FORM 10-Q
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

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

For the quarterly period ended September 30, 2012

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 N. 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 ☒ No ☐

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 November 13, 2012
Common Stock, $0.0005 par value	14,836,340

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)

	September 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Cash and cash equivalents (Note 2)	$ 1,815	$ 5,541
Accounts receivable (net of $37 and zero, respectively)	4,172	3,219
Inventory, net (Note 2)	3,414	2,688
Prepaid expenses and other current assets	1,104	1,747
Total current assets	10,505	13,195
Intangible asset, licensed technology (Note 3)	3,577	3,577
Property, plant and equipment, net of accumulated depreciation of $3,796 and $3,608, respectively (Note 2)	2,452	2,307
	$ 16,534	$ 19,079
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Accounts payable	$ 537	$ 885
Accrued royalties (Note 4)	3,524	3,524
Accrued advertising and other allowances	2,143	2,959
Other current liabilities	439	485
Total current liabilities	6,643	7,853
Commitments and contingencies (Note 4)	-	-
STOCKHOLDERS' EQUITY:		
Common Stock, $.0005 par value; authorized 50,000,000; issued: 20,172,393 and 20,161,636 shares, respectively	10	10
Additional paid-in-capital	41,760	41,552
Accumulated deficit	(6,242)	(4,699)
Treasury stock, at cost 5,336,053 and 5,336,053 shares, respectively	(25,637)	(25,637)
Total stockholders' equity	9,891	11,226
	$ 16,534	$ 19,079

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		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Net sales (Note 2)	$ 5,415	$ 5,083	$ 13,328	$ 9,992
Cost of sales (Note 2)	2,016	1,487	4,763	3,508
Gross profit	3,399	3,596	8,565	6,484
Operating expenses:				
Sales and marketing	1,035	1,158	5,032	3,376
Administration	1,126	1,134	4,027	3,417
Research and development	165	198	1,055	594
	2,326	2,490	10,114	7,387
Income (loss) from operations	1,073	1,106	(1,549)	(903)
Interest and other income	1	4	6	26
Income (loss) before income taxes	1,074	1,110	(1,543)	(877)
Income tax (benefit) (Note 6)	-	-	-	-
Net income (loss)	$ 1,074	$ 1,110	$ (1,543)	$ (877)
Basic income (loss) per share:				
Net income (loss)	$ 0.07	$ 0.07	$ (0.10)	$ (0.06)
Diluted income (loss) per share:				
Net income (loss)	$ 0.07	$ 0.07	$ (0.10)	$ (0.06)
Weighted average common shares outstanding:				
Basic	14,836	15,113	14,804	14,901
Diluted	14,981	15,113	14,804	14,901

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 Outstanding	Par Value	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total
Balance at December 31, 2011	14,825,583	$ 10	$ 41,552	$ (4,699)	$ (25,637)	$ 11,226
Net loss	-	-	-	(1,543)	-	(1,543)
Share-based compensation expense	-	-	115	-	-	115
Common stock granted pursuant to employment agreements	10,757	-	93	-	-	93
Balance at September 30, 2012	14,836,340	$ 10	$ 41,760	$ (6,242)	$ (25,637)	$ 9,891

See accompanying notes to condensed consolidated financial statements

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

	Nine Months Ended	
	September 30, 2012	September 30, 2011
Cash flows from operating activities:		
Net loss	$ (1,543)	$ (877)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	188	297
Share-based compensation expense	208	316
Bad debt expense	37	-
Gain on sale of asset	-	(28)
Changes in operating assets and liabilities:		
Accounts receivable	(990)	402
Inventory	(726)	(1,836)
Accounts payable	(348)	237
Accrued advertising and other allowances	(816)	(605)
Other operating assets and liabilities, net	597	(951)
Net cash used in operating activities	(3,393)	(3,045)
Cash flows from investing activities:		
Capital expenditures	(333)	(288)
Proceeds from the sale of fixed assets	-	166
Net cash flows used in investing activities	(333)	(122)
Cash flows from financing activities:		
Purchase of treasury stock	-	(449)
Net cash used in financing activities	-	(449)
Net decrease in cash and cash equivalents	(3,726)	(3,616)
Cash and cash equivalents at beginning of period	5,541	8,232
Cash and cash equivalents at end of period	$ 1,815	$ 4,616
Supplemental disclosures of cash flow information:		
Common stock issued in lieu of cash, as payment of accrued compensation	$ -	$ 294

See accompanying notes to condensed consolidated financial statements

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

Note 1 – Organization and Business

ProPhase Labs, Inc ("we", "us" or the "Company"), 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. Our flagship brand is Cold-EEZE® Cold Remedy and our principal product is Cold-EEZE® zinc gluconate lozenges, proven in clinical studies to reduce the duration and severity of symptoms of the common cold by nearly half. Cold-EEZE® is an established product in the health care and cold remedy market. For the three and nine months ended September 30, 2012 and 2011, our revenues from operations have come principally from our OTC cold remedy products.

We use a December 31 year-end for financial reporting purposes. References herein to the fiscal year ended December 31, 2012 shall be the term "Fiscal 2012" and references to other "Fiscal" years shall mean the year, which ended on December 31 of the year indicated. The term the "we", "us: or the "Company" as used herein also refer, where appropriate, to the Company, together with its subsidiaries unless the context otherwise requires.

Note 2 – Summary of Significant Accounting Policies

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 in the United States ("GAAP"). 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, 2011. 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 nine months ended September 30, 2012 are not necessarily indicative of operating results that may be achieved over the course of the full year.

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 third and 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.

Note 2 – Summary of Significant Accounting Policies – continued

Use of Estimates

The preparation of financial statements and the accompanying notes thereto, in conformity with GAAP, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the 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. 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-EEZE® lozenges, 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® lozenges, we market and distribute Cold-EEZE® Oral Spray, Cold-EEZE® Cold Remedy Daytime/Nighttime QuickMelts® and Kids-EEZE® soft chew children's OTC cold remedies ("Kids-EEZE® Products"). We also manufacture, market and distribute an organic cough drop and a Vitamin C supplement ("Organix®"). Each of the Cold-EEZE® Oral Spray products, Cold-EEZE® Cold Remedy Daytime/Nighttime QuickMelts®, Kids-EEZE® Products and Organix® products carry shelf-life expiration dates for which we aggregate such new product market experience data and update our 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 a maturity of three months or less at the time of purchase to be cash equivalents. Cash equivalents include cash on hand and monies invested in money market funds. The carrying amount approximates the fair market value due to the short-term maturity of these investments.

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 appropriate valuation adjustments are established. At September 30, 2012 and December 31, 2011, inventory included raw material, work in progress and packaging amounts of $1.4 million and $981,000 respectively, and finished goods of $2.0 million and $1.7 million, respectively.

Property, Plant and Equipment

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

Note 2 – Summary of Significant Accounting Policies – continued

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 September 30, 2012, our cash balance was $1.8 million and our bank balance was $2.4 million. Of the total bank balance, $766,000 was covered by federal depository insurance and $1.6 million was uninsured at September 30, 2012.

Trade accounts receivable potentially subject us to credit concentrations from time-to-time as a consequence of the timing, payment pattern and ultimate purchase volumes or shipping schedules with our customers. We extend credit to our customers based upon an evaluation of the customer's financial condition and credit history and generally we do not require collateral. Our 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. Our largest accounts receivable balances are with five customers representing approximately 68.3% and 52.7% of total trade receivable balances at September 30, 2012 and December 31, 2011, respectively. Three of such customers represented approximately 56.2% of total trade receivable balances at September 30, 2012. Two of such customers represented approximately 34.4% of total trade receivable balances at December 31, 2011, respectively.

Our revenues are principally generated from the sale of OTC cold remedy products which represented approximately 92% and 95% of total revenues for the nine months ended September 30, 2012 and 2011, 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 nine months ended September 30, 2012 and 2011, our net sales were principally related to domestic markets.

Raw materials used in the production of our products are available from numerous sources. Certain raw material active ingredients used in connection with Cold-EEZE® products are purchased from a single unaffiliated supplier. Should the relationship terminate or the vendor become unable to supply material, we believe that the current contingency plans would prevent a termination from materially affecting our operations. However, if the relationship was terminated, there may be delays in production of our products until an acceptable replacement supplier is located.

Note 2 – Summary of Significant Accounting Policies – continued

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.

Fair Value of Financial Instruments

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.

Note 2 – Summary of Significant Accounting Policies – continued

As of September 30, 2012 and December 31, 2011, we included a provision for sales allowances of $93,000 and $101,000, 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 $37,000 and zero as of September 30, 2012 and December 31, 2011, respectively. Additionally, accrued advertising and other allowances as of September 30, 2012 included $1.3 million for estimated future sales returns and $822,000 for cooperative incentive promotion costs. As of December 31, 2011 accrued advertising and other allowances included $1.7 million for estimated future sales returns, $1.0 million for cooperative incentive promotion costs and $279,000 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.

Stock and stock options for the purchase of our common stock, $0.0005 par value ("Common Stock"), have been granted to both employees and non-employees pursuant to the terms of certain agreements and stock option plans (see Note 5). Stock options are exercisable during a period determined by us, but in no event later than ten years from the date granted. For the three months ended September 30, 2012 and 2011, we charged to operations $45,000 and $125,000, respectively, for share-based compensation expense for the aggregate fair value of stock grants issued and vested stock options earned. For the nine months ended September 30, 2012 and 2011, we charged to operations $208,000 and $316,000, respectively, for share-based compensation expense for the aggregate fair value of stock grants issued and vested stock options earned.

Variable Interest Entity

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. The Joint Venture, of which we own a 50% membership interest, qualifies as a variable interest entity ("VIE"), we are the current primary beneficiary and we have consolidated the Joint Venture beginning with the quarter ended March 31, 2010. Expenses incurred to date by the Joint Venture have been principally for certain product research and development activities which have been charged to research and development expense by the Company.

Note 2 – Summary of Significant Accounting Policies – continued

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 September 30, 2012 and 2011 were $1.3 million and $1.7 million, respectively. Advertising and incentive promotion costs incurred for the nine months ended September 30, 2012 and 2011 were $5.5 million and $3.9 million, respectively. Included in prepaid expenses and other current assets was $947,000 and $1.2 million at September 30, 2012 and December 31, 2011, respectively, relating to prepaid advertising and promotion expenses.

Research and Development

Research and development costs are charged to operations in the period incurred. Research and development costs for the three months ended September 30, 2012 and 2011 were $165,000 and $198,000, respectively. Research and development costs for the nine months ended September 30, 2012 and 2011 were $1.0 million and $594,000, 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.

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 2011 remain open to examination by the major taxing jurisdictions to which we are subject.

Recently Issued Accounting Standards

In June 2011, the Financial Accounting Standards Board (“FASB”) 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 is effective for fiscal periods beginning after December 15, 2011. The adoption of ASU 2011-05 did not have a material impact on our consolidated financial position, results of operations or cash flows.

Note 2 – Summary of Significant Accounting Policies – continued

In September 2011, the FASB issued Accounting Standards Update No. 2011-08, "Intangibles – Goodwill and Other Topics" ("ASU 2011-08") which provides authoritative guidance on testing goodwill for impairment that became effective beginning January 1, 2012, with earlier adoption permitted. The revised standards are intended to reduce the cost and complexity of the annual goodwill impairment test by providing entities an option to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under ASU 2011-08, an entity would not be required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The amendments include a number of events and circumstances for an entity to consider in conducting the qualitative assessment. The adoption of ASU 2011-08 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In July 2012, the FASB provided further guidance pertaining to the testing of goodwill for impairment with the issuance of Accounting Standards Update No. 2012-05, "Intangibles – Goodwill and Other Topics" ("ASU 2012-02"). The new guidance gives the option to first assess qualitative factors to determine if it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount as a basis for determining whether it is necessary to perform a quantitative valuation test. The new standard is effective for fiscal years beginning on or after September 15, 2012. We will adopt this accounting standard in the fourth quarter of Fiscal 2012 and we do not anticipate that this adoption will have a significant impact on our financial position, results of operations or cash flows.

Note 3 – Investment in Phusion Laboratories, LLC.

Our Joint Venture was formed to develop and commercialize for worldwide distribution and sale, a wide range of non-prescription remedies using PSI Parent's proprietary patented TPM. Pursuant to a License Agreement, dated March 22, 2010, as amended (the "Amended License Agreement"), with PSI Parent, our Joint Venture obtained, (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. 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 and made a one-time payment to PSI Parent of $1.0 million. In September 2011, PSI Parent sold, with our consent, an aggregate of 750,000 shares of our Common Stock to various third parties. Contemporaneously, we entered into a redemption agreement with PSI Parent. Under the terms of the redemption agreement, we redeemed 690,000 shares of our Common Stock held by PSI Parent for the aggregate redemption price of $448,500 in cash. The redemption price was equal to $0.65 per share and the 690,000 shares were added to our treasury stock.

Pursuant to the LLC Agreement, 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 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 Joint Venture has not engaged in any financial transactions, other than organizational expenses and general market and product analysis. At September 30, 2012, cash and equivalents includes $388,000 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.

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

The $3.6 million payment made in March 2010 represents the estimated fair value to acquire the product license and is recorded as an intangible asset. We currently estimate the expected useful life of the product license to be approximately 10 years which we will begin amortizing the cost of intangible asset once product commercialization is completed with PSI Parent and the OTC drug products begin to ship to our retail customers.

The product development effort of the Joint Venture is a multi-stage process that includes (i) market analysis and research, (ii) product formulation research and development, (iii) product evaluation, (iv) product commercialization, (v) production and distribution, and (vi) retail and consumer advertising and marketing. During Fiscal 2011, we conducted preliminary market analysis to identify market opportunities to develop differentiated, science-based, efficacious products that deliver results to consumers and worked with PSI and PSI Parent to provide initial formulations for certain identified OTC active ingredients. In December 2011, we initiated a study of these preliminary formulations to evaluate product attributes, performance and potential commercial viability. These studies are expected to be completed later in Fiscal 2012. For Fiscal 2011 and through September 30, 2012, expenses, including organizational, marketing analysis and preliminary formulations have been absorbed by the respective Joint Venture members. As of September 30, 2012, we have not established a formal commercialization program timeline, pending the results of the recently initiated studies, for any specific OTC product covered under the product license but we do not project that any such OTC products will be available for shipment within the next twelve months.

Note 4 – Commitments and Contingencies

We had maintained a separate representation and distribution agreement relating to the development of the zinc gluconate 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 September 30, 2012 and December 31, 2011 is $3.5 million.

We have estimated future minimum obligations over the next five years, including the remainder of Fiscal 2012, as follows (in thousands):

Fiscal Year	Employment Contracts
2012	$ 256
2013	1,025
2014	1,025
2015	555
2016	-
2017	-
Total	$ 2,861

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 and further amended effective August 18, 2009. 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.

The 1997 Option Plan

On December 2, 1997, our Board of Directors approved a Stock Option Plan (the "1997 Plan"), which was amended in 2005, and 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. Stockholders approved the 1997 Plan in Fiscal 1998. No options were granted under this Plan for the three month or nine month period ended September 30, 2012 or September 30, 2011, respectively.

As of December 31, 2011, 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 September 30, 2012, there are 99,000 options outstanding under the 1997 Plan with various expiration dates ranging from October 2013 through December 2015, depending upon the date of grant.

Note 5 – Transactions Affecting Stockholders' Equity – continued

The 2010 Equity Compensation Plan

On May 5, 2010, our shareholders approved the 2010 Equity Compensation Plan which was subsequently amended, restated and approved by shareholders on April 24, 2011 (the "2010 Equity Compensation Plan"). The 2010 Equity Compensation Plan provides that the total number of shares of Common Stock that may be issued is equal to 900,000 shares plus up to 900,000 shares that are authorized for issuance, Issued Options (defined below) but unissued under the 1997 Plan, an aggregate of 1.8 million shares. The 1997 Plan expired on December 2, 2007 and no additional awards may be made; however, as of March 31, 2010, there remained 1,449,750 shares subject to vested options that were authorized for issuance (the "Issued Options") but were unissued under the 1997 Plan. As of September 30, 2012, 1,350,750 of the Issued Options under the 1997 Plan expired unexercised or were terminated (the "Expired Options"). As a consequence, these options are deemed and remain unissued which up to a maximum of 900,000 shares became available for issuance under the 2010 Equity Compensation Plan and the remaining 450,750 options are deemed cancelled. For the three months and nine months ended September 30, 2012, no options were granted pursuant to the 2010 Equity Compensation Plan. For the three months and nine months ended September 30, 2011, we granted 524,329 options, to employees pursuant to the 2010 Equity Compensation Plan. At September, 30, 2012, there are 13,659 shares of Common Stock that may be issued pursuant to the terms of the 2010 Equity Compensation Plan.

The 2010 Directors' Equity Compensation Plan

On May 5, 2010, our shareholders approved the 2010 Directors' Equity Compensation Plan. A primary purpose of the 2010 Directors' Equity Compensation 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' Equity Compensation Plan provides that the total number of shares of Common Stock that may be issued under the 2010 Directors' Equity Compensation Plan is equal to 250,000. No shares were granted under this plan for the three months and nine months ended September 30, 2012. For the three months and nine months ended September 30, 2011 we issued 49,160 and 114,010 shares, respectively, of our Common Stock valued at $41,000 and $122,000, respectively, for share-based director compensation expense. At September 30, 2012, there are 17,605 shares of Common Stock that may be issued pursuant to the terms of the 2010 Directors' Equity Compensation Plan.

Stock Option Exercises and Other Grants

Pursuant to the terms of Robert V. Cuddihy, Jr.'s, our Chief Operating Officer and Chief Financial Officer, initial employment agreement dated August 19, 2009 which terminated effective January 1, 2012, Mr. Cuddihy received an annual grant of shares of Common Stock that is equal to $50,000, payable quarterly, promptly following the close of each quarter calculated based on the average closing price of our Common Stock for the last five (5) trading days of the quarter. For the three months and nine months ended September 30, 2011 Mr. Cuddihy earned 15,665 shares and 40,885 shares, respectively, valued at $12,500 and $37,500, respectively, as share-based compensation. In January 2012, we issued to Mr. Cuddihy 10,757 shares valued at $12,500 that were earned in Fiscal 2011 as share-based compensation pursuant to the terms of the initial employment agreement.

There were no stock options exercised for the three months or nine months ended September 30, 2012 or September 30, 2011.

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.

Note 6 – Income Taxes - continued

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 $6.3 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, 2011, we had net operating loss carry-forwards of approximately $31.6 million for federal purposes that will expire beginning in Fiscal 2020 through 2031. Additionally, there are net operating loss carry-forwards of $20.0 million for state purposes that will expire beginning Fiscal 2018 through 2031. 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 September 30, 2012 and December 31, 2011. As of September 30, 2012 and December 31, 2011, 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 (loss) per share is computed by dividing net income or loss attributable to common stockholders by the weighted-average number of shares of our Common Stock outstanding for the period. Diluted earnings (loss) per share reflects the potential dilution that could occur if securities or other contracts to issue Common Stock were exercised or converted into Common Stock or resulted in the issuance of Common Stock that shared in the earnings of the entity. Diluted 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 September 30, 2012 and 2011 were 1,293,000 and 1,281,250, respectively.

For the nine months ended September 30, 2012 and 2011, 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 nine months ended September 30, 2012 and 2011, there were 86,328 and 53,517 Common Stock Equivalents, respectively, which were in the money, that were excluded from the earnings per share computation. For the three months ended September 30, 2012, there were 144,943 Common Stock Equivalents, which were in the money, that were included in the earnings per share computation. For the three months ended September 30, 2011, there were zero Common Stock Equivalents which were in the money, that were excluded from the earnings per share computation.

Note 7 – Earnings (Loss) Per Share – continued

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 September 30, 2012			Three Months Ended September 30, 2011			Nine Months Ended September 30, 2012			Nine Months Ended September 30, 2011		
	Income	Shares	EPS	Income	Shares	EPS	Loss	Shares	EPS	Loss	Shares	EPS
Basic earnings (loss) per share	$ 1,074	14,836	$ 0.07	$ 1,110	15,113	$ 0.07	$ (1,543)	14,804	$ (0.10)	$ (877)	14,901	$ (0.06)
Dilutives:												
Options	-	145	-	-	-	-	-	-	-	-	-	-
Diluted loss per share	$ 1,074	14,981	$ 0.07	$ 1,110	15,113	$ 0.07	$ (1,543)	14,804	$ (0.10)	$ (877)	14,901	$ (0.06)

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

General

ProPhase Labs, Inc. ("we", "us", "ProPhase" 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 food, multi-outlet pharmacy and chain drug stores, large wholesalers and mass merchandisers. Our flagship brand is Cold-EEZE® Cold Remedy and our principal product is Cold-EEZE® zinc gluconate lozenges, 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 nine months ended September 30, 2012 and 2011, our revenues from operations have come principally from our OTC cold remedy products.

Recent Developments

In a letter dated May 29, 2012, ProPhase received an expression of interest and a non-binding proposal to be acquired by a to-be-formed affiliate of Matrixx Initiatives, Inc. ("Matrixx"). At a meeting of the Board of Directors held on June 28, 2012, the Company's Board of Directors, after careful consideration and consultation with its advisors, unanimously voted to reject the Matrixx proposal. Matrixx is the owner of the Zicam® brand of cold and allergy products and is a direct competitor to ProPhase's Cold-EEZE® Cold Remedy product line.

In a letter to ProPhase dated September 6, 2012, Matrixx then repeated its non-binding proposal on the same terms as its May 29, 2012 letter to ProPhase. Matrixx repeated the identical non-binding proposal in a September 14, 2012 letter. The Matrixx September 14, 2012 letter was attached to the report on Schedule 13D filed by Matrixx on September 14, 2012.

On September 4, 2012, Matrixx purchased for $200,000 a three year option to acquire 1,453,427 shares of the Company's common stock for $1.40 per share from Guy J. Quigley, ProPhase's former Chairman and Chief Executive Officer. Matrixx also acquired from Mr. Quigley a voting proxy to vote the shares subject to the option. The Company learned of Matrixx's transactions with Mr. Quigley through the filing by Mr. Quigley of reports on Form 4 and Schedule 13-D filed with the SEC.

On October 9, 2012, ProPhase received a revised non-binding proposal, on essentially the same terms as Matrixx's earlier offer, except that in this latest proposal Matrixx raised the proposed price by $0.20 per share. In response, the Company again sought advice from its independent financial advisors. At a meeting held on October 24, 2012, the Company's Board of Directors unanimously voted to reject this latest Matrixx proposal after careful consideration and consultation with its advisors.

In evaluating the Matrixx revised proposal, the Board unanimously determined, among other things, that:

- The non-binding Matrixx proposal undervalues ProPhase's current business and future prospects.
- The Matrixx proposal does not adequately reflect the true value of ProPhase's unique market position, business opportunities and new product launches. The Board believes that the Company's recent and potential future revenue growth will result in superior value to that offered by Matrixx in a sale transaction.

- The Matrixx proposal is conditioned upon Matrixx being permitted access to non-public and confidential ProPhase information. Even if Matrixx were to sign a confidentiality agreement, there is undue risk to ProPhase in disclosing confidential information to one of its largest and most aggressive competitors.
- The interests of ProPhase's stockholders will be best served by the Company continuing to pursue its independent strategic plan. The Company has made substantial investments in its Cold-EEZE® brand and believes that shareholders should be given the opportunity to realize a return on these investments.

Furthermore, we have implemented a business and marketing strategy designed to deliver superior results to our stockholders over the long term. First, we preserved the Cold-EEZE® brand, then we repositioned the brand, and now we are growing and leveraging the brand. As we have consistently explained to our shareholders, it remains our view that by investing in our Cold-EEZE® brand, we are building our distribution platform and pipeline, which has led to securing increased shelf space with our retailers for the upcoming cold season, and which has provided us with the opportunity to introduce new and improved products, including the national launch of Cold-EEZE® Oral Spray and Cold-EEZE® Daytime/Nighttime QuickMelts® for the upcoming cold season. The extra $0.20 per share that Matrixx has tacked on to its prior inadequate offer does not alter our Board's view that the current shareholders of the Company should benefit from the upside created by our current strategies, not the private equity owners of one of our primary competitors

It is understood that Matrixx's goal, like that of any suitor, is to buy our shares at the lowest possible price, which is why Matrixx has acquired the right to buy 1,453,427 shares at $1.40 per share from another shareholder. Nevertheless, our Board of Directors and management are disappointed that Matrixx resorted to publishing faulty arguments in their October 9, 2012 press release as to why the Company should be sold. The Matrixx tactic appears to be an attempt to coerce our shareholders, our Board and our management to accept an inadequate offer from Matrixx. Matrixx's fundamental assertion that ProPhase supposedly 'lacks the scale to effectively compete…' is demonstrably false, as evidenced by the most recent 52 week industry retail sales data *(based on reported industry data for the cough cold category through the end of Q3 2012)*, which shows that even without including ProPhase's new products, our core Cold-EEZE® Cold Remedy products continue to grow at double digit rates while sales of many of our competitor's products, including Matrixx's Zicam® brand core cough/cold products, declined by double digits during the same time period. Matrixx's desire to acquire ProPhase is therefore not surprising.

Management believes we are now beginning to realize the rewards for our efforts and clearly one of our competitors has taken notice. However, our Board continues to believe that the timing is not right to sell the Company for a number of reasons. Sales and shelf space of our flagship Cold-EEZE® brand were in significant decline when new management took the helm in mid-2009, and now, after implementing a broad range of carefully developed strategies, our brand is gaining market share and growing nicely. Our new product introductions have been well received by the retail trade and we look forward to further expanding our product line next season. Our management team is committed to achieving our well planned and outlined longer term goals. If we stay the course, we believe that our shareholders will be well rewarded for their patience.

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 Food and Drug Administration ("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.

The 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. The Joint Venture may disrupt our ongoing operations, divert management from day-to-day responsibilities and increase our expenses.

We face significant technological risks inherent in developing these products. The Joint Venture 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^{TM} that exploit certain compounds that embody the TPM^{TM} 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. Many of our competitors have substantially greater capital resources, technical staffs, facilities, marketing resources, product development, distribution and experience than we do. As a consequence, our competitors may have certain advantages, including the ability to allocate greater resources for new product development, marketing and other purposes.

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-EEZE® lozenges, 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® lozenges we market and distribute Cold-EEZE® Oral Spray, Cold-EEZE® Cold Remedy Daytime/Nighttime QuickMelts® and Kids-EEZE® soft chew children's OTC cold remedies ("Kids-EEZE® Products"). We also manufacture, market and distribute an organic cough drop and a Vitamin C supplement ("Organix®"). Each of the Cold-EEZE® Oral Spray products, Cold-EEZE® Cold Remedy Daytime/Nighttime QuickMelts®, Kids-EEZE® Products and Organix® products carry shelf-life expiration dates for which we aggregate such new product market experience data and update our 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.

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 September 30, 2012 and December 31, 2011, we included a provision for sales allowances of $93,000 and $101,000, 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 $37,000 and zero as of September 30, 2012 and December 31, 2011, respectively. Additionally, accrued advertising and other allowances as of September 30, 2012 included $1.3 million for estimated future sales returns and $822,000 for cooperative incentive promotion costs. As of December 31, 2011 accrued advertising and other allowances included $1.7 million for estimated future sales returns, $1.0 million for cooperative incentive promotion costs and $279,000 for certain other advertising and marketing promotions.

A one percent deviation for these Sales Allowance provisions for the three months ended September 30, 2012 and 2011 would affect net sales by approximately $66,000 and $68,000, respectively. A one percent deviation for these Sales Allowance provisions for the nine months ended September 30, 2012 and 2011 would affect net sales by approximately $162,000 and $127,000, respectively.

Income Taxes

As of December 31, 2011, we have net operating loss carry-forwards of approximately $31.6 million for federal purposes that will expire beginning in Fiscal 2020 through Fiscal 2031. Additionally, there are net operating loss carry-forwards of approximately $20.0 million for state purposes that will expire beginning in Fiscal 2018 through Fiscal 2031. 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 (as 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 in our industry 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 our 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 September 30, 2012
as Compared to the Three Months Ended September 30, 2011

For the three months ended September 30, 2012, net sales were $5.4 million as compared to $5.1 million for the three months ended September 30, 2011. For the three months ended September 30, 2012, net sales of OTC cold remedy products were $5.1 million as compared to net sales of $4.9 million for three months ended September 30, 2011. For the three months ended September 30, 2012 and 2011, our contract manufacturing operations generated net sales to third party customers of $316,000 and $192,000, respectively.

Net sales of OTC cold remedy products remained stable for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 due to similar timing of shipments to retailers from period to period. The timing, stocking and ultimate level of demand of retailer purchases of our OTC cold remedy products are affected by the change in the timing and the comparative severity of the respective Cold Season as well as the effects of the timing and scope of our marketing and promotional efforts to increase consumer awareness and to influence purchase decisions.

Cost of sales for the three months ended September 30, 2012 were $2.0 million as compared to $1.5 million for the three months ended September 30, 2011. For the three months ended September 30, 2012 as compared to the three months ended September 30, 2011, we realized a gross margin of 62.8% and 70.7%, respectively. The decrease of 7.9% in gross margin is principally due (i) an increase in ingredient commodity costs incurred and (ii) an unfavorable variance in our manufacturing operations overhead absorption rate as a consequence of the timing of production and the product mix shipped to retailers during the three months ended September 30, 2012 as compared to the three months ended September 30, 2011. 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, retail cooperative incentive promotion 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 September 30, 2012 decreased $123,000 to $1.0 million as compared to $1.2 million for the three months ended September 30, 2011. The decrease in sales and marketing expense for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 was due to a decrease in advertising expenditures.

General and administration expense for the three months ended September 30, 2012 were $1.1 million as compared to $1.1 million for the three months ended September 30, 2011 as we continued to control our general and administration expenses from period to period.

Research and development costs during the three months ended September 30, 2012 decreased $33,000 to $165,000, as compared to $198,000 for the three months ended September 30, 2011. The decrease in research and development costs for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 was due principally to a decrease in outside research expenditures. 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 September 30, 2012 was $1,000 as compared to $4,000 for the three months ended September 30, 2011. The decrease of $3,000 for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 was the result of decreased bank balance and lower interest rates.

As a consequence of the effects of the above, the net income for the three months ended September 30, 2012, was $1.1 million or $0.07 per share, as compared to net income of $1.1 million or $0.07 per share, for the three months ended September 30, 2011.

Financial Condition and Results of Operations
Results from Operations for the Nine Months Ended September 30, 2012
as Compared to the Nine Months Ended September 30, 2011

For the nine months ended September 30, 2012, net sales were $13.3 million as compared to $10.0 million for the nine months ended September 30, 2011. For the nine months ended September 30, 2012, net sales of OTC cold remedy products were $12.3 million as compared to net sales of $9.5 million for nine months ended September 30, 2011. For the nine months ended September 30, 2012 and 2011, our contract manufacturing operations generated net sales to third party customers of $1.0 million and $536,000, respectively. Net sales of OTC cold remedy products increased $2.8 million for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 due to the timing of shipments to retailers from period to period principally as a result of an increase in consumer demand during the 2011-2012 Cold Season as compared to the 2010-2011 Cold Season. We believe that consumer demand for our products increased as a consequence of our increased, targeted marketing investment in our Cold-EEZE® Cold Remedy products during the 2011-2012 Cold Season as compared to 2010-2011 Cold Season. The timing, stocking and ultimate level of demand of our retailer purchases of our OTC cold remedy products are affected by the change in the timing and the comparative severity of the respective Cold Season as well as the effects of the timing and scope of our marketing and promotional efforts to increase consumer awareness and to influence purchase decisions.

Cost of sales for the nine months ended September 30, 2012 were $4.8 million as compared to $3.5 million for the nine months ended September 30, 2011. For the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011, we realized a gross margin of 64.3% and 64.9%, respectively. As a consequence of the increased sales volume, we realized certain production efficiencies and improved overhead expense absorption while our raw ingredient and packaging costs increase slightly from period to period. 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, retail cooperative incentive promotion 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 nine months ended September 30, 2012 increased $1.7 million to $5.0 million as compared to $3.4 million for the nine months ended September 30, 2011. The increase in sales and marketing expense for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was principally due to an increase in advertising expenditures as we expanded the scope and timing of our media and product promotion advertising campaigns with the cold season from period to period 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 nine months ended September 30, 2012 increased $610,000 to $4.0 million as compared to $3.4 million for the nine months ended September 30, 2011. The increase in general and administration expense for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was principally due to an increase in personnel expense and legal fees.

Research and development costs during the nine months ended September 30, 2012 increased $461,000 to $1.0 million, as compared to $594,000 for the nine months ended September 30, 2011. The increase in research and development costs for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was due principally to an increase in personnel expense and outside research expenditures. 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 nine months ended September 30, 2012 was $6,000 as compared to $26,000 for the nine months ended September 30, 2011. The decrease of $20,000 for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was the result of decreased bank balance and lower interest rates.

As a consequence of the effects of the above, the net loss for the nine months ended September 30, 2012, was $ 1.5 million or ($0.10) per share, as compared to a net loss of $877,000 or ($0.06) per share, for the nine months ended September 30, 2011.

Liquidity and Capital Resources

Our aggregate cash and cash equivalents as of September 30, 2012 were $1.8 million as compared to $5.5 million at December 31, 2011. Our working capital was $3.9 million and $5.3 million as of September 30, 2012 and December 31, 2011, respectively. Changes in working capital for the nine months ended September 30, 2012 were principally due to (i) the net loss of $1.5 million, (ii) our increase in amounts carried as accounts receivable of $990,000 and inventory of $726,000 as a consequence of the seasonality of our business and (ii) our reduction in accrued advertising and other allowances of $816,000.

As a consequence of our research and development initiatives, in July 2012 we launched our first-ever Cold-EEZE® Cold Remedy Daytime/Nighttime QuickMelt® tablets. Each QuickMelt® tablet dissolves quickly in your mouth without water and delivers the same amount of cold remedy (active ingredient zinc gluconate) found in our Cold-EEZE® lozenges. The Cold-EEZE® Daytime QuickMelts® shorten your cold and are non-drowsy. The Cold-EEZE® Nighttime QuickMelts® are a combination product formulated to shorten your cold and also help you fall asleep faster, naturally and are non-habit forming. Retail acceptance for QuickMelts® has been strong and we commenced shipments in July 2012. In addition to the QuickMelts' nationwide availability, the Cold-EEZE® Oral Spray, launched in August 2011, has gone from an initial distribution in the 2011-2012 Cold Season to full national distribution for the upcoming 2012-2013 Cold Season. Two sprays deliver the same amount of cold remedy (active ingredient zinc gluconate) as in one Cold-EEZE® lozenge.

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 (i) seasonal variations, (ii) changes in the scope, timing and cost of our marketing campaigns and (iii) the retail and consumer acceptance of our new products such as the Cold-EEZE® Cold Remedy Daytime/Nighttime QuickMelt® tablets launched July 2012, 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 to fund normal business operations for at least the next twelve months. However, 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 2012 are not expected to be material.

Recently Issued Accounting Standards

In June 2011, the Financial Accounting Standards Board ("FASB") 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 is effective for fiscal periods beginning after December 15, 2011. The adoption of ASU 2011-05 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In September 2011, the FASB issued Accounting Standards Update No. 2011-08, "Intangibles – Goodwill and Other Topics" ("ASU 2011-08") which provides authoritative guidance on testing goodwill for impairment that became effective beginning January 1, 2012, with earlier adoption permitted. The revised standard is intended to reduce the cost and complexity of the annual goodwill impairment test by providing entities an option to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under ASU 2011-08, an entity would not be required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The amendments include a number of events and circumstances for an entity to consider in conducting the qualitative assessment. The adoption of ASU 2011-08 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In July 2012, the FASB provided further guidance pertaining to the testing of goodwill for impairment with the issuance of Accounting Standards Update No. 2012-05, "Intangibles – Goodwill and Other Topics" ("ASU 2012-02"). The new guidance gives the option to first assess qualitative factors to determine if it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount as a basis for determining whether it is necessary to perform a quantitative valuation test. The new standard is effective for fiscal years beginning on or after September 15, 2012. We will adopt this accounting standard in the fourth quarter of Fiscal 2012 and we do not anticipate that this adoption will have a significant impact on our financial position, results of operations or cash flows.

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® Cold Remedy and our ability to successfully develop and commercialize new products, including our Cold-EEZE® Oral Spray and our Cold-EEZE® Daytime/Nighttime QuickMelts®;

- 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, 2011, 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 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 our 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 our review, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level as of the end of the period covered by this Report.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining an adequate system of internal control over financial reporting. Our system of internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Our internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of our assets;
- provide reasonable assurance that our transactions are recorded as necessary to permit preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipts and expenditures are being made only in accordance with authorizations of our management and our directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting during the nine months ended September 30, 2012 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.

Our management conducted an evaluation of our effectiveness of the system of internal control over financial reporting based on the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon our review, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company's internal controls over financial reporting were effective as of September 30, 2012.

Part II. Other Information

Item 1. Legal Proceedings.

None

Item 1A. Risk Factors.

Not applicable

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

None

Item 3. Defaults Upon Senior Securities.

None

Item 4. Mine Safety Disclosures.

Not applicable

Item 5. Other Information.

None

Item 6. Exhibits

(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.

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

Date: November 13, 2012

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

Date: November 13, 2012

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 reportbased 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: November 13, 2012

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 reportbased 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: November 13, 2012

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 September 30, 2012, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), do hereby represent, warrant and certify, in compliance with Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

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

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

/s/ Ted Karkus
Ted Karkus
Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)
November 13, 2012

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 September 30, 2012, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), do hereby represent, warrant and certify, in compliance with Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

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

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

/s/ Robert V. Cuddihy, Jr.
Robert V. Cuddihy, Jr.
Chief Operating Officer and Chief Financial Officer
(Principal Accounting and Financial Officer)
November 13, 2012