. Managements Discussion and Analysis of Financial Condition and Results of Operations.

General

ProPhase Labs, Inc. ("we", "us" or the "Company"), organized under the laws of the State of Nevada, is a manufacturer, marketer and distributor of a diversified range of homeopathic and health products that are offered to the general public. We are also engaged in the research and development of potential over-the-counter ("OTC") drug, natural base health products along with supplements, personal care and cosmeceutical products.

Our primary business is currently the manufacture, distribution, marketing and sale of OTC cold remedy products to consumers through national chain, regional, specialty and local retail stores. One of our principal products is Cold-EEZEÒ, a zinc gluconate glycine product proven in clinical studies to reduce the duration and severity of the common cold symptoms by nearly half. Cold-EEZEÒ is an established product in the health care and cold remedy market. For the three and six months ended June 30, 2011 and 2010, our revenues from continuing operations have come principally from our cold remedy products.

Certain Risk Factors

Our business is regulated by various agencies of the states and localities where our products are sold. Governmental regulations in foreign countries where we plan to commence or expand sales may prevent or delay entry into a market or prevent or delay the introduction, or require the reformulation of certain of our products. In addition, no prediction can be made as to whether new domestic or foreign legislation regulating our activities will be enacted. Any new legislation could have a material adverse effect on our business, financial condition and operations. Non-compliance with any applicable requirements may subject us or the manufacturers of our products to agency action, including warning letters, fines, product recalls, seizures and injunctions.

The manufacturing, processing, formulation, packaging, labeling and advertising of our OTC cold remedy products are subject to regulation by several federal agencies, including (i) the FDA, (ii) the Federal Trade Commission ("FTC"), (iii) the Consumer Product Safety Commission, (iv) the United States Department of Agriculture, (v) the United States Postal Service, (vi) the United States Environmental Protection Agency and (vii) the United States Occupational Safety and Health Administration.

In addition to OTC and prescription drug products, the FDA regulates the safety, manufacturing, labeling and distribution of dietary supplements, including vitamins, minerals and herbs, food additives, food supplements and cosmetics. The FTC also has overlapping jurisdiction with the FDA to regulate the promotion and advertising of vitamins, OTC drugs, cosmetics and foods. In addition, certain of our OTC cold remedy products are homeopathic remedies which are subject to standards established by the Homeopathic Pharmacopoeia of the United States ("HPUS"). HPUS sets the standards for source, composition and preparation of homeopathic remedies which are officially recognized under the Federal Food, Drug and Cosmetics Act, as amended.

Preclinical development, clinical trials, product manufacturing, labeling, distribution and marketing of potential new products are also subject to federal and state regulation in the United States and other countries. Clinical trials and product marketing and manufacturing are subject to the rigorous review and approval processes of the FDA and foreign regulatory authorities. To obtain approval of a new drug product, a company must demonstrate through adequate and well-controlled clinical trials that the drug product is safe and effective for its intended use. Obtaining FDA and other required regulatory approvals is lengthy and expensive. Typically, obtaining regulatory approval for pharmaceutical products requires substantial resources and takes several years. The length of this process depends on the type, complexity and novelty of the product and the nature of the disease or other indication to be treated. Preclinical studies must comply with FDA regulations. Clinical trials must also comply with FDA regulations to ensure safety of the human subjects in the trial and may require large numbers of test subjects, complex protocols and possibly lengthy follow-up periods. Consequently, satisfaction of government regulations may take several years, may cause delays in introducing potential new products for considerable periods of time and may require imposing costly procedures upon our activities. If regulatory approval of new products is not obtained in a timely manner or not at all, we could be materially adversely affected. Even if regulatory approval of new products is obtained, such approval may impose limitations on the indicated uses for which the products may be marketed which could also materially adversely affect our business, financial condition and future operations.

Our Joint Venture is at its early stage of development where product and market research has been initiated and new product initiatives are being evaluated and prioritized for future development and commercialization. Prior to any new product being available for sale, substantial resources will have to be committed to commercialize a product which may include research, development, preclinical testing, clinical trials, manufacturing scale-up and regulatory approval. We face significant technological risks inherent in developing these products. The Joint Venture may require additional capital and/or may be subject to delays and/or ultimately unable to successfully implement its business plan and strategy to develop and commercialize one or more non-prescription remedies using certain patented and proprietary TPM™ technology ("TPM") that exploit certain compounds that embody the TPM for use in a product combining one or more of such compounds with an OTC drug. The commercialization and ultimate product market acceptance is subject to, among other influences, consumer purchasing trends, demand for our OTC drug, health and wellness trends, regulatory factors, retail acceptance and overall economic and market conditions. As a consequence, we may suspend or abandon some or all of our proposed new products before they become commercially viable. Even if we develop and obtain approval of a new product, if we cannot successfully commercialize it in a timely manner, our business and financial condition may be materially adversely affected.

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 capability and the requirements associated with the development of potential OTC drug and other medicinal products in order to continue to compete on a national and international level. Our business development is dependent on continued conformity with government regulations, a reliable information technology system capable of supporting continued growth and continued reliable sources for product and materials to satisfy consumer demand.

Readers should carefully review the risk factors described in other sections of this filing as well as in other documents we file from time to time with the Securities and Exchange Commission.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Our significant accounting policies are described in Note 2 of Notes to Condensed Consolidated Financial Statements included under Item 1 of this Part I. However, certain accounting policies are deemed "critical", as they require management's highest degree of judgment, estimates and assumptions. These accounting estimates and disclosures have been discussed with Audit Committee of our Board of Directors. A discussion of our critical accounting policies, 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:

Revenue Recognition – Sales Allowances

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 the accounting policies, assumptions, estimates and judgments on a quarterly basis. Actual results could differ from those estimates.

Our primary product, Cold-EEZEÒ, utilizes a proprietary formulation which has been clinically proven to reduce the severity and duration of common cold symptoms. Factors considered in estimating the appropriate sales returns and allowances for this product include it being (i) a unique product with limited competitors, (ii) competitively priced, (iii) promoted, (iv) unaffected for remaining shelf-life as there is no product expiration date and (v) monitored for inventory levels at major customers and third-party consumption data. In addition to Cold-EEZE®, we market and distribute Kids-EEZE® Chest Relief, Kids-EEZE® Cough Cold and Kids-EEZE® Allergy children OTC cold remedies ("Kids-EEZE® Products"). We introduced Kids-EEZE® Chest Relief in Fiscal 2008 and expanded the product line to include Kids-EEZE® Cough Cold and Kids-EEZE® Allergy in Fiscal 2010. We also manufacturer, market and distribute an organic cough drop and a Vitamin C supplement ("Organix"). Each of the Kids-EEZE® Products and Organix® products do carry shelf-life expiration dates for which we aggregate such new product market experience data and update its sales returns and allowances estimates accordingly. Sales Allowances estimates are tracked at the specific customer and product line levels and are tested on an annual historical basis, and reviewed quarterly. Additionally, the monitoring of current occurrences, developments by customer, market conditions and any other occurrences that could affect the expected provisions relative to net sales for the period presented are also performed.

Our return policy 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 product may 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 fall 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 item that it purchased directly from us. We will not accept return requests pertaining to customer inventory "Overstocking" or "Resets". We will only accept return requests for product 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 classify product returns into principally three categories, (i) non-routine returns, (ii) obsolete product and (iii) product mix realignment by certain of our customers. "Non-routine" returns are defined as product returned to us as a consequence of unanticipated circumstances principally due to (i) retail store closings or (ii) unexpected poor retail sell through to consumers causing us to discontinue the product. "Obsolete" returns are defined as product returned to us as a consequence of product shelf-life "use by" expiration date. "Product mix realignment" returns are defined as product returned to us due to initiatives by the trade to discontinue purchasing certain of our products. Product mix realignment returns are generally nominal and are frequently related to discontinued or soon to be discontinued products.

As of June 30, 2011 and December 31, 2010, we included a provision for sales allowances of $54,000 and $106,000, respectively, for other allowances which are reported as a reduction to account receivables. Additionally, accrued advertising and other allowances as of June 30, 2011 include $1.1 million for estimated future sales returns and $537,000 for cooperative incentive promotion costs and $159,000 for certain other advertising and marketing promotions. As of December 31, 2010, accrued advertising and other allowances included $1.5 million for estimated future sales returns, $1.2 million for cooperative incentive promotion costs and $828,000 for certain other advertising and marketing promotions. We also included an estimate of the uncollectability of our accounts receivable as an allowance for doubtful accounts of $10,000 and $13,000 as of June 30, 2011 and December 31, 2010, respectively.

A one percent deviation for these Sales Allowance provisions for the three months ended June 30, 2011 and 2010 would affect net sales by approximately $21,000 and $15,000, respectively. A one percent deviation for these Sales Allowance provisions for the six months ended June 30, 2011 and 2010 would affect net sales by approximately $59,000 and $40,000, respectively.

Income Taxes

As of December 31, 2010, we have net operating loss carry-forwards of approximately $28.7 million for federal purposes that will expire beginning in Fiscal 2018 through Fiscal 2030. Additionally, there are net operating loss carry-forwards of $19.9 million for state purposes that will expire beginning in Fiscal 2018 through Fiscal 2030. Until sufficient taxable income to offset the temporary timing differences attributable to operations and the tax deductions attributable to option, warrant and stock are assured, a valuation allowance equaling the total deferred tax asset is being provided. Management believes that this allowance is required due to the uncertainty of realizing these tax benefits in the future. The uncertainty arises largely due to substantial marketing and research and development costs.

Seasonality of the Business

Our sales are derived principally from our OTC cold remedy products. As a consequence, a significant portion of our business is highly seasonal, which causes major variations in operating results from quarter to quarter. The third and fourth quarters generally represent the largest sales volume for our OTC cold remedy products with a corresponding increase in marketing and advertising expenditures designed to promote our products during the Cold Season (defined below). In addition, our sales are influenced by and subject to fluctuations in the timing of purchase and the ultimate level of demand for our products which are a function of the timing, length and severity of each cold season. Generally, a cold season is defined as the period of September to March ("Cold Season") when the incidence of the common cold rises as a consequence of the change in weather and other factors. We track health and wellness trends and develop retail promotional strategies to align its production scheduling, inventory management and marketing programs to optimize consumer purchases.

Financial Condition and Results of Operations
Results from Operations for the Three Months Ended June 30, 2011
as Compared to the Three Months Ended June 30, 2010

For the three months ended June 30, 2011, net sales were $1.7 million as compared to $1.1 million for the three months ended June 30, 2010. For the three months ended June 30, 2011, net sales of OTC cold remedy products were $1.5 million as compared to net sales of $1.0 million for three months ended June 30, 2010. For the three months ended June 30, 2011 and 2010, our contract manufacturing operations generated net sales to third party customers of $197,000 and $96,000, respectively.

Net sales of OTC cold remedy products increased $513,000 for the three months ended June 30, 2011 as compared to the three months ended June 30, 2010 due principally to an increase in shipments to retailers from period to period. Data suggests that the highest incidence of upper respiratory disorders for the 2010-2011 Cold Season occurred principally from December 2010 to February 2011 as compared to the 2009-2010 Cold Season when such incidences occurred principally from October 2009 to December 2009. As a consequence, the timing, stocking and ultimate level of demand of our retailer purchases of our OTC cold remedy products was affected by the change in the timing and the comparative severity of the respective cold season as well as the effects of our expanded marketing efforts to increase consumer awareness and to influence purchase decisions.

Cost of sales for the three months ended June 30, 2011 were $848,000 as compared to $660,000 for the three months ended June 30, 2010. Our sales increased 54.2% during the three months ended June 30, 2011 as compared to the three months ended June 30, 2010 and we realized a gross margin of 51.4% and 41.7%, respectively. Our increase of 9.7% in gross margin is principally due to the net effect of (i) an increase in the absorption rate of fixed production overhead costs as a percentage of revenues as a consequence of increased shipments to retailers, offset by (ii) an increase in raw ingredient and packaging costs. Gross margins are principally 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, if any, and the timing of shipments to customers which are factors of the seasonality of our sales activities and products.

Sales and marketing expense for the three months ended June 30, 2011 decreased $117,000 to $663,000 as compared to $780,000 for the three months ended June 30, 2010. The decrease in sales and marketing expense for the three months ended June 30, 2011 as compared to the three months ended June 30, 2010 was principally due to (i) a decrease in advertising spend as we aligned the timing of our advertising campaigns with the cold season from period to period, offset by (ii) an increase in our product promotion as we continue to make significant, strategic marketing investments in an effort to build and grow the sales of our OTC cold remedy products.

General and administration expense for the three months ended June 30, 2011 decreased $779,000 to $1.0 million as compared to $1.8 million for the three months ended June 30, 2010. The decrease in general and administration expense for the three months ended June 30, 2011 as compared to the three months ended June 30, 2010 was principally due to (i) a decrease in personnel expense and (ii) a decrease in legal fees.

Research and development costs during the three months ended June 30, 2011 increased $26,000 to $176,000, as compared to $150,000 for the three months ended June 30, 2010. The increase in research and development costs for the three months ended June 30, 2011 period as compared to the three months ended June 30, 2010 was due to principally to (i) an increase in personnel expense, offset by (ii) a decrease in outside research expenditures based upon the timing and scope our product development initiatives from period to period. Additionally, we continue to engage in other market analysis, research and development activities that we determine are appropriate and we may increase our research and development activities in future periods as a consequence of the Joint Venture.

Interest and other income for the three months ended June 30, 2011 was $9,000 as compared to $24,000 for the three months ended June 30, 2010. The decrease of $15,000 for the three months ended June 30, 2011 as compared to the three months ended June 30, 2010 was principally the result of decreased bank balance and lower interest rates.

As a consequence of the effects of the above, the net loss for the three months ended June 30, 2011, was $974,000 or $0.06 per share, as compared to a net loss of $2.3 million, or $0.15 per share, for the three months ended June 30, 2010.

Financial Condition and Results of Operations
Results from Operations for the Six Months Ended June 30, 2011
as Compared to the Six Months Ended June 30, 2010

For the six months ended June 30, 2011, net sales were $4.9 million as compared to $3.1 million for the six months ended June 30, 2010. For the six months ended June 30, 2011, net sales of OTC cold remedy products were $4.6 million as compared to net sales of $2.9 million for six months ended June 30, 2010. For the six months ended June 30, 2011 and 2010, our contract manufacturing operations generated net sales to third party customers of $344,000 and $213,000, respectively.

Net sales of OTC cold remedy products increased $1.7 million for the six months ended June 30, 2011 as compared to the six months ended June 30, 2010 due principally to an increase in shipments to retailers from period to period. Data suggests that the highest incidence of upper respiratory disorders for the 2010-2011 Cold Season occurred principally from December 2010 to February 2011 as compared to the 2009-2010 Cold Season when such incidences occurred principally from October 2009 to December 2009. As a consequence, the timing, stocking and ultimate level of demand of our retailer purchases of our OTC cold remedy products was affected by the change in the timing and the comparative severity of the respective cold season as well as the effects of our expanded marketing efforts to increase consumer awareness and to influence purchase decisions. Our flagship product, Cold-EEZE® continues to compete for market share with new products entering the category and many retailer initiatives to reduce the number of products it carries on shelf within the cold and flu remedy category. We are continuing to support Cold-EEZE® as a clinically proven cold remedy product through in-store promotion, media advertising and coupon programs.

Cost of sales for the six months ended June 30, 2011 were $2.0 million as compared to $1.5 million for the six months ended June 30, 2010. Our sales increased 58.0% during the six months ended June 30, 2011 as compared to the six months ended June 30, 2010 and we realized a gross margin of 58.8% and 52.8%, respectively. Our increase of 6.0% in gross margin is principally due to the net effects of (i) an increase in the absorption rate of fixed production overhead costs as a percentage of revenues as a consequence of increased shipments to retailers, offset by (ii) an increase in raw ingredient and packaging costs. Gross margins are principally 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, if any, and the timing of shipments to customers which are factors of the seasonality of our sales activities and products.

Sales and marketing expense for the six months ended June 30, 2011 increased $704,000 to $2.2 million as compared to $1.5 million, for the six months ended June 30, 2010. The increase in sales and marketing expense for the six months ended June 30, 2011 as compared to the six months ended June 30, 2010 was principally due to an increase in the scope, timing and cost of our marketing campaigns for the 2010–2011 Cold Season and we continue to make significant, strategic marketing investments in an effort to build and grow the sales of our OTC cold remedy products.

General and administration expense for the six months ended June 30, 2011 decreased $946,000 to $2.3 million as compared to $3.2 million for the six months ended June 30, 2010. The decrease in general and administration expense for the six months ended June 30, 2011 as compared to the six months ended June 30, 2010 was principally due to (i) a decrease in personnel expense and (ii) a decrease in legal fees.

Research and development costs during the six months ended June 30, 2011 increased $157,000 to $395,000 as compared to $238,000 for the six months ended June 30, 2010. The increase in research and development costs for the six months ended June 30, 2011 period as compared to the six months ended June 30, 2010 was due to an increase in activity and related development costs incurred to expand our OTC cold remedy product offerings. In February 2011, we introduced to the retail trade an offering of a new product, Cold-EEZE® Oral Spray, an oral delivery application of our proprietary cold remedy formula of zinc gluconate glycine. The Cold-EEZE® Oral Spray cold remedy commenced production in June 2011 and is expected to start shipping to retailers the third quarter of Fiscal 2011. Additionally, we continue to engage in other research and development activities that we determine are appropriate and we may increase our research and development activities in future periods as a consequence of the Joint Venture.

Interest and other income for the six months ended June 30, 2011 was $21,000 as compared to $26,000 for the six months ended June 30, 2010. The decrease of $5,000 for the six months ended June 30, 2011 as compared to the six months ended June 30, 2010 was principally the result of the decreased bank balances and lower interest rates.

As a consequence of the effects of the above, the net loss for the six months ended June 30, 2011, was $2.0 million or $0.13 per share, as compared to a net loss of $3.3 million, or $0.24 per share, for the six months ended June 30, 2010.

Liquidity and Capital Resources

Our aggregate cash and cash equivalents as of June 30, 2011 were $8.7 million as compared to $8.2 million at December 31, 2010. Our working capital was $6.0 million and $7.5 million as of June 30, 2011 and December 31, 2010, respectively. Changes in working capital for the six months ended June 30, 2011 were primarily due to the net effect of (i) cash provided by operations of $549,000, (ii) proceeds from sale of assets of $166,000, offset by (iii) capital expenditures of $204,000. Significant factors impacting our working capital for the six months ended June 30, 2011 were the net effects of (i) a decrease to accounts receivable and inventory levels of $3.8 million, offset by (ii) a decrease in accounts payable and accrued advertising of $2.1 million.

Management believes that its strategy to maintain Cold-EEZE® as a recognized brand name, its broader range of products, its adequate manufacturing capacity, together with its current working capital, should provide an internal source of capital to fund normal business operations. Our operations support the current research and development expenditures related to new products. In addition to the funding from operations, we may in the short and long term raise capital through the issuance of securities or secure other financing sources to support such product development research, new product acquisitions or a venture investment or acquisition. Such funding through the issuance of equity securities would result in the dilution of current stockholders' ownership in the Company. Should our product development initiatives progress on certain formulations, additional development expenditures may require substantial financial support and may necessitate the consideration of alternative approaches such as licensing, joint venture, or partnership arrangements that we determine will meet our long term goals and objectives. Ultimately, should internal working capital be insufficient and external funding methods or other business arrangements become unattainable, it would likely result in the deferral or abandonment of future development relative to current and prospective product development initiatives and formulations.

Management is not aware of any 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 continuing operations. Our business is subject to seasonal variations thereby impacting liquidity and working capital during the course of our fiscal year.

Management believes that cash generated from operations, along with our current cash balances, will be sufficient to finance working capital and capital expenditure requirements for at least the next twelve months. However, in the longer term, we may require additional capital to support, among other items, (i) new product introductions, (ii) expansion of our product marketing and promotion activities, (iii) additional research development activities, (iv) further investment in our Joint Venture, (v) venture investments or acquisitions and/or (vi) support current operations. Since late Fiscal 2008, there has been volatility in the capital and financial markets due at least in part to the constricted global economic environment resulting in uncertainty and access to financing is uncertain. Moreover, consumer and as a consequence, customer spending habits may be adversely affected by the current uncertain economic environment. These conditions could have an adverse effect on our industry and business, including our financial condition, results of operations and cash flows.

To the extent that we do not generate sufficient cash from operations, we may need to incur indebtedness 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.

Capital Expenditures

Capital expenditures during the remainder of Fiscal 2011 are not expected to be material.

Recently Issued Accounting Standards

In November 2008, the SEC issued for comment a proposed roadmap regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board ("IASB"). The proposed roadmap has since been superseded by an SEC work plan and no date is currently proposed that we could be required to prepare financial statements in accordance with IFRS. The SEC has targeted late 2011 to make a determination regarding the mandatory adoption of IFRS. We are currently assessing the impact that this potential change would have on our consolidated financial statements and we will continue to monitor the development of the potential implementation of IFRS.

In June 2011, the Financial Accounting Standards Board issued Accounting Standards Update No. 2011-05, "Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income," ("ASU 2011-05") which amends current comprehensive income guidance. This accounting update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. Instead, comprehensive income must be presented in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. ASU 2011-05 will be effective for fiscal periods beginning after December 15, 2011 with early adoption permitted. The adoption of ASU 2011-05 will not have a material impact on our consolidated financial position, results of operations or cash flows.

ProPhase Labs, Inc. and Subsidiaries
Management's Discussion and Analysis of
Financial Condition and Results of Operations

Forward-Looking Statements

This Quarterly Report on Form 10-Q 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 Report may contain forward-looking statements attributed 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 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 Report.

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

- The ability of our management to successfully implement our business plan and strategy;
- Our ability to fund our operations including the cost and availability of capital and credit;
- 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 dependence on sales from our main product, Cold-EEZE®, and our ability to successfully develop and commercialize new products;
- The uncertain length and severity of the current general financial and economic downturn, the timing and strength of an economic recovery, if any, and their impacts on our business including demand for our products;
- Our ability to protect our proprietary rights;
- Our continued ability to comply with regulations relating to our current products and 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;
- Potential disruptions in our ability to manufacture our products or our access to raw materials;
- Seasonal fluctuations in demand for our products;
- Our ability to attract, retain and motivate key employees;
- The ability of our Joint Venture to successfully implement its business plan and strategy to develop and commercialize one or more non-prescription remedies using certain patented and proprietary technology; and
- Other risks identified in this Report.

You should also consider carefully the statements under other sections of this Report and our Annual Report on Form 10-K for the year ended December 31, 2010, which 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 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.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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 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 due to a reduction in the availability of credit, financial market volatility and recession.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to provide reasonable assurance that material information required to be disclosed by us in the reports filed or submitted under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission ("SEC") rules and forms, and that the information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. We performed an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the disclosure controls and procedures as of the end of the period covered by this report. Based on the remediation efforts implemented by management during the three months ended March 31, 2011, as discussed below under the heading "*Successful Implementation and Remediation of Material Weaknesses as of March 31, 2011*", our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures are now effective at the reasonable assurance level as of the end of the period covered by this Report.

Material Weaknesses

As of December 31, 2010 and as a consequence of management's review of its then effectiveness of the design and operation of the disclosure controls and procedures, management made a determination of the existence of material weaknesses and our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of the end of the period covered by its report as of December 31, 2010. A material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Material Weakness – Control Environment at December 31, 2010

Lack of documentation and/or the availability of documentation or records in the Company's files of business transactions, contracts and/or evaluations engaged by the Company. As new management was installed in Fiscal 2009 by the Board of Directors, it was discovered during the second quarter of Fiscal 2009 that the Company was either missing or lacked pertinent information regarding its operations, including but not limited to certain business commitments to product supply agreements, advertising programs, product placement initiatives and other promotional initiatives, and asset sales. As a consequence of this lack of documentation or availability of documentation or records, management has concluded that this control deficiency constituted a material weakness.

Lack of sufficient segregation of duties during the transition to a new ERP System. During the third and fourth quarter of Fiscal 2010, we implemented a new accounting and operating software and hardware platform ("ERP System") to upgrade and integrate the company's operations onto a common, state-of-the-art ERP System. The new ERP System is projected to provide management with improved data gathering, processing, retrieval and analysis on a more timely and cost effective basis than its prior methods and systems. The installation and transition period of the new ERP System was from June to December 2010.

However, during the transition period, certain personnel had significant access to and certain initial processing responsibilities within the ERP System as part of the installation, integration testing, launch, shakedown and training processes. Specifically, such personnel had access to certain processing functions within the various software applications whereby they could, enter, process, record and report transactions without our customary level of segregation of duties. Although there was significant oversight by management during the transition period, there were limited, appropriately trained staff available to provide adequate separation of duties during the transition period.

As a consequence of the above, management determined that during this period of transition (through December 31, 2010), there was inadequate separation of duties which is deemed a control deficiency and a material weakness.

Successful Implementation and Remediation of Material Weaknesses as of March 31, 2011

Lack of Documentation: Our new executive management has been in place for two full Cold Seasons. During such time, it has met with each of its retail customers, significant suppliers, associates, and professional service providers, among others, and has performed various independent research regarding the historical practices and transactions engaged by us. Based upon these procedures, the receipt of certain copies of documents previously not on file with the Company, our own diligence and further research, and the passage of time, management believes that it currently has the pertinent information regarding its operations to properly conduct its operations and process, record, summarize and report timely the financial and other material information of the Company required to be disclosed.

Segregation of Duties: Management has completed its remediation for the segregation of duties which included (i) the completion of the personnel training of each aspect of the ERP System such personnel would be responsible for (i.e. entering, processing, recording or reporting), (ii) designating and documenting specific personnel access rights, roles and responsibilities within the ERP System and (iii) eliminating the ability of an individual to have the ability to enter, process, record and report transactions.

We believe that the above remediation measures have been effectively implemented and maintained and therefore have effectively remediated as of March 31, 2011 the material weaknesses previously reported in our Annual Report on Form 10-K for the year ended December 31, 2010.

Changes in Internal Control Over Financial Reporting

Other than as described above, there have been no changes in our internal control over financial reporting during the six months ended June 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, because of changes in conditions, effectiveness of internal controls over financial reporting may vary over time. Our system contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Part II. Other Information

Item 1. Legal Proceedings.

Not applicable

Item 1A. Risk Factors.

Not applicable

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

Not applicable

Item 3. Defaults Upon Senior Securities.

Not applicable

Item 5. Other Information.

Not applicable

Item 6. Exhibits

(1)	Exhibit 31.1	Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(2)	Exhibit 31.2	Certification by the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(3)	Exhibit 32.1	Certification by the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
(4)	Exhibit 32.2	Certification by the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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.

Date: August 12, 2011	By: /s/ Ted Karkus Ted Karkus Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
Date: August 12, 2011	By: /s/ Robert V. Cuddihy, Jr. Robert V. Cuddihy, Jr. Chief Operating Officer and Chief Financial Officer (Principal Accounting and Financial Officer)

EXHIBIT 31.1

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 controlover financial reporting.

Date: August 12, 2011

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

EXHIBIT 31.2

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

I, Robert V. Cuddihy, Jr., 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 controlover financial reporting.

Date: August 12, 2011

By: /s/ Robert V. Cuddihy, Jr.
Robert V. Cuddihy, Jr.
Chief Operating Officer and Chief Financial Officer
(Principal Accounting and Financial Officer)

EXHIBIT 32.1

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 Nevada corporation (the "Registrant"), in connection with the Registrant's Quarterly Report on Form 10-Q for the period ended June 30, 2011, 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)
August 12, 2011

EXHIBIT 32.2

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 V. Cuddihy, Jr., Chief Financial Officer of ProPhase Labs, Inc., a Nevada corporation (the “Registrant”), in connection with the Registrant’s Quarterly Report on Form 10-Q for the period ended June 30, 2011, 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, a 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 V. Cuddihy, Jr.

Robert V. Cuddihy, Jr.
Chief Operating Officer and Chief Financial Officer
(Principal Accounting and Financial Officer)
August 12, 2011