LANNETT CO INC
Form 10-Q
May 09, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2012

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission File No. 001-31298

LANNETT COMPANY, INC.

(Exact Name of Registrant as Specified in its Charter)

State of Delaware	**23-0787699**
(State of Incorporation)	**(I.R.S. Employer I.D. No.)**

9000 State Road

Philadelphia, PA 19136

(215) 333-9000

(Address of principal executive offices and telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 x **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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12B-12 of the Exchange Act).

Yes **No** x

Indicate the number of shares outstanding of each class of the registrant s common stock, as of the latest practical date.

Class	Outstanding as of May 3, 2012
Common stock, par value $0.001 per share	28,365,296 shares

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	(Unaudited) March 31, 2012	June 30, 2011
ASSETS		
Current Assets		
Cash and cash equivalents	$ 18,989,168	$ 5,276,735
Investment securities	5,571,049	19,382,079
Trade accounts receivable (net of allowance of $123,573 and $123,573 respectively)	37,499,169	33,464,440
Inventories, net	27,975,938	26,902,521
Income taxes receivable	3,205,508	3,636,306
Deferred tax assets	4,867,255	4,537,881
Other current assets	1,472,069	941,902
Total Current Assets	99,580,156	94,141,864
Property, plant and equipment	58,181,257	54,516,229
Less accumulated depreciation	(27,371,657)	(24,586,448)
	30,809,600	29,929,781
Construction in progress	6,266,583	5,760,686
Intangible assets (product rights) - net of accumulated amortization	4,899,021	5,909,636
Deferred tax assets	8,747,015	10,446,500
Other assets	1,174,377	1,555,831
Total Assets	$ 151,476,752	$ 147,744,298
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES		
Current Liabilities		
Accounts payable	$ 15,753,524	$ 18,377,782
Accrued expenses	1,170,576	1,354,095
Accrued payroll and payroll related	2,159,723	934,504
Current portion of long-term debt	639,591	629,435
Rebates, chargebacks and returns payable	15,394,344	13,564,395
Total Current Liabilities	35,117,758	34,860,211
Long-term debt, less current portion	6,781,862	7,192,496
Other long-term liabilities	-	2,417
Total Liabilities	41,899,620	42,055,124
Commitment and Contingencies, See notes 9 and 10		
SHAREHOLDERS EQUITY		
Common stock - authorized 50,000,000 shares, par value $0.001;		
issued and outstanding, 28,572,304 and 28,403,946 shares, respectively	28,572	28,404
Additional paid in capital	98,925,755	97,082,360
Retained earnings	11,820,680	9,287,732
Noncontrolling interest	173,154	139,082
Accumulated other comprehensive (loss) income	(19,293)	23,899
	110,928,868	106,561,477
Less: Treasury stock at cost - 280,469 and 156,611 shares, respectively	(1,351,736)	(872,303)
TOTAL SHAREHOLDERS EQUITY	109,577,132	105,689,174

TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	151,476,752	$	147,744,298

The accompanying notes to the consolidated financial statements are an integral part of these statements.

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three months ended March 31,		Nine months ended March 31,	
	2012	**2011**	**2012**	**2011**
Net sales	$ 30,687,726	$ 25,892,483	$ 87,299,709	$ 81,327,667
Cost of sales	19,275,765	20,098,084	58,788,334	60,667,878
Amortization of intangible assets	470,409	463,769	1,409,015	1,385,892
Product royalties	50,054	26,980	168,142	(290,380)
Gross profit	10,891,498	5,303,650	26,934,218	19,564,277
Research and development expenses	2,911,530	1,854,216	7,850,744	5,557,296
Selling, general, and administrative expenses	5,616,186	4,279,502	14,779,953	11,755,062
Operating income (loss)	2,363,782	(830,068)	4,303,521	2,251,919
Other income (expense):				
Foreign currency (loss) gain	(3,308)	1,529	(5,804)	5,494
(Loss) gain on sale of assets	-	(17,565)	3,536	(16,299)
Realized gain on investments	361,059	59,689	214,696	74,454
Unrealized gain (loss) on investments	104,896	(17,898)	(45,776)	(17,898)
Interest and dividend income	28,305	24,744	117,252	39,852
Interest expense	(63,698)	(28,030)	(213,406)	(174,882)
	427,254	22,469	70,498	(89,279)
Income (loss) before income tax expense (benefit)	2,791,036	(807,599)	4,374,019	2,162,640
Income tax expense (benefit)	1,056,684	(449,797)	1,787,999	554,568
Net income (loss)	1,734,352	(357,802)	2,586,020	1,608,072
Less net income attributable to noncontrolling interest	(16,468)	(4,259)	(53,072)	(20,540)
Net income (loss) attributable to Lannett Company, Inc.	$ 1,717,884	$ (362,061)	$ 2,532,948	$ 1,587,532
Basic earnings (loss) per common share - Lannett Company, Inc.	$ 0.06	$ (0.01)	$ 0.09	$ 0.06
Diluted earnings (loss) per common share - Lannett Company, Inc.	$ 0.06	$ (0.01)	$ 0.09	$ 0.06
Basic weighted average number of shares	28,571,062	28,373,436	28,509,595	26,215,510
Diluted weighted average number of shares	28,719,669	28,373,436	28,668,281	26,558,432

The accompanying notes to the consolidated financial statements are an integral part of these statements.

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock		Additional				Accum. Other	
	Shares Issued	Amount	Paid-in Capital	Retained Earnings	Treasury Stock	Noncontrolling Interest	Comprehensive Income (Loss)	Shareholders Equity
Balance, June 30, 2011	28,403,946	$ 28,404	$ 97,082,360	$ 9,287,732	$ (872,303)	$ 139,082	$ 23,899	$ 105,689,174
Exercise of stock options	5,000	5	13,945	-	-	-	-	13,950
Shares issued in connection with employee stock purchase plan	50,858	51	177,377	-	-	-	-	177,428
Share based compensation								
Restricted stock	-	-	539,887	-	-	-	-	539,887
Stock options	-	-	1,074,100	-	-	-	-	1,074,100
Employee stock purchase plan	-	-	45,414	-	-	-	-	45,414
Shares issued in connection with restricted stock grant	112,500	112	(112)	-	-	-	-	-
Tax shortfall on stock options exercised	-	-	(7,216)	-	-	-	-	(7,216)
Purchase of treasury stock	-	-	-	-	(479,433)	-	-	(479,433)
Distribution to noncontrolling interests	-	-	-	-	-	(19,000)	-	(19,000)
Other comprehensive loss, net of income tax	-	-	-	-	-	-	(43,192)	(43,192)
Net income	-	-	-	2,532,948	-	53,072	-	2,586,020
Balance, March 31, 2012	28,572,304	$ 28,572	$ 98,925,755	$ 11,820,680	$ (1,351,736)	$ 173,154	$ (19,293)	$ 109,577,132

The accompanying notes to the consolidated financial statements are an integral part of these statements.

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the nine months ended March 31,	
	2012	**2011**
OPERATING ACTIVITIES:		
Net income	$ 2,586,020	$ 1,608,072
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,206,252	3,652,356
Deferred tax expense	1,371,322	3,133,015
Stock compensation expense	1,659,401	1,438,069
Realized gain on investments	(214,696)	(74,454)
Unrealized loss on investments	45,776	17,898
(Gain) loss on sale of assets	(3,536)	16,299
Other noncash expenses	9,510	16,697
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(4,034,729)	3,456,112
Inventories	(1,073,417)	(5,689,291)
Prepaid and income taxes payable	430,798	(3,887,008)
Prepaid expenses and other assets	(559,040)	(34,222)
Accounts payable	(2,624,258)	823,803
Accrued expenses	(183,519)	(2,468,929)
Rebates, chargebacks and returns payable	1,829,949	(1,412,848)
Accrued payroll and payroll related	1,225,219	(5,219,431)
Net cash provided by (used in) operating activities	4,671,052	(4,623,862)
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment (including construction in progress)	(4,186,417)	(5,663,361)
Proceeds from sale of property, plant and equipment	7,000	8,306
Purchases of investment securities	(18,662,147)	(11,925,702)
Proceeds from sale of investment securities	32,639,069	4,434,800
Net cash provided by (used in) investing activities	9,797,505	(13,145,957)
FINANCING ACTIVITIES:		
Proceeds from public stock offering	-	14,950,342
Proceeds from issuance of stock	191,378	397,506
Purchase of treasury stock	(479,433)	(220,890)
Tax shortfall on stock options exercised	(7,216)	(49,917)
Repayments of debt	(400,478)	(4,734,895)
Distribution to noncontrolling interests	(19,000)	(10,000)
Net cash (used in) provided by financing activities	(714,749)	10,332,146
Effect of foreign currency rates on cash and cash equivalents	(41,375)	(8,671)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	13,712,433	(7,446,344)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	5,276,735	21,895,648
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 18,989,168	$ 14,449,304
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -		
Interest paid	$ 213,062	$ 235,000
Income taxes (refunded) paid	$ (6,905)	$ 1,363,186

The accompanying notes to the consolidated financial statements are an integral part of these statements.

LANNETT COMPANY, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for presentation of interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations, and cash flows for the periods presented. In the opinion of management, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. Operating results for the three and nine months ended March 31, 2012 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2012. You should read these unaudited financial statements in combination with the other Notes in this section; Management s Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Financial Statements, including the Notes to the Financial Statements, included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2011.

Note 2. Summary of Significant Accounting Policies

Lannett Company, Inc., a Delaware corporation, and subsidiaries (the Company or Lannett), develop, manufacture, package, market, and distribute active pharmaceutical ingredients as well as pharmaceutical products sold under generic chemical names. The Company manufactures solid oral dosage forms, including tablets and capsules, topical and oral solutions, and is pursuing partnerships and research contracts for the development and production of other dosage forms, including ophthalmic, nasal and parenterals products.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Principles of Consolidation - The consolidated financial statements include the accounts of the operating parent company, Lannett Company, Inc., and its wholly owned subsidiaries, as well as the consolidation of Cody LCI Realty, LLC, a variable interest entity (VIE). See Note 15 regarding the consolidation of this variable interest entity. All intercompany accounts and transactions have been eliminated.

Foreign Currency Translation - The local currency is the functional currency of the Company s foreign subsidiary. Assets and liabilities of the foreign subsidiary are translated into U.S. dollars at the period-end currency exchange rate and revenues and expenses are translated at an average currency exchange rate for the period. The resulting translation adjustment is recorded in a separate component of shareholders equity and changes to such are included in comprehensive income (loss). Exchange adjustments resulting from transactions denominated in foreign

currencies are recognized in the consolidated statements of operations.

Reclassifications - Certain prior year amounts have been reclassified to conform to the current period financial statement presentation.

Revenue Recognition - The Company recognizes revenue when its products are shipped. At this point, title and risk of loss have transferred to the customer and provisions for estimates, including rebates, promotional adjustments, price adjustments, returns, chargebacks, and other potential adjustments are reasonably determinable. Accruals for these provisions are presented in the consolidated financial statements as rebates, chargebacks and returns payable and reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not

use information about product levels in distribution channels from third-party sources, such as IMS and Wolters Kluwer, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations.

Chargebacks The provision for chargebacks is the most significant and complex estimate used in the recognition of revenue. The Company sells its products directly to wholesale distributors, generic distributors, retail pharmacy chains, and mail-order pharmacies. The Company also sells its products indirectly to independent pharmacies, managed care organizations, hospitals, nursing homes, and group purchasing organizations, collectively referred to as indirect customers. Lannett enters into agreements with its indirect customers to establish pricing for certain products. The indirect customers then independently select a wholesaler from which to actually purchase the products at these agreed-upon prices. Lannett will provide credit to the wholesaler for the difference between the agreed-upon price with the indirect customer and the wholesaler s invoice price if the price sold to the indirect customer is lower than the direct price to the wholesaler. This credit is called a chargeback. The provision for chargebacks is based on expected sell-through levels by the Company s wholesale customers to the indirect customers and estimated wholesaler inventory levels. As sales to the large wholesale customers, such as Cardinal Health, AmerisourceBergen, and McKesson increase, the reserve for chargebacks will also generally increase. However, the size of the increase depends on the product mix and the amount of those sales that end up at indirect customers with which the Company has specific chargeback agreements. The Company continually monitors the reserve for chargebacks and makes adjustments when management believes that expected chargebacks on actual sales may differ from actual chargeback reserves.

Rebates Rebates are offered to the Company s key chain drug store, distributor and wholesaler customers to promote customer loyalty and increase product sales. These rebate programs provide customers with rebate credits upon attainment of pre-established volumes or attainment of net sales milestones for a specified period. Other promotional programs are incentive programs offered to the customers. As a result of the Patient Protection and Affordable Care Act (PPACA) enacted in the U.S. in March 2010, the Company participates in a new cost sharing program for certain Medicare Part D beneficiaries designed primarily for the sale of brand drugs and certain generic drugs if their FDA approval was granted under a New Drug Application (NDA) or 505(b) NDA versus an Abbreviated New Drug Application (ANDA). Because our drugs used for the treatment of thyroid deficiency and our Morphine Sulfate Oral Solution product were approved by the FDA as a 505(b)(2) NDA, they qualify as branded drugs for purposes of the PPACA. Drugs purchased under this program during Medicare Part D coverage gap (commonly referred to as the donut hole) result in additional rebates. At the time of shipment, the Company estimates reserves for rebates and other promotional credit programs based on the specific terms in each agreement. The reserve for rebates increases as sales to certain wholesale and retail customers increase. However, since these rebate programs are not identical for all customers, the size of the reserve will depend on the mix of customers that are eligible to receive rebates.

Returns Consistent with industry practice, the Company has a product returns policy that allows customers to return product within a specified period prior to and subsequent to the product s lot expiration date in exchange for a credit to be applied to future purchases. The Company s policy requires that the customer obtain pre-approval from the Company for any qualifying return. The Company estimates its provision for returns based on historical experience, changes to business practices, and credit terms. While such experience has allowed for reasonable estimations in the past, history may not always be an accurate indicator of future returns. The Company continually monitors the provisions for returns and makes adjustments when management believes that actual product returns may differ from established reserves. Generally, the reserve for returns increases as net sales increase. The reserve for returns is included in the rebates, chargebacks and returns payable account on the balance sheet.

Other Adjustments Other adjustments consist primarily of price adjustments, also known as shelf stock adjustments, which are credits issued to reflect decreases in the selling prices of the Company s products that customers have remaining in their inventories at the time of the price reduction. Decreases in selling prices are discretionary decisions made by management to reflect competitive market conditions. Amounts recorded for estimated shelf stock adjustments are based upon specified terms with direct customers, estimated declines in market prices, and estimates of inventory held by customers. The Company regularly monitors these and other factors and evaluates the reserve as additional information becomes available. Other adjustments are included in the rebates, chargebacks and returns payable account on the balance sheet.

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the nine months ended March 31, 2012 and 2011:

For the nine months ended March 31, 2012

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2011	$ 5,496,911	$ 2,925,477	$ 5,142,007	$ -	$ 13,564,395
Actual credits issued related to sales recorded in prior fiscal years	(5,350,016)	(3,083,836)	(3,426,013)	(151,846)	(12,011,711)
Reserves or (reversals) charged during Fiscal 2012 related to sales in prior fiscal years	(54,015)	158,359	-	151,846	256,190
Reserves charged to net sales during Fiscal 2012 related to sales recorded in Fiscal 2012	50,391,821	15,405,473	3,566,636	487,945	69,851,875
Actual credits issued related to sales recorded in Fiscal 2012	(44,091,799)	(11,686,661)	-	(487,945)	(56,266,405)
Reserve Balance as of March 31, 2012	$ 6,392,902	$ 3,718,812	$ 5,282,630	$ -	$ 15,394,344

For the nine months ended March 31, 2011

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2010	$ 6,282,127	$ 3,566,031	$ 5,401,254	$ -	$ 15,249,412
Actual credits issued related to sales recorded in prior fiscal years	(6,258,862)	(3,946,924)	(3,290,619)	-	(13,496,405)
Reserves or (reversals) charged during Fiscal 2011 related to sales in prior fiscal years	-	380,893	-	-	380,893
Reserves charged to net sales during Fiscal 2011 related to sales recorded in Fiscal 2011	40,105,340	12,276,977	5,602,225	2,739,301	60,723,843
Actual credits issued related to sales recorded in Fiscal 2011	(34,059,033)	(10,144,801)	(2,078,044)	(2,739,301)	(49,021,179)
Reserve Balance as of March 31, 2011	$ 6,069,572	$ 2,132,176	$ 5,634,816	$ -	$ 13,836,564

The total reserve for chargebacks, rebates, returns and other adjustments increased from $13,564,395 at June 30, 2011 to $15,394,344 at March 31, 2012. The increase in total reserves was partially due to an increase in rebate reserves as a result of increased sales, the timing of credits taken, as well as an additional rebate program the Company became obligated under Medicare Part D. The increase in chargeback reserves is related to sales to major wholesalers resulting in increased inventory levels at wholesaler distribution centers. The activity in the Other category for the nine months ended March 31, 2012 includes shelf-stock, shipping, and other sales adjustments.

The Company ships its products to the warehouses of its wholesale and retail chain customers. When the Company and a customer enter into an agreement for the supply of a product, the customer will generally continue to purchase the product, stock its warehouse(s), and resell the product to its own customers. The Company s customer will reorder the product as its warehouse is depleted. The Company generally has no minimum size orders for its customers. Additionally, most warehousing customers prefer not to stock excess inventory levels due to the additional carrying costs and inefficiencies created by holding excess inventory. As such, the Company s customers continually reorder the Company s products. It is common for the Company s customers to order the same products on a monthly basis. For generic pharmaceutical

manufacturers, it is critical to ensure that customers warehouses are adequately stocked with its products. This is important due to the fact that several generic competitors compete for the consumer demand for a given product. Availability of inventory ensures that a manufacturer s product is considered. Otherwise, retail prescriptions would be filled with competitors products. For this reason, the Company periodically offers incentives to its customers to purchase its products. These incentives are generally up-front discounts off its standard prices at the beginning of a

generic campaign launch for a newly-approved or newly-introduced product, or when a customer purchases a Lannett product for the first time. Customers generally inform the Company that such purchases represent an estimate of expected resale for a period of time. This period of time is generally up to three months. The Company records this revenue, net of any discounts offered and accepted by its customers at the time of shipment. The Company s products generally have 24 months or 36 months of shelf-life at the time of manufacture. The Company monitors its customers purchasing trends to attempt to identify any significant lapses in purchasing activity. If the Company observes a lack of recent activity, inquiries will be made to such customers regarding the success of the customer s resale efforts. The Company attempts to minimize any potential return (or shelf life issues) by maintaining an active dialogue with the customers.

The products that the Company sells are generic versions of brand named drugs. The consumer markets for such drugs are well-established markets with many years of historically-confirmed consumer demand. Such consumer demand may be affected by several factors, including alternative treatments and costs. However, the effects of changes in such consumer demand for the Company s products, like generic products manufactured by other generic companies, are gradual in nature. Any overall decrease in consumer demand for generic products generally occurs over an extended period of time. This is because there are thousands of doctors, prescribers, third-party payers, institutional formularies and other buyers of drugs that must change prescribing habits and medicinal practices before such a decrease would affect a generic drug market. If the historical data the Company uses and the assumptions management makes to calculate its estimates of future returns, chargebacks, and other credits do not accurately approximate future activity, its net sales, gross profit, net income and earnings per share could change. However, management believes that these estimates are reasonable based upon historical experience and current conditions.

Cash and cash equivalents The Company considers all highly liquid securities purchased with original maturities of 90 days or less to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value, and consist of certificates of deposit that are readily convertible to cash. The Company maintains cash and cash equivalents with several major financial institutions.

Accounts Receivable - The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history and the customer s current credit worthiness, as determined by a review of current credit information. The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses based upon historical experience and any specific customer collection issues that have been identified. While such credit losses have historically been within both the Company s expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

Fair Value of Financial Instruments - The carrying value of certain financial instruments, primarily cash and cash equivalents, accounts receivable, accounts payable, accrued expenses approximate their estimated fair values based upon the short-term nature of these instruments. The carrying amount of the Company s debt obligations approximates fair value based on current rates available to the Company on similar debt obligations.

Investment Securities - The Company s investment securities consist of certificates of deposit, equity securities and marketable debt securities. The Company s certificates of deposit are classified as held-to-maturity, its equity securities are classified as trading and all of its marketable debt securities are classified as available-for-sale. Available-for-sale and trading investment securities are recorded at fair value based on quoted market prices. For trading investments, unrealized holding gains and losses are recorded on the consolidated statements of operations. For available-for-sale investments, unrealized holding gains and losses are recorded, net of any tax effect, as a separate component of accumulated other comprehensive income. No gains or losses on investment securities are realized until they are sold or a decline in fair value is determined to be other-than-temporary. The Company reviews its investment securities and determines whether the investments are other-than-temporarily impaired. If the investments are deemed to be other-than-temporarily impaired, the investments are written down to their then current fair market value with a new cost basis being established. There were no securities determined by management to be other-than-temporarily impaired during the nine months ended March 31, 2012 or the fiscal year ended June 30, 2011.

Shipping and Handling Costs The cost of shipping products to customers is recognized at the time the products are shipped, and is included in cost of sales.

Research and Development Research and development expenses are charged to operations as incurred.

Other Assets - As of July 2010, Lannett stopped manufacturing and distributing Morphine Sulfate Oral Solution. Lannett filed a 505(b)(2) New Drug Application (MS NDA) in February 2010 and received FDA approval on the submission in June 2011. The filing fee related to this application totaled $1,405,500 and was initially recorded within other current assets on the consolidated balance sheets because part or all of this fee was thought to be refundable. Lannett met with the FDA in January 2011 to review the status of the application. At that time, the FDA stated that it will need to finalize and issue its Establishment Inspection Report for the February 2011 inspection of Lannett s facilities before it could give final approval on the MS NDA. Additionally, the Company corresponded with the FDA in March 2011 regarding whether any of the fee is refundable. The FDA s initial response was that all of the filing fee was not refundable, but the Company awaits a final decision from the FDA.

As of June 30, 2011, the Company received approval on the MS application, but, as of March 31, 2012, it has not received final determination on whether any of the fee is refundable. The Company s position is that the value related to the part of the fee that is not refunded is the cost of getting regulatory approval for its MS product and that this value should be properly recorded as an intangible asset based upon approval and amortized over the product s estimated useful life upon shipment of the product. The revenues and gross profit margins attained by the Company when it was previously selling its MS product currently substantiate its value as an intangible asset. As of March 31, 2012, the Company has restarted shipments of the MS product. As a result of the FDA approval of the MS NDA, an estimate of the nonrefundable amount totaling $398,400 determined based upon a third party analysis was reclassified to intangible assets upon shipment of the product which commenced in August 2011.

Intangible Assets In March 2004, the Company entered into an agreement with Jerome Stevens Pharmaceuticals, Inc. (JSP) for the exclusive marketing and distribution rights in the United States to the current line of JSP products in exchange for 4,000,000 shares of the Company s common stock. As a result of the JSP agreement, the Company recorded an intangible asset for the exclusive marketing and distribution rights obtained from JSP. The Company will incur annual amortization expense of approximately $1,785,000 for the JSP intangible asset over the remaining term of the agreement.

In April 2007, the Company entered into a Stock Purchase Agreement to acquire Cody Laboratories, Inc. (Cody) by purchasing all of the remaining shares of common stock of Cody. The consideration for the April 2007 acquisition was approximately $4,438,000, which represented the fair value of the tangible net assets acquired. The agreement also required Lannett to issue to the sellers up to 120,000 shares of unregistered common stock of the Company contingent upon the receipt of a license from a regulatory agency. This license was subsequently received in July 2008 and triggered the payment of 105,000 shares (87.5% of the 120,000 shares to be issued as the Company already owned 12.5% of Cody) of Lannett stock to the former owners of Cody Labs, which was completed in October 2008. Therefore, the Company recorded an intangible asset related to the acquisition of a drug import license in the original amount of $581,175 and recorded a corresponding deferred tax liability of approximately $150,700 due to the non-deductibility of the amortization for tax purposes. The Company has assigned a 15 year life to this intangible asset based on average life cycles of Lannett products.

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased, for $100,000 and future royalty payments, the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. owned the ANDA. In May 2008, the Company and Pharmeral waived their rights to any royalty payments on the sales of the drug by Lannett under Lannett s current ownership structure. Should Lannett undergo a change in control transaction with a third party, this royalty would be reinstated. In Fiscal 2008, the Company obtained FDA approval to use these proprietary rights. Accordingly, the Company originally capitalized these purchased product rights as an indefinite lived intangible asset and tested this asset for impairment at least on an annual basis. During the fourth quarter of fiscal year 2009, it was determined that this intangible asset no longer had an indefinite life. No impairment existed because the estimated fair value exceeded the carrying amount on that date. Accordingly, the $100,000 carrying amount of this intangible asset is being amortized on a straight line basis prospectively over its 10 year estimated useful life.

In August 2009, the Company acquired eight new ANDAs covering three separate product lines from another generic drug manufacturer for a purchase price of $500,000. The Company began shipping one of these product lines in October 2010. Accordingly, the Company allocated $325,000 of the purchase price to this product line, based on the relative fair market values of the acquired ANDAs, which is being amortized on a straight line basis over its 15 year estimated product life. It is expected that the Company will be able to produce one of the other product lines by the first half of the fiscal year ended June 30, 2013. Since it has no current plans to manufacture the third product line acquired under these new ANDAs, the Company wrote off the purchase price that was allocated to that product line during the fourth quarter of fiscal year 2011 which amounted to $26,000. Amortization will begin on the remaining $149,000 when the Company starts shipping this product.

An intangible asset that is not subject to amortization shall be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. An impairment loss is measured as the excess of the asset s carrying value over its fair value, calculated using a discounted future cash flow method. Our discounted cash flow models are highly reliant on assumptions which are considered level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates, and expectations about variations in the amount and timing of cash flows and the probability of achieving the estimated cash flows. As of March 31, 2012 and June 30, 2011, no impairment existed with respect to these non-amortized assets.

As of July 2010, Lannett stopped manufacturing and distributing Morphine Sulfate Oral Solution. Lannett filed a MS NDA in February 2010 and received FDA approval on the submission in June 2011. As of March 31, 2012, the Company has restarted shipments of the MS product, but it has not received final determination on whether any of the filing fee is refundable. As a result of the FDA approval of the MS NDA, an estimate of the nonrefundable amount totaling $398,400 determined based upon a third party analysis was reclassified to intangible assets upon shipment of the product which commenced in August 2011. Amortization began upon shipment of the product in August 2011 over the products estimated 15 year remaining useful life. Amortization will be adjusted prospectively once the nonrefundable amount is finalized. See Other Assets above.

For the three months ended March 31, 2012 and 2011, the Company incurred amortization expense of approximately $470,000 and $464,000, respectively. For the nine months ended March 31, 2012 and 2011, the Company incurred amortization expense of approximately $1,409,000 and $1,386,000, respectively. As of March 31, 2012 and June 30, 2011, accumulated amortization totaled approximately $12,743,000 and $11,334,000, respectively.

Future annual amortization expense consists of the following as of March 31, 2012:

Fiscal Year Ending June 30,		Annual Amortization Expense
2012	$	470,411
2013		1,881,639
2014		1,435,472
2015		96,972
2016		96,972
Thereafter		768,555
	$	4,750,021

The amounts above do not include the non-amortized product line covered by the ANDAs purchased in August 2009 for $149,000 as amortization will begin when the Company starts shipping this product.

Advertising Costs - The Company charges advertising costs to operations as incurred. Advertising expense for the nine months ended March 31, 2012 and 2011 was approximately $26,000 and $23,000, respectively.

Income Taxes - The Company uses the liability method to account for income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense/(benefit) is the result of changes in deferred tax assets and liabilities. The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements

from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative standards issued by the FASB also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

Segment Information - The Company operates one business segment - generic pharmaceuticals; accordingly the Company has one reporting segment. The Company aggregates its financial information for all products and reports as one operating segment. The following table identifies the Company s approximate net product sales by medical indication for the three and nine months ended March 31, 2012 and 2011:

	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
Medical Indication	**2012**	**2011**	**2012**	**2011**
Migraine Headache	$ 1,441,975	$ 1,949,168	$ 4,601,079	$ 6,984,922
Prescription Vitamin	-	-	-	1,820,867
Cardiovascular	6,049,949	3,012,168	11,511,861	9,816,836
Thyroid Deficiency	12,542,855	12,330,638	36,788,397	34,897,688
Antibiotic	1,662,408	1,664,403	4,798,040	4,502,155
Pain Management	4,042,947	2,735,294	14,609,187	11,137,244
Glaucoma	993,084	860,415	3,092,604	2,175,635
Gallstone Prevention	1,418,857	1,718,553	4,285,549	4,310,952
Obesity	978,923	842,465	2,570,007	2,500,399
Other	1,556,728	779,379	5,042,985	3,180,969
Total	$ 30,687,726	$ 25,892,483	$ 87,299,709	$ 81,327,667

Concentration of Market and Credit Risk - The following table identifies certain of the Company s products, defined as generics containing the same active ingredient or combination of ingredients, which accounted for greater than 10% of net sales in either of the three and nine month periods ended March 31, 2012 and 2011, respectively.

	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
	2012	**2011**	**2012**	**2011**
Product 1	41%	48%	42%	43%
Product 2	11%	-	-	-
Product 3	9%	12%	9%	12%

The following table identifies certain of the Company s customers which accounted for greater than 10% of net sales in either of the three and nine month periods ended March 31, 2012 and 2011, respectively.

	For the Three Months Ended March 31,	For the Nine Months Ended March 31,

	2012	2011	2012	2011
Customer A	16%	22%		