LANNETT CO INC
Form 10-Q
November 12, 2009
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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 SEPTEMBER 30, 2009

o	**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 o**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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 o No o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12B-12 of the Exchange Act). **Yes o 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 November 9, 2009**
Common stock, par value $0.001 per share	24,699,089 shares

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

		(Unaudited) September 30, 2009		June 30, 2009
ASSETS				
Current Assets				
Cash and cash equivalents	$	23,611,254	$	25,832,456
Investment securities - available for sale		747,448		347,921
Trade accounts receivable (net of allowance of $132,000 and $132,000, respectively)		30,891,483		29,945,748
Inventories, net		17,010,224		16,195,361
Interest receivable		92,770		90,425
Deferred tax assets		4,346,311		4,296,929
Other current assets		541,848		602,335
Total Current Assets		77,241,338		77,311,175
Property, plant and equipment		41,771,570		41,431,158
Less accumulated depreciation		(19,242,024)		(18,533,773)
		22,529,546		22,897,385
Construction in progress		1,318,534		591,685
Investment securities - available for sale		398,470		801,748
Intangible assets (product rights) - net of accumulated amortization		9,160,357		9,118,710
Deferred tax assets		13,321,236		13,757,545
Other assets		89,846		98,873
Total Assets	$	124,059,327	$	124,577,121
LIABILITIES AND SHAREHOLDERS EQUITY				
LIABILITIES				
Current Liabilities				
Accounts payable	$	15,649,685	$	16,805,468
Accrued expenses		2,132,314		1,842,434
Accrued payroll and payroll related		2,954,609		5,150,104
Income taxes payable		1,224,663		711,073
Current portion of long-term debt		357,806		435,386
Rebates, chargebacks and returns payable		12,656,106		13,734,540
Total Current Liabilities		34,975,183		38,679,005
Long-term debt, less current portion		7,644,677		7,703,382
Unearned grant funds		500,000		500,000
Other long-term liabilities		11,693		47,111
Total Liabilities		43,131,553		46,929,498
Commitment and Contingencies, See notes 10 and 11				
SHAREHOLDERS EQUITY				
Common stock - authorized 50,000,000 shares, par value $0.001;				
issued and outstanding, 24,587,281 and 24,517,696 shares, respectively		24,587		24,518
Additional paid in capital		76,733,498		76,250,309
Retained earnings		4,600,935		1,743,565
Noncontrolling interest		104,548		93,654
Accumulated other comprehensive income		22,500		24,751
		81,486,068		78,136,797
Less: Treasury stock at cost - 90,160 and 82,228 shares, respectively		(558,294)		(489,174)
TOTAL SHAREHOLDERS EQUITY		80,927,774		77,647,623
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	124,059,327	$	124,577,121

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

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LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three months ended September 30, 2009		2008	
Net sales	$	31,434,989	$	25,567,653
Cost of sales		19,012,318		16,120,195
Amortization of intangible assets		448,667		446,166
Product royalties		439,774		
Gross profit		11,534,230		9,001,292
Research and development expenses		3,027,841		1,863,113
Selling, general, and administrative expenses		3,763,161		4,949,144
Loss on sale of investments				4,931
Operating income		4,743,228		2,184,104
Interest income		23,099		45,767
Interest expense		(70,413)		(66,209)
		(47,314)		(20,442)
Income before income tax expense		4,695,914		2,163,662
Income tax expense		1,827,650		919,990
Consolidated net income		2,868,264		1,243,672
Less net income from noncontrolling interest		(10,894)		(17,507)
Net income attributable to Lannett Company, Inc.	$	2,857,370	$	1,226,165
Basic income per common share - Lannett Company, Inc.	$	0.12	$	0.05
Diluted income per common share - Lannett Company, Inc.	$	0.11	$	0.05
Basic weighted average number of shares		24,533,562		24,306,488
Diluted weighted average number of shares		25,054,661		24,382,951

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

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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, 2009	24,517,696	$ 24,518	$ 76,250,309	$ 1,743,565	$ (489,174)	$ 93,654	$ 24,751	$ 77,647,623
Exercise of stock options	36,100	36	152,650					152,686
Shares issued in connection with employee stock purchase plan	7,985	8	33,249					33,257
Share based compensation								
Restricted stock			43,007					43,007
Stock options			232,868					232,868
Employee stock purchase plan			21,440					21,440
Shares issued in connection with restricted stock grant	25,500	25	(25)					
Purchase of treasury stock					(69,120)			(69,120)
Income from noncontrolling interest						10,894		10,894
Other comprehensive loss, net of income tax							(2,251)	(2,251)
Net income				2,857,370				2,857,370
Balance, September 30, 2009	24,587,281	$ 24,587	$ 76,733,498	$ 4,600,935	$ (558,294)	$ 104,548	$ 22,500	$ 80,927,774

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

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LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the three months ended September 30, 2009	2008
OPERATING ACTIVITIES:		
Net income - Lannett Company, Inc.	$ 2,857,370	$ 1,226,165
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,166,604	1,283,617
Deferred tax expense	388,427	911,872
Stock compensation expense	297,315	389,797
Other noncash (income) expenses	(26,391)	1,949
Income from noncontrolling interest	10,894	17,506
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(1,152,466)	5,341,230
Inventories	(814,863)	294,571
Prepaid and income taxes payable	513,590	784,009
Prepaid expenses and other assets	58,142	(106,188)
Accounts payable	(1,155,783)	(1,259,114)
Accrued expenses	289,880	157,703
Rebates, chargebacks and returns payable	(871,703)	20,132
Accrued payroll and payroll related	(2,195,495)	398,639
Deferred revenue		(258,283)
Net cash (used in) provided by operating activities	(634,479)	9,203,605
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment (including construction in progress)	(1,067,261)	(209,210)
Purchase of intangible asset (product rights)	(500,000)	
Proceeds from sale of investment securities - available for sale		316,099
Purchase of investment securities - available for sale		(298,528)
Net cash used in investing activities	(1,567,261)	(191,639)
FINANCING ACTIVITIES:		
Repayments of debt	(136,285)	(147,583)
Proceeds from issuance of stock	185,943	31,281
Purchase of treasury stock	(69,120)	(19,950)
Net cash used in financing activities	(19,462)	(136,252)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,221,202)	8,875,714
CASH AND CASH EQUIVLAENTS, BEGINNING OF PERIOD	25,832,456	6,256,712
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 23,611,254	$ 15,132,426
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -		
Interest paid	$ 41,762	$ 64,852
Income taxes paid	$ 925,633	$ 250,000
Lannett stock issued - contingent consideration - Cody Labs acquistion	$	$ 430,500

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

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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 months ended September 30, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2010. 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, 2009.

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 primarily manufactures solid oral dosage forms, including tablets and capsules, and is pursuing partnerships and research contracts for the development and production of other dosage forms, including liquids and injectable 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. As applicable to these consolidated financial statements, the most significant estimates and assumptions relate to sales reserves and allowances, income taxes, inventories, contingencies and valuation of intangible assets.

Principles of Consolidation - The consolidated financial statements include the accounts of the operating parent company, Lannett Company, Inc., and its wholly owned subsidiaries, Lannett Holdings, Inc. and Cody Laboratories, Inc. (Cody). Cody includes the consolidation of Cody LCI Realty, LLC, a variable interest entity. See Note 16 regarding the consolidation of this variable interest entity. All intercompany accounts and transactions have been eliminated.

Reclassifications - Certain prior year amounts have been reclassified to conform to the current year 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

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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 NDC Health, 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. 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.

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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 and chargebacks 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 three months ended September 30, 2009 and 2008:

For the three months ended September 30, 2009

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2009	$ 6,089,802	$ 2,537,746	$ 5,106,992	$	$ 13,734,540
Actual credits issued related to sales recorded in prior fiscal years	(4,767,581)	(1,852,708)	(1,147,720)		(7,768,009)
Reserves or (reversals) charged during Fiscal 2010 related to sales in prior fiscal years					
Reserves charged to net sales during Fiscal 2010 related to sales recorded in Fiscal 2010	10,272,936	4,066,855	1,140,128	407,784	15,887,703
Actual credits issued related to sales recorded in Fiscal 2010	(7,000,389)	(1,789,955)		(407,784)	(9,198,128)
Reserve Balance as of September 30, 2009	$ 4,594,768	$ 2,961,938	$ 5,099,400	$	$ 12,656,106

For the three months ended September 30, 2008

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2008	$ 4,049,407	$ 632,314	$ 13,642,589	$ 2,107	$ 18,326,417
Actual credits issued related to sales recorded in prior fiscal years	(2,865,229)	(255,126)	(6,425,413)		(9,545,768)
Reserves or (reversals) charged during Fiscal 2009 related to sales in prior fiscal years			2,107	(2,107)	
Reserves charged to net sales during Fiscal 2009 related to sales recorded in Fiscal 2009	9,144,349	2,949,913	1,142,474	42,957	13,279,693
Actual credits issued related to sales recorded in Fiscal 2009	(5,129,939)	(1,537,556)		(40,096)	(6,707,591)
Reserve Balance as of September 30, 2008	$ 5,198,588	$ 1,789,545	$ 8,361,757	$ 2,861	$ 15,352,751

The total reserve for chargebacks, rebates, returns and other adjustments decreased from $13,734,540 at June 30, 2009 to $12,656,106 at September 30, 2009. As of September 30, 2009 approximately $9,924,000 of the original $10,545,000 return reserve recorded in Fiscal 2008 for Prenatal Multivitamin was applied to accounts receivable for customers who had returned the Prenatal Multivitamin product by that date, leaving a balance of approximately $621,000 of Multivitamin returns reserve on the consolidated balance sheet at September 30, 2009. The decrease in chargeback reserves between June 30, 2009 and September 30, 2009 was due primarily to a decrease in inventory levels at wholesaler distribution centers.

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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 have either 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 customer 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, etc. 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 market value, and consist of certificates of deposit that are readily converted to cash.

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 Company s financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and debt obligations. The carrying values of these assets and liabilities approximate fair value based upon the short-term nature of these instruments. The

Company has estimated that the fair value of long-term debt associated with the 20 year mortgage on its land and building in Cody, Wyoming approximates the discounted amount of future payments to the mortgage-holder.

Investment Securities - The Company s investment securities consist of marketable debt securities, primarily in U.S. government and agency obligations. All of the Company s marketable debt securities are classified as available-for-sale and recorded at fair value, based on quoted market prices. 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 marketable debt securities are realized until they are sold or a decline in fair value is determined to be other-than-temporary. The Company reviews its marketable 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 three months ended September 30, 2009, or the fiscal year ended June 30, 2009.

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.

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 four million (4,000,000) shares of the Company s common stock. As a result of the JSP agreement, the Company recorded an intangible asset of $67,040,000 for the exclusive marketing and distribution rights obtained from JSP. The intangible asset was recorded based upon the fair value of the four million (4,000,000) shares at the time of issuance to JSP. During the quarter ended March 31, 2005, the Company recorded a non-cash impairment loss of approximately $46,093,000 to reduce the carrying value of the intangible asset to its fair value of approximately $16,062,000 as of the date of the impairment. As of September 30, 2009 and June 30, 2009, management concluded the carrying value of the intangible asset was less than its fair value and, therefore, no further impairment was required. The Company will incur annual amortization expense of approximately $1,785,000 for the JSP intangible asset over the remaining term of the agreement.

On April 10, 2007, the Company entered into a Stock Purchase Agreement to acquire Cody by purchasing all of the remaining shares of common stock of Cody. The consideration for the April 10, 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 as the Company already owned 12.5%) 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 will 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 2009, it was determined that this intangible asset no longer has 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 remaining 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. It is expected that the Company will be able to produce these products by the third quarter of this fiscal year. The Company has assigned a 15 year life to this intangible asset based on average life cycles of Lannett products. Amortization will begin when the Company starts shipping these products.

For the three months ended September 30, 2009 and 2008, the Company incurred amortization expense of approximately $458,000 and $446,000, respectively. As of September 30, 2009 and June 30, 2009, accumulated amortization totaled approximately $8,083,000 and $7,624,000, respectively.

Future annual amortization expense consists of the following as of September 30, 2009:

Fiscal Year Ending June 30,		**Annual Amortization Expense**
2010	$	1,375,059
2011		1,833,412
2012		1,833,412
2013		1,833,412
2014		1,387,245
Thereafter		397,817
	$	8,660,357

The amounts above do not include the ANDA s purchased in August 2009 for $500,000 as amortization will begin when the Company starts shipping these products.

Advertising Costs - The Company charges advertising costs to operations as incurred. Advertising expense for the three months ended September 30, 2009 and 2008 was approximately $10,000 and $13,000, 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 months ended September 30, 2009 and 2008:

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Medical Indication	For the Three Months Ended September 30, 2009		For the Three Months Ended September 30, 2008	
Migraine Headache	$	2,663,000	$	2,319,000
Epilepsy		611,000		680,000
Prescription Vitamin		1,489,000		
Heart Failure		4,852,000		6,348,000
Thyroid Deficiency		13,024,000		11,466,000
Antibiotic		1,661,000		1,496,000
Pain Management		2,880,000		276,000
Other		4,255,000		2,983,000
Total	$	31,435,000	$	25,568,000

Concentration of Market and Credit Risk - Five of the Company s products, defined as generics containing the same active ingredient or combination of ingredients, accounted for approximately 41%, 15%, 9%, 8% and 5%, respectively of net sales for the three months ended September 30, 2009. Those same products accounted for 45%, 25%, 1%, 9% and 0% respectively, of net sales for the three months ended September 30, 2008.

Four of the Company s customers accounted for 26%, 14%, 9%, and 8%, respectively, of net sales for the three months ended September 30, 2009, and 29%, 5%, 3%, and 8%, respectively, of net sales for the three months ended September 30, 2008. At September 30, 2009, these four customers accounted for 60% of the Company s accounts receivable balances. At June 30, 2009, these four customers accounted for 54% of the Company s accounts receivable balances.

Share-based Compensation - The Company recognizes compensation cost for share-based compensation issued to or purchased by employees, net of estimated forfeitures, under share-based compensation plans using a fair value method.

At September 30, 2009, the Company had three stock-based employee compensation plans (the Old Plan, the 2003 Plan, and the Long-term Incentive Plan, or LTIP).

During the three months ended September 30, 2008, the Company awarded 30,000 shares of restricted stock under the LTIP which vested immediately. Stock compensation expense of $101,400 was recognized during the three months ended September 30, 2008, related to these shares of restricted stock.

During the fiscal year ended June 30, 2008, the Company awarded 209,264 shares of restricted stock under the LTIP of which, 74,464 of these shares vested 100% on January 1, 2008. The remainder vests in equal portions on September 18, 2008, 2009 and 2010. Stock compensation expense of $43,007 and $43,007 was recognized during the three months ended September 30, 2009 and 2008, respectively, related to the vesting of these shares of restricted stock.

The Company measures the fair value of share-based compensation cost for options using the Black-Scholes option pricing model. The following table presents the weighted average assumptions used to estimate fair values of the stock options granted and the estimated forfeiture rates during the three months ended September 30:

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	Incentive Stock Options FY 2010	Non-qualified Stock Options FY 2010	Incentive Stock Options FY 2009	Non-qualified Stock Options FY 2009
Risk-free interest rate	2.4%	%	2.5%	2.5%
Expected volatility	67.1%	%	56.5%	56.5%
Expected dividend yield	0.0%	%	0.0%	0.0%
Forfeiture rate	5.0%	%	5.0%	5.0%
Expected term	5.0 years	n/a	5.0 years	5.0 years
Weighted average fair value at date of grant	$ 4.86	$	$ 1.41	$ 1.41

There were no options issued under the LTIP during the three months ended September 30, 2009. Approximately 100,000 options were issued under the LTIP during the three months ended September 30, 2008. There were 36,100 and zero shares under option that were exercised in the three months ended September 30, 2009 and 2008, respectively. At September 30, 2009, there were 1,563,181 options outstanding. Of those, 571,800 were options issued under the LTIP, 780,148 were issued under the 2003 Plan, and 211,233 under the Old Plan. There are no further shares authorized to be issued under the Old Plan. 1,125,000 shares were authorized to be issued under the 2003 Plan, with 20,490 shares under option having already been exercised under that plan. 2,500,000 shares were authorized to be issued under the LTIP, with 34,100 shares under option having already been exercised under that plan.

Expected volatility is based on the historical volatility of the price of our common shares since the date we commenced trading on the NYSE-Amex, April 2002, or a historical period equal to the expected term of the option, whichever is shorter. We use historical information to estimate expected term within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using the straight-line method over the vesting or service period and is net of estimated forfeitures.

The forfeiture rate assumption is the estimated annual rate at which unvested awards are expected to be forfeited during the vesting period. This assumption is based on our historical forfeiture rate. Periodically, management will assess whether it is necessary to adjust the estimated rate to reflect changes in actual forfeitures or changes in expectations. For example, adjustments may be needed if forfeitures were affected by turnover that resulted from a business restructuring that is not expected to recur. The Company will incur additional expense if the actual forfeiture rate is lower than originally estimated. A recovery of prior expense will be recorded if the actual rate is higher than originally estimated.

The following table presents all share-based compensation costs recognized in our statements of operations, substantially all of which is reflected in the selling, general and administrative expense line:

	Three Months Ended September 30, 2009	2008
Share based compensation		
Stock options	$ 232,868	$ 218,799
Employee stock purchase plan	21,440	26,591
Restricted stock	43,007	144,407
Tax benefit at effective rate	27,604	22,180

Options outstanding that have vested and are expected to vest as of September 30, 2009 are as follows:

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	Awards		Weighted - Average Exercise Price		Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Options vested	1,149,641	$	8.73	$	1,575,149	5.7
Options expected to vest	392,863	$	4.62	$	1,143,046	8.5
Total vested and expected to vest	1,542,504	$	7.68	$	2,718,195	6.4

A summary of nonvested restricted stock award activity as of September 30, 2009 and changes during the three months then ended, is presented below:

	Awards		Weighted Average Grant Date Fair Value
Nonvested at July 1, 2009	77,198	$	311,108
Granted			
Vested	(25,500)		(102,765)
Forfeited	(6,200)		(24,986)
Nonvested at September 30, 2009	45,498	$	183,357

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A summary of award activity under the Plans as of September 30, 2009 and 2008, and changes during the three months then ended, is presented below:

	Incentive Stock Options				Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Outstanding at July 1, 2009	958,909	$ 5.60			626,772	$ 10.52		
Granted	20,000	$ 8.48				$		
Exercised	(36,100)	$ 4.23						
Forfeited, expired or repurchased	(6,400)	$ 5.38				$		
Outstanding at September 30, 2009	936,409	$ 5.71	$ 2,217,739	7.2	626,772	$ 10.52	$ 551,242	5.3
Outstanding at September 30, 2009 and not yet vested	350,474	$ 4.64	$ 1,015,723	8.6	63,067	$ 4.51	$ 187,483	8.1
Exercisable at September 30, 2009	585,935	$ 6.36	$ 1,202,016	6.3	563,705	$ 11.19	$ 373,133	4.9

	Incentive Stock Options				Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Outstanding at July 1, 2008	991,267	$ 5.76			703,064	$ 10.16		
Granted	62,002	$ 2.80			37,998	$ 2.80		
Exercised								
Forfeited or expired	(42,000)	$ 4.89			(25,000)	$ 5.02		
Outstanding at September 30, 2008	1,011,269	$ 5.62	$ 3,000	7.9	716,062	$ 9.95		6.4
Outstanding at September 30, 2008 and not yet vested	521,180	$ 4.45		8.9	163,288	$ 4.75		8.8
Exercisable at September 30, 2008	490,089	$ 6.86	$ 3,000	6.8	552,774	$ 11.48		5.7

Options with a fair value of $421,281 vested during the three months ended September 30, 2009. As of September 30, 2009, there was $946,124 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the Plans. That cost is expected to be recognized over a weighted average period of 1.4 years. As of September 30, 2008, there was approximately $1,663,000 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the Plans. The Company issues new shares when stock options are exercised.

Unearned Grant Funds The Company records all grant funds received as a liability until the Company fulfills all the requirements of the grant funding program.

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Earnings per Common Share A dual presentation of basic and diluted earnings per share is required on the face of the Company s consolidated statement of operations as well as a reconciliation of the computation of basic earnings per share to diluted earnings per share. Basic earnings per share excludes the dilutive impact of common stock equivalents and is computed by dividing net income by the weighted-average number of shares of common stock outstanding for the period. Diluted earnings per share include the effect of potential dilution from the exercise of outstanding common stock equivalents into common stock using the treasury stock method. A reconciliation of the Company s basic and diluted income per share follows:

	2009		2008	
	Net Income (Numerator)	**Shares (Denominator)**	**Net Loss (Numerator)**	**Shares (Denominator)**
Basic earnings per share factors	$ 2,857,370	24,533,562	$ 1,226,165	24,306,488
Effect of potentially dilutive option and restricted stock plans		521,099		76,463
Diluted earnings per share factors	$ 2,857,370	25,054,661	$ 1,226,165	24,382,951
Basic earnings per share	$ 0.12		$ 0.05	
Diluted earnings per share	$ 0.11		$ 0.05	

The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the three months ended September 30, 2009 and 2008 were 352,845 and 1,807,529, respectively.

Note 3. New Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued the FASB Accounting Standards Codification (the Codification), which establishes the Codification as the source of authoritative accounting guidance to be applied in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). The Codification, which changes the referencing of financial standards, became effective for interim and annual periods ending on or after September 15, 2009. The Codification is now the single official source of authoritative U.S. GAAP (other than guidance issued by the Securities and Exchange Commission), superseding existing FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and related literature. Only one level of authoritative U.S. GAAP now exists. All other literature is considered non-authoritative. The Codification does not change U.S. GAAP. We adopted the Codification during the first quarter of fiscal year 2010.

In December 2007, the FASB issued authoritative guidance which significantly changes the accounting for business combinations in a number of areas including the treatment of contingent consideration, contingencies, acquisition costs, in-process research and development and restructuring costs. In addition, under the guidance, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. In April 2009, updated guidance was issued to address application issues regarding the accounting and disclosure provisions for contingencies. The authoritative guidance applies prospectively to business combinations for which the acquisition date is on or after the beginning of the fiscal year beginning July 1, 2009. Early application is not permitted. The effect of this authoritative guidance on our consolidated financial statements will depend on the nature and terms of any business combinations that occur after the effective date.

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In December 2007, the FASB issued authoritative guidance to establish accounting and reporting standards for the noncontrolling (minority) interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and establishes a single method of accounting for changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation. We adopted this authoritative guidance effective July 1, 2009. As a result of the adoption, the Company presents noncontrolling interests as a component of equity on its consolidated balance sheets. Minority interest expense is now shown below net income under the heading net income from noncontrolling interest . Prior year financial statements have been reclassified to reflect the adoption of this guidance. The adoption of this guidance did not have any other significant impact on our consolidated financial statements.

In April 2008, the FASB issued authoritative guidance which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. The guidance is intended to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. We adopted this authoritative guidance effective July 1, 2009. The adoption of this guidance did not have a significant impact on our consolidated financial statements.

In June 2009, the FASB issued authoritative guidance for determining whether an entity is a variable interest entity and modifies the methods allowed for determining the primary beneficiary of a variable interest entity. This guidance requires an enterprise to perform an analysis to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity. It also requires ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. The authoritative guidance is effective for the annual reporting period that begins after November 15, 2009. We do not expect the adoption of this authoritative guidance to have a significant impact on our consolidated financial statements.

Note 4. Inventories

The Company values its inventory at the lower of cost (determined by the first-in, first-out method) or market, regularly reviews inventory quantities on hand, and records a provision for excess and obsolete inventory based primarily on estimated forecasts of product demand. The Company s estimates of future product demand may fluctuate, in which case estimated required reserves for excess and obsolete inventory may increase or decrease. If the Company s inventory is determined to be overvalued, the Company recognizes such costs in cost of goods sold at the time of such determination. Likewise, if inventory is determined to be undervalued, the Company may have recognized excess cost of goods sold in previous periods and would recognize such additional operating income at the time of sale.

Inventories consist of the following:

	September 30, 2009	June 30, 2009
Raw materials	$ 5,023,930	$ 5,755,982
Work-in-process	3,328,786	2,846,600
Finished goods		