

LANNETT CO INC  
Form 10-Q/A  
September 12, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q/A**

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED December 31, 2005.**
- 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**  
(State of Incorporation)

**23-0787699**  
(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

No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes

No

As of January 23, 2006, there were 24,135,625 shares of the issuer's common stock, \$.001 par value, outstanding.

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**EXPLANATORY NOTE**

This amendment on Form 10-Q/A (the Amendment ) amends Lannett Company Inc. s quarterly report on Form 10-Q for the quarter ended December 31, 2005, as initially filed with the Securities and Exchange Commission on February 8, 2006 (the Form 10-Q ).

The Company has expanded and enhanced the disclosure in the text and tables located in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations, ( MD&A ) relating to chargebacks, rebates and returns. Similarly, tables in the Notes to the Financial Statements have also been expanded to reflect enhanced disclosure.

The Company has added disclosure of its methods of tracking Days Sales Outstanding in the section titled Accounts Receivable within the MD&A. This has been undertaken to provide enhanced disclosure relating to the Company s ability to manage receivables.

The Company has provided enhanced disclosure relating to the changes in sales year over year in the section titled Results of Operations within the MD&A.

The filing of this Amendment shall not be deemed an admission that the original Form 10-Q, when filed, included any untrue statement of material fact or omitted to state a material fact necessary to make a statement not misleading.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## LANNETT COMPANY, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

	(UNAUDITED)	
	12/31/2005	6/30/2005
<b><u>ASSETS</u></b>		
<i>Current Assets</i>		
Cash	\$ 87,169	\$ 4,165,601
Trade accounts receivable (net of allowance)	17,357,057	10,735,529
Inventories	10,890,571	9,988,769
Prepaid taxes	2,107,305	3,957,993
Deferred tax assets - current portion	3,123,953	3,123,953
Other current assets	1,871,173	1,966,270
<b>Total current assets</b>	<b>35,437,228</b>	<b>33,938,115</b>
Property, plant, & equipment	25,033,226	23,746,161
Less accumulated depreciation	(8,159,900)	(7,121,313)
	16,873,326	16,624,848
Construction in progress	3,471,432	2,079,650
Investments - available for sale	5,590,014	7,888,708
Note receivable	2,000,000	
Intangible asset, net of accumulated amortization	14,723,502	15,615,835
Deferred tax asset - less current portion	18,593,364	18,610,159
Other assets	216,042	159,745
<b>Total Assets</b>	<b>\$ 96,904,908</b>	<b>\$ 94,917,060</b>
<b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>		
<i>Current Liabilities</i>		
Accounts payable	\$ 1,468,010	\$ 1,208,148
Accrued expense	2,765,526	1,667,638
Unearned grant funds	500,000	500,000
Current portion of long term debt	1,037,087	2,269,776
Rebates and chargebacks	9,074,208	10,750,000
<b>Total current liabilities</b>	<b>14,844,831</b>	<b>16,395,562</b>
Long term debt, less current portion	7,234,179	7,262,672
Deferred tax liabilities	2,009,582	2,009,582
<b>Total Liabilities</b>	<b>24,088,592</b>	<b>25,667,816</b>
<i>Shareholders' Equity</i>		
Common stock - authorized 50,000,000 shares, par value \$0.001; issued and outstanding, 24,125,884 and 24,111,140, respectively	24,126	24,111
Additional paid-in capital	70,908,450	70,157,431
Retained earnings (deficit)	2,352,516	(512,535)
Accumulated other comprehensive loss, net	(74,206)	(25,193)
	73,210,886	69,643,814
Treasury stock at cost - 50,900 shares	394,570	394,570
<b>Total shareholders' equity</b>	<b>72,816,316</b>	<b>69,249,244</b>

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Total Liabilities and Shareholders' Equity	\$	96,904,908	\$	94,917,060
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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 INCOME

	Three months ended: (UNAUDITED)		Six months ended: (UNAUDITED)	
	12/31/2005	12/31/2004	12/31/2005	12/31/2004
Net sales	\$ 15,228,767	\$ 12,918,521	\$ 28,870,299	\$ 27,930,017
Cost of sales (excluding amortization of intangible asset)	8,063,974	7,085,479	14,926,759	14,706,313
Gross profit	7,164,793	5,833,042	13,943,540	13,223,704
Research and development	2,420,977	1,000,437	3,562,077	2,348,654
Selling, general, & administrative	2,204,916	1,776,392	4,782,051	3,887,281
Amortization of intangible assets	446,167	1,690,084	892,333	3,380,168
Operating income	2,092,733	1,366,129	4,707,079	3,607,601
Other income (expense):				
Interest expense	(85,441 )	(87,630 )	(193,444 )	(148,683 )
Interest income	99,300	33,899	247,349	48,777
	13,859	(53,731 )	53,905	(99,906 )
Income before income tax expense	2,106,592	1,312,398	4,760,984	3,507,695
Income tax expense	842,518	524,921	1,895,933	1,403,077
Net income	\$ 1,264,074	\$ 787,477	\$ 2,865,051	\$ 2,104,618
Basic earnings per share	\$ 0.05	\$ 0.03	\$ 0.12	\$ 0.09
Diluted earnings per share	\$ 0.05	\$ 0.03	\$ 0.12	\$ 0.09
Basic weighted average number of shares	24,125,884	24,093,609	24,122,181	24,088,038
Diluted weighted average number of shares	24,151,222	24,185,378	24,140,863	24,192,686

The accompanying notes to 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 Shares	Amount	Additional Paid-in Capital	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Loss, net	Total Shareholders Equity
<b>Balance at June 30, 2005</b>	24,111,140	\$ 24,111	\$ 70,157,431	\$ (512,535)	\$ (394,570)	\$ (25,193)	\$ 69,249,244
Shares issued in connection with employee stock purchase plan	14,744	15	65,036				65,051
Amortization expense in connection with employee stock options			685,983				685,983
Unrealized net losses on investment securities, net of reclassification adjustments and income taxes						(49,013)	(49,013)
Net Income				2,865,051			2,865,051
<b>Balance at December 31, 2005</b>	24,125,884	\$ 24,126	\$ 70,908,450	\$ 2,352,516	\$ (394,570)	\$ (74,206)	\$ 72,816,316

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)

	<b>For the six months ended</b>	
	<b>12/31/2005</b>	<b>12/31/2004</b>
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 2,865,051	\$ 2,104,618
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,930,920	4,214,504
Deferred tax expense	16,795	
Stock compensation expense	685,983	
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(8,297,320 )	8,676,423
Inventories	(901,802 )	(3,272,743 )
Prepaid taxes	1,850,688	203,078
Prepaid expenses and other assets	38,800	(129,764 )
Accounts payable	259,862	(4,778,937 )
Accrued expenses	1,097,888	(2,698,043 )
Net cash (used in)provided by operating activities	(453,135 )	4,319,136
<b>INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment(including construction in progress)	(2,678,847 )	(2,037,335 )
Sales(purchases) of investment securities - available for sale	2,249,681	(2,886,575 )
Purchase of note receivable	(2,000,000 )	
Net cash used in investing activities	(2,429,166 )	(4,923,910 )
<b>FINANCING ACTIVITIES:</b>		
Repayments of debt	(7,011,182 )	(1,034,985 )
Proceeds from grant funding		500,000
Proceeds from debt, net of restricted cash released	5,750,000	1,602,610
Proceeds from issuance of stock	65,051	158,426
Net cash (used in)provided by financing activities	(1,196,131 )	1,226,051
NET (DECREASE)/INCREASE IN CASH	(4,078,432 )	621,277
CASH, BEGINNING OF PERIOD	4,165,601	8,966,954
CASH, END OF PERIOD	\$ 87,169	\$ 9,588,231
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -</b>		
Interest paid	\$ 193,444	\$ 148,683

The accompanying notes to 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. 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 our opinion, however, 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. You should not base your estimate of our results of operations for fiscal year-end 2006 solely on our results of operations for the six months ended December 31, 2005. 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 year ended June 30, 2005.

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

Lannett Company, Inc. and subsidiary (the Company), a Delaware corporation, develop, manufacture, package, market, and distribute pharmaceutical products sold under generic chemical names.

The Company is engaged in an industry which is subject to considerable government regulation related to the development, manufacturing and marketing of pharmaceutical products. In the normal course of business, the Company periodically responds to inquiries or engages in administrative and judicial proceedings involving regulatory authorities, particularly the Food and Drug Administration (FDA) and the Drug Enforcement Agency (DEA).

***Principles of Consolidation*** The consolidated financial statements include the accounts of the operating parent company, Lannett Company, Inc., and its wholly owned subsidiary, Lannett Holdings, Inc.

***Reclassifications*** Certain reclassifications have been made to the prior period's financial information to conform to the December 31, 2005 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 and chargebacks 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 rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional and other credits are estimated based on historical payment experience, estimated customer inventory levels, and contract terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks require management to make subjective judgments. Unlike branded innovator companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS Health and NDC Health, in estimating future returns and other credits.

**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. The Company 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. The Company 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. The Company continually monitors the reserve for chargebacks and makes adjustments when management believes that actual chargebacks may differ from estimated reserves.

**Rebates** Rebates are offered to the Company's key customers to promote customer loyalty and encourage greater 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, these rebate programs are tailored to the customers' individual programs. Hence, the reserve will depend on the mix of customers that comprise such rebate programs.

**Returns** Consistent with industry practice, the Company has a product returns policy that allows select 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 and chargebacks 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 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 six months ended December 31, 2005 and 2004:

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**For the six months ended December 31, 2005**

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2005	\$ 7,999,700	\$ 1,028,800	\$ 1,692,000	\$ 29,500	\$ 10,750,000
Actual credits issued related to sales recorded in prior fiscal years	(7,100,000)	(950,000)	(1,100,000)	(29,500)	(9,179,500)
Reserves or (reversals) charged during Fiscal 2006 related to sales recorded in prior fiscal years					
Reserves charged to net sales during fiscal 2006 related to sales recorded in fiscal 2006	10,756,058	2,697,566	252,950	470,300	14,176,874
Actual credits issued related to sales recorded in Fiscal 2006	(3,674,309)	(2,487,104)	(129,410)	(382,343)	(6,673,166)
Reserve Balance as of December 31, 2005	\$ 7,981,449	\$ 289,262	\$ 715,540	\$ 87,957	\$ 9,074,208

**For the six months ended December 31, 2004**

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2004	\$ 6,484,500	\$ 1,864,200	\$ 448,000	\$ 88,300	\$ 8,885,000
Actual credits issued related to sales recorded in prior fiscal years	(4,478,700)	(1,936,500)	(408,400)	(87,000)	(6,910,600)
Reserves or (reversals) charged during Fiscal 2005 related to sales recorded in prior fiscal years					
Reserves charged to net sales during fiscal 2005 related to sales recorded in fiscal 2005	9,808,000	5,642,700	737,900	472,800	16,661,400
Actual credits issued related to sales recorded in Fiscal 2005	(4,128,600)	(3,100,200)	(467,500)	(274,500)	(7,970,800)
Reserve Balance as of December 31, 2004	\$ 7,685,200	\$ 2,470,200	\$ 310,000	\$ 199,600	\$ 10,665,000

The Company ships its products to the warehouses of its wholesale and retail chain customers. When the Company and a customer come to 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 continually 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

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estimate of expected resales 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 from 18 months to 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 returns (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, cost, 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.

**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.

**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 and production requirements. The Company's estimates of future product demand may prove to be inaccurate, in which case it may have understated or overstated the provision required for excess and obsolete inventory. In the future, if the Company's inventory is determined to be overvalued, the Company would be required to recognize 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 be required to recognize such additional operating income at the time of sale.

**Property, Plant and Equipment** Property, plant and equipment are stated at cost. Depreciation is provided for by the straight-line and accelerated methods over estimated useful lives of the assets. Depreciation expense for the three months ended December 31, 2005 and 2004 was approximately \$530,000 and \$450,000, respectively. Depreciation expense for the six months ended December 31, 2005 and 2004 was approximately \$1,039,000 and \$834,000, respectively.

**Investment Securities** The Company's investment securities consist of marketable debt securities, primarily in U.S. government and agency obligations, and a \$500,000 equity investment in an API provider. All of the Company's marketable debt securities are classified as available-for-sale and recorded at fair value, based on quoted market prices. The Company accounts for its investment in the API provider at cost. 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. If a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established. There were no securities determined by management to be other-than-temporarily impaired for the six month period ended December 31, 2005.

**Deferred Debt Acquisition Costs** Costs incurred in connection with obtaining financing are amortized by the straight-line method over the term of the loan arrangements. Amortization expense for debt acquisition costs for the three months ended December 31, 2005 and 2004 was approximately \$36,000 and \$5,500, respectively. Amortization expense for debt acquisition costs for the six months ended December 31, 2005 and 2004 was approximately \$42,000 and \$11,000, respectively.

**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.

**Advertising Costs** The Company charges advertising costs to operations as incurred. Advertising expense for the three months ended December 31, 2005 and 2004 was approximately \$100,000 and \$33,000, respectively. Advertising expense for the six months ended December 31, 2005 and 2004 were \$141,000 and \$107,000, respectively.

**Income Taxes** The Company uses the liability method specified by Statement of Financial Accounting Standards No. 109 (FAS 109), *Accounting 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.

**Segment Information** The Company reports segment information in accordance with Statement of Financial Accounting Standard No. 131 (FAS 131), *Disclosures about Segments of an Enterprise and Related Information*. The Company operates one business segment-generic pharmaceuticals; accordingly the Company has one reporting segment. In accordance with FAS 131, the Company aggregates its financial information for all products and reports on one operating segment. The Company's products contain various active pharmaceutical ingredients aimed at treating a diverse range of medical indications. The following table identifies the Company's approximate net product sales by medical indication for the three and six months ended December 31, 2005 and 2004:

Medical Indication	For the Three Months Ended		For the Six Months Ended	
	12/31/05	12/31/04	12/31/05	12/31/04
Migraine Headache	\$ 3,346,000	\$ 3,181,000	\$ 6,519,000	\$ 6,470,000
Epilepsy	3,329,000	4,573,000	6,689,000	8,874,000
Heart Failure	1,518,000	1,771,000	3,266,000	3,208,000
Thyroid Deficiency	3,411,000	2,736,000	7,280,000	8,101,000
Other	3,625,000	658,000	5,116,000	1,277,000
Total	\$ 15,229,000	\$ 12,919,000	\$ 28,870,000	\$ 27,930,000

**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 22%, 22%, 10%, 11%, and 11%, respectively, of net sales for the three months ended December 31, 2005. The same five products accounted for 37%, 26%, 14%, 16%, and 6%, respectively, of net sales for the three months ended December 31, 2004; 25%, 23%, 13%, 11%, 10% of net sales for the six months ended December 31, 2005; 34%, 24%, 12%, 26%, and 5%, respectively, of net sales for the six months ended December 31, 2004.

Credit terms are offered to customers based on evaluations of the customers' financial condition. Generally, collateral is not required from customers. Accounts receivable payment terms vary and are stated in the financial statements at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

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**Stock Options** In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (R), *Share-Based Payment* (SFAS 123(R)). This standard is a revision of SFAS 123, *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board Opinion ( APB ) No. 25, *Accounting for Stock Issued to Employees*. SFAS 123(R) addresses the accounting for share-based compensation in which we receive employee services in exchange for our equity instruments. Under the standard, we are required to recognize 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 December 31, 2005, the Company had two stock-based employee compensation plans. Prior to July 1, 2005, the Company accounted for those plans under the recognition and measurement provisions of APB 25, and related Interpretations, as permitted by SFAS 123. No stock-based employee compensation cost was recognized in the Statement of Operations for the year ended June 30, 2005, nor in the three-month or six month period ended December 31, 2004, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant. Effective July 1, 2005, the Company adopted the fair value recognition provisions of SFAS 123(R), using the modified-prospective-transition method.

Accordingly, prior periods have not been restated. Under this method, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding as of the beginning of the period of adoption. We measured share-based compensation cost using the Black-Scholes option pricing model. The following ranges of assumptions were used to compute share-based compensation:

Risk-free interest rate	2.92% - 4.5	%
Expected volatility	55.36	%
Expected dividend yield	0.0	%
Expected life (in years)	5.00	
Forfeiture rate	3.0	%
Weighted average fair value at date of grant	\$ 2.36 - \$9.54	

Expected volatility is based on the historical volatility of the price of our common shares over the past three years, the date we commenced trading on the AMEX. We use historical information to estimate expected life and forfeitures 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 a 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 will be forfeited during the next year. This assumption is based on our historical forfeiture rate. Periodically, management will assess whether it is necessary to adjust the historical rate to reflect its expectations. For example, adjustments may be needed if, historically, forfeitures were affected mainly by turnover that resulted from a business restructuring that is not expected to recur.

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The following table presents all share-based compensation costs recognized in our statements of income:

Method used to account for share-based compensation	Six Months Ended December 31,	
	2005	2004
	Fair Value	Intrinsic
Share-based compensation under SFAS 123(R)	\$ 685,983	\$
Tax benefit at effective rate	\$ 158,700	\$

The following table illustrates the pro forma effect on net income and earnings per share if we had recorded compensation expense based on the fair value method for all share-based compensation awards:

	Six Months Ended December 31,	
	2005	2004
Net income as reported	\$ 2,865,051	\$ 2,104,618
Deduct: total share-based compensation, determined under fair value based method		(1,823,644)
Add: tax benefit at effective rate		729,459
Net income pro forma	\$ 2,865,051	\$ 1,010,428
Basic earnings per share as reported	\$ 0.12	\$ 0.09
Basic earnings per share pro forma	\$ 0.12	\$ 0.04
Diluted earnings per share as reported	\$ 0.12	\$ 0.09
Diluted earnings per share pro forma	\$ 0.12	\$ 0.04

A summary of award activity under the Plans as of December 31, 2005, and changes during the six months then ended, is presented below:

	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Contractual Life
Outstanding at July 1, 2005	857,108	\$ 13.72		
Granted	83,500	5.18		
Exercised				
Forfeited or expired				
Outstanding at December 31, 2005	940,608	\$ 11.33	\$ 8.2	
Outstanding at December 31, 2005 and not yet vested	418,527	\$ 11.17	\$ 8.4	
Exercisable at December 31, 2005	522,081	\$ 11.45	\$ 7.8	

As of December 31, 2005, there was approximately \$1,806,000 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 1.5 years.

**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.

**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.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position and the results of operations and cash flows. The results of operations for the six months ended December 31, 2005 and 2004 are not necessarily indicative of results for the full year. While management believes that the disclosures presented are adequate to make the information not misleading, it is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and the notes included in the Company's Annual Report on Form 10-K for the year ended June 30, 2005.

**Note 3. New Accounting Standards**

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets – an amendment of APB Opinion No. 29* (SFAS No. 153). APB Opinion No. 29 requires a nonmonetary exchange of assets be accounted for at fair value, recognizing any gain or loss, if the exchange meets a commercial substance criterion and fair value is determinable. The commercial substance criterion is assessed by comparing the entity's expected cash flows immediately before and after the exchange. SFAS No. 153 eliminates the similar productive assets exception, which accounts for the exchange of assets at book value with no recognition of gain or loss. SFAS No. 153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a material impact on our financial statements.

In March 2005, the FASB issued FIN 47 *Accounting for Conditional Asset Retirement Obligations*, an Interpretation of FASB Statement No. 143. This Interpretation clarifies that a conditional retirement obligation refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The liability should be recognized when incurred, generally upon acquisition, construction or development of the asset. FIN 47 is effective no later than the end of the fiscal years ending after December 15, 2005. We have not completed an assessment of the impact that adoption of FIN 47 will have on our financial statements.

**Note 4. Inventories**

Inventories consist of the following:

	<b>December 31, 2005 (unaudited)</b>	<b>June 30, 2005</b>
Raw materials	\$ 5,201,001	\$ 5,091,883
Work-in-process	1,551,236	1,351,112
Finished goods	3,773,164	3,303,478
Packaging supplies	365,170	242,296
	<b>\$ 10,890,571</b>	<b>\$ 9,988,769</b>

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The preceding amounts are net of inventory reserves of \$4,380,000 and \$5,300,000 at December, 2005 and June 30, 2005, respectively.

**Note 5. Property, Plant and Equipment**

Property, plant and equipment consist of the following:

	Useful Lives	Dec. 31 2005 (unaudited)	June 30, 2005
Land		\$ 233,414	\$ 233,414
Building and improvements	10 - 39 years	9,981,309	9,339,706
Machinery and equipment	5 - 10 years	13,992,878	13,347,416
Furniture and fixtures	5 - 7 years	825,625	825,625
		\$ 25,033,226	\$ 23,746,161

**Note 6. Investment Securities - Available-for-Sale**

The amortized cost, gross unrealized gains and losses, and fair value of the Company's available-for-sale securities are summarized as follows:

	31-Dec-05 Available-for-Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Other Investments	\$ 500,000	\$	\$	\$ 500,000
U.S. Government Agency	4,446,934	32	(99,561 )	4,347,405
Mortgage-Backed Securities	342,843		(16,232 )	326,611
Asset-Backed Securities	423,914		(7,916 )	415,998
	\$ 5,213,691	\$ 32	\$ (123,709 )	\$ 5,590,014

	June 30, 2005 Available-for-Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government Agency	\$ 6,582,022	\$ 8,970	\$ (35,794 )	\$ 6,555,198
Mortgage-Backed Securities	363,429		(10,105 )	353,324
Asset-Backed Securities	985,245	5,361	(10,421 )	980,185
	\$ 7,930,696	\$ 14,331	\$ (56,320 )	\$ 7,888,708

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The amortized cost and fair value of the Company's current available-for-sale securities by contractual maturity at December 31, 2005 are summarized as follows:

	<b>31-Dec-05 Available for Sale Amortized Cost</b>	<b>Fair Value</b>
Due in one year or less	\$	\$
Due after one year through five years	3,705,499	4,129,671
Due after five years through ten years	388,581	380,873
Due after ten years	1,119,611	1,079,470
	<b>\$ 5,213,691</b>	<b>\$ 5,590,014</b>

The Company uses the specific identification method to determine the cost of securities sold. There were no securities held from a single issuer that represented more than 15% of shareholders' equity.

The table below indicates the length of time individual securities have been in a continuous unrealized loss position as of December 31, 2005:

Description of Securities	Number of Securities	As of December 31, 2005				Total Fair Value	Unrealized Loss
		Less than 12 months Fair Value	Unrealized Loss	12 months or longer Fair Value	Unrealized Loss		
U.S. Government Agency	27	4,144,456	(95,797 )	138,401	(3,764 )	4,282,857	(99,561 )
Mortgage-Backed Securities	3	326,611	(16,232 )			326,611	(16,232 )
Asset-Backed Securities	4	415,998	(7,916 )			415,998	(7,916 )
Total temporarily impaired investment securities	34	\$ 4,887,065	\$ (119,945 )	\$ 138,401	\$ (3,764 )	\$ 5,025,466	\$ (123,709 )

The investment securities shown above currently have fair values less than amortized cost and therefore contain unrealized losses. The Company has evaluated these securities and has determined that the decline in value is not related to any company or industry specific event. At December 31, 2005, there were approximately 34 out of 36 investment securities with unrealized losses. The Company anticipates full recovery of amortized costs with respect to these securities at maturity or sooner in the event of a more favorable market interest rate environment.

**Note 7. Note Receivable**

A loan agreement with an API provider (the Borrower) was entered into in July 2005. In the agreement, the Company loaned the Borrower \$2,000,000 to finance general business activities. The note receivable is secured by a promissory note and a security interest in substantially all the Borrower's assets. Interest on the principal balance will be earned at 10% per annum for the first three years, and then at variable rates based on the Prime Rate plus 500 basis points. Borrower shall pay all interest that has accrued and is due and owing on the Loan on the first, second and third anniversary date of this Agreement. The Borrower shall pay the principal balance on the loan, plus accrued interest, in twenty four equal consecutive monthly installments beginning July 2008.

**Note 8. Bank Line of Credit**

The Company has a \$3,000,000 line of credit from Wachovia Bank, N.A. that bears interest at the prime interest rate less 0.25% (7.00% at December 31, 2005). The line of credit was renewed and extended to November 30,



2006. At December 31, 2005 and 2004, the Company had \$0 outstanding and \$3,000,000 available under the line of credit. The line of credit is collateralized by substantially all of the Company's assets. The Company currently has no plans to borrow under this line of credit

**Note 9. Unearned Grant Funds**

In July 2004, the Company received \$500,000 of grant funding from the Commonwealth of Pennsylvania, acting through the Department of Community and Economic Development. The grant funding program requires the Company to use the funds for machinery and equipment located at their Pennsylvania locations, hire an additional 100 full-time employees by June 30, 2006, operate its Pennsylvania locations a minimum of five years and meet certain matching investment requirements. If the Company fails to comply with any of the requirements above, the Company would be liable to repay the full amount of the grant funding (\$500,000). The Company records the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program. On a quarterly basis, the Company will monitor its progress in fulfilling the requirements of the grant funding program and will determine the status of the liability. As of December 31, 2005, the Company has recognized the grant funding as a short term liability under the caption of Unearned Grant Funds.

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**Note 10. Long-Term Debt**

Long-term debt consists of the following:

	December 31, 2005 (unaudited)	June 30, 2005
PIDC Regional Center, LP III Loan	\$ 4,500,000	\$ -0-
Pennsylvania Industrial Development Authority Loan	1,250,000	-0-
Tax-exempt Bond Loan	1,318,220	1,645,720
Mortgage Loan	-0-	2,700,000
Equipment Loan	1,203,046	4,486,729
Construction Loan	-0-	699,999
	\$ 8,271,266	\$ 9,532,448
Less current portion	1,037,087	2,269,766
	\$ 7,234,179	\$ 7,262,672

On December 13, 2005 the Company refinanced \$5,750,000 of its debt through the Philadelphia Industrial Development Corporation (PIDC). With the proceeds from the refinancing, the Company paid off its Mortgage and Construction Loan, as well as a portion of the Equipment loan. These loans were with Wachovia Bank. \$4,500,000 was financed through the Immigrant Investor Program (PIDC Regional Center, LP III). The Company will pay a bi-annual interest payment at a rate equal to two and one-half percent per annum. The outstanding principal balance shall be due and payable 5 years (60 months) from January 1, 2006. The remaining \$1,250,000 is financed through the Pennsylvania Industrial Development Authority (PIDA Loan). The Company is required to make equal payments each month for 180 months starting February 1, 2006 with interest of two and three-quarters percent per annum. As of December 31, 2005, none of the PIDC Loan is currently due and \$61,571 is currently due on the PIDA Loan.

In April 1999, the Company entered into a loan agreement (the Agreement) with a governmental authority, the Philadelphia Authority for Industrial Development (the Authority), to finance future construction and growth projects of the Company. The Authority issued \$3,700,000 in tax-exempt variable rate demand and fixed rate revenue bonds to provide the funds to finance such growth projects pursuant to a trust indenture (the Trust Indenture). A portion of the Company's proceeds from the bonds was used to pay for bond issuance costs of approximately \$170,000. The Trust Indenture requires that the Company repay the Authority loan through installment payments beginning in May 2003 and continuing through May 2014, the year the bonds mature. The bonds bear interest at the floating variable rate determined by the organization responsible for selling the bonds (the remarketing agent). The interest rate fluctuates on a weekly basis. The effective interest rate at December 31, 2005 was 3.67%. At December 31, 2005, the Company has \$1,318,220 outstanding on the Authority loan, of which \$654,996 is classified as currently due. The remainder is classified as a long-term liability. In April 1999, an irrevocable letter of credit of \$3,770,000 was issued by Wachovia Bank, National Association (Wachovia) to secure payment of the Authority Loan and a portion of the related accrued interest. At December 31, 2005, no portion of the letter of credit has been utilized.

The Equipment Loan consists of a term loan with a maturity date of five years. The Company as part of the 2003 Loan Financing agreement with Wachovia is required to make equal payments of principal and interest. As of December 31, 2005, the Company has outstanding \$1,203,046 under the Equipment Loan, of which \$320,520 is classified as currently due.



The financing facilities under the 2003 Loan Financing bear interest at a variable rate equal to the LIBOR rate plus 150 basis points. The LIBOR rate is the rate per annum, based on a 30-day interest period, quoted two business days prior to the first day of such interest period for the offering by leading banks in the London interbank market of dollar deposits. As of December 31, 2005, the interest rate for the 2003 Loan Financing (of which only the Equipment loan remains) was 5.89%.

The Company has executed Security Agreements with Wachovia, PIDA and PIDC in which the Company has agreed to use substantially all of its assets to collateralize the amounts due.

The terms of the line of credit, the loan agreement, the related letter of credit, the Equipment loan, and the PIDC financing require that the Company meet certain financial covenants and reporting standards, including the attainment of standard financial liquidity and net worth ratios. As of December 31, 2005, the Company has complied with such terms, and successfully met its financial covenants.

**Note 11. Income Taxes**

The provision for federal, state and local income taxes for the three month period ended December 31, 2005 and 2004 was \$843,000 and \$525,000, respectively, with effective tax rates of 40.0% and 40.0%, respectively. The provision for federal, state, and local income taxes for the six month period ended December 31, 2005 and 2004 was \$1,896,000 and \$1,403,000, respectively, with effective tax rates of 39.8% and 40.0% respectively.

**Note 12. Earnings Per Share**

Statement of Financial Accounting Standards No. 128 (FAS 128), *Earnings per Share*, requires the presentation of basic and diluted earnings per share on the face of the Company's consolidated statement of income and 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. Earnings per share amounts for all periods presented have been calculated in accordance with the requirements of FAS 128. A reconciliation of the Company's basic and diluted earnings per share follows:

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	Three Months Ended December 31, 2005		2004	
	Net Income (Numerator)	Shares (Denominator)	Net Income (Numerator)	Shares (Denominator)
Basic earnings per share factors	\$ 1,264,850	24,125,884	\$ 784,477	24,093,609
Effect of dilutive stock options		25,338		91,769
Diluted earnings per share factors	\$ 1,264,850	24,151,222	\$ 784,477	24,185,378
Basic earnings per share	\$ 0.05		\$ 0.03	
Diluted earnings per share	\$ 0.05		\$ 0.03	

	Six Months Ended December 31, 2005		2004	
	Net Income (Numerator)	Shares (Denominator)	Net Income (Numerator)	Shares (Denominator)
Basic earnings per share factors	\$ 2,865,051	24,122,181	\$ 2,104,618	24,088,038
Effect of dilutive stock options		45,590		104,648
Diluted earnings per share factors	\$ 2,865,051	24,140,863	\$ 2,104,618	24,192,686
Basic earnings per share	\$ 0.12		\$ 0.09	
Diluted earnings per share	\$ 0.12		\$ 0.09	

The number of anti-dilutive weighted average shares that have been excluded in the computation of diluted earnings per share for the three months ended December 31, 2005 and 2004 were 871,428 and 461,695, respectively. The number of anti-dilutive weighted average shares that have been excluded in the computation of diluted earnings per share for the six months ended December 31, 2005 and 2004 were 871,428 and 461,695, respectively.

### **Note 13. Comprehensive Income**

The Company's other comprehensive loss is comprised of unrealized losses on investment securities classified as available-for-sale. The components of comprehensive income and related taxes consisted of the following as of December 31, 2005 and 2004:

## COMPREHENSIVE (LOSS) INCOME

	For the Three Months Ended		For the Six Months Ended	
	12/31/2005	12/31/2004	12/31/2005	12/31/2004
<i>Other Comprehensive Loss:</i>				
Unrealized Holding Loss on Securities	\$ (12,402 )	\$ (3,461 )	\$ (81,688 )	\$ (5,498 )
Add: Tax savings at effective rate	4,961	1,385	32,675	2,200
Total Unrealized Loss on Securities, Net	(7,441 )	(2,076 )	(49,013 )	(3,298 )
Total Other Comprehensive Loss	(7,441 )	(2,076 )	(49,013 )	(3,298 )
Net Income	1,264,074	787,477	2,865,051	2,104,618
Total Comprehensive Income	\$ 1,256,633	\$ 785,401	\$ 2,816,038	\$ 2,101,320

**Note 14. Related Party Transactions**

The Company had sales of approximately \$169,000 and \$278,900 during the six months ended December 31, 2005 and 2004, respectively, to a distributor (the related party) owned by Jeffrey Farber, the son of the Chairman of the Board of Directors and principal shareholder of the Company, William Farber. Accounts receivable includes amounts due from the related party of approximately \$84,000 and \$105,000 at December 31, 2005 and 2004, respectively. In management's opinion, the terms of these transactions were not more favorable to the related party than they would have been to a non-related party.

Stuart Novick, the son of Marvin Novick, a Director on the Company's Board of Directors through January 13, 2005, was employed by two insurance brokerage companies (the Insurance Brokers) that provide insurance agency services to the Company. The Company paid approximately \$125,600 and \$381,500 during the six months ended December 31, 2005 and 2004 to the Insurance Brokers for various insurance policies. In management's opinion, the terms of these transactions were not more favorable to the related party than they would have been to a non-related party.

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. owns the ANDA. This agreement is subject to the Company's ability to obtain FDA approval to use the proprietary rights. In the event that an approval can not be obtained, Pharmeral, Inc. must repay the \$100,000 to the Company. Accordingly, the Company has treated this payment as a prepaid asset. Arthur Bedrosian, President and Chief Executive Officer of the Company, was formerly the President and Chief Executive Officer and currently owns 100% of Pharmeral, Inc. This transaction was approved by the Board of Directors of the Company and in their opinion the terms were not more favorable to the related party than they would have been to a non-related party.

**Note 15. Material Contract with Supplier**

The Company's primary finished product inventory supplier is Jerome Stevens Pharmaceuticals, Inc. (JSP), in Bohemia, New York. On March 23, 2004, the Company entered into an agreement with JSP for the exclusive 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. The JSP products covered under the agreement included Butalbital, Aspirin, Caffeine with Codeine Phosphate capsule; Digoxin tablets; and Levothyroxine Sodium tablets, sold generically and under the brand name Unithroid®. The term of the agreement is ten years ending on March 22, 2014. Both Lannett and JSP have the right to terminate the contract if one of the parties does not cure a material breach of the contract within sixty (60) days of notice from the non-breaching party.

During the term of the agreement, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP's products being distributed by the Company. The minimum quantity to be purchased in the first year of the agreement was \$15 million. Thereafter, the minimum quantity to be purchased increases by \$1 million per year up to \$24 million for the last year of the ten-year contract. The Company met the minimum purchase requirement for the first year of the contract, but there is no guarantee that the Company will be able to continue to do so in the future. If the Company does not meet the minimum purchase requirements, JSP's sole remedy is to terminate the agreement.

Under the agreement, JSP is entitled to nominate one person to serve on the Company's Board of Directors (the Board) provided, however, that the Board shall have the right to reasonably approve any such nominee in order to fulfill its fiduciary duty by ascertaining that such person is suitable for membership on the board of a publicly traded corporation. Suitability is determined by, but not limited to, the requirements of the Securities and Exchange Commission, the American Stock Exchange, and other applicable laws, including the Sarbanes-Oxley Act of 2002. As of December 31, 2005, JSP has not exercised the nomination provision of the agreement. The agreement was included as an Exhibit in the Current Report on Form 8-K filed by the Company on May 5, 2004, as subsequently amended.

Management determined that the intangible product rights asset created by this agreement was impaired as of March 31, 2005.

In October 2004, the Company signed an agreement with Orion Pharma (Orion), based in Finland to purchase and distribute three drug products. Under the terms of the agreement, Orion will supply Lannett with the finished products and all laboratory documentation and Lannett will coordinate the completion of the clinical biostudies necessary to submit Abbreviated New Drug Applications (ANDAs) to the Food and Drug Administration.

#### **Note 16. Contingencies**

The Company monitors its compliance with all environmental laws. Any compliance costs which may be incurred are contingent upon the results of future site monitoring and will be charged to operations when incurred. No monitoring costs were incurred during the three or six months ended December 31, 2005 and 2004.

The Company is currently engaged in several civil actions as a co-defendant with many other manufacturers of Diethylstilbestrol (DES), a synthetic hormone. Prior litigation established that the Company's pro rata share of any liability is less than one-tenth of one percent. The Company was represented in many of these actions by the insurance company with which the Company maintained coverage during the time period that damages were alleged to have occurred. The insurance company denies coverage for actions alleging involvement of the Company filed after January 1, 1992. With respect to these actions, the Company paid nominal damages or stipulated to its pro rata share of any liability. The Company has either settled or is currently defending over 500 such claims. At this time, management is unable to estimate a range of loss, if any, related to these actions. Management believes that the outcome of these cases will not have a material adverse impact on the financial position or results of operations of the Company.

In addition to the matters reported herein, the Company is involved in litigation which arises in the normal course of business. In the opinion of management, the resolution of these lawsuits will not have a material adverse effect on the consolidated financial position or results of operations.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

**Introduction**

The following information should be read in conjunction with the consolidated financial statements and notes in Part I, Item 1 of this Quarterly Report and with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2005.

In addition to historical information, this Form 10-Q/A contains forward-looking information. The forward-looking information contained herein is subject to certain risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Important factors that might cause such a difference include, but are not limited to, those discussed in the following section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis only as of the date of this Form 10-Q/A. The Company undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances which arise later. Readers should carefully review the risk factors described in other documents the Corporation files from time to time with the Securities and Exchange Commission, including the Annual report on Form 10-K filed by the Company in Fiscal 2005, and any Current Reports on Form 8-K filed by the Company.

In addition to the risks and uncertainties posed generally by the generic drug industry, the Company faces the following risks and uncertainties:

- competition from other manufacturers of generic drugs;
- potential declines in revenues and profits from individual generic pharmaceutical products due to competitors' introductions of their own generic equivalents;
- new products or treatments by other manufacturers that could render the Company's products obsolete;
- the value of the Company's common stock has fluctuated widely in the past, which could lead to investment losses for shareholders;
- intense regulation by government agencies may delay the Company's efforts to commercialize new drug products; and
- dependence on third parties to supply raw materials and certain finished goods inventory any failure to obtain a sufficient supply of raw materials from these suppliers could materially and adversely affect the Company's business.

Because of the foregoing and other factors, the Company may experience fluctuations in future operating results on a quarterly or annual basis which could materially adversely affect the business, financial condition, operating results and the Company's stock price.

**Critical Accounting Policies**

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies include those described below.

**Stock Options** We adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), *Share-Based Payment*, (123(R)) effective July 1, 2005. We applied the standard using the modified prospective-transition method with no restatement of prior periods. Prior to July 1, 2005, the Company accounted for those plans under the recognition and measurement provisions of APB 25, and related Interpretations, as permitted by SFAS 123. No stock-based employee compensation cost was recognized in the Statement of Operations for the year ended June 30, 2005, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant.

Since we applied the standard using the modified-prospective-transition-method, prior periods have not been restated. Under this method, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding as of the beginning of the period of adoption. We measured share-based compensation cost using the Black-Scholes option pricing model. Total share-based compensation expense under SFAS 123(R) was \$358,000 and \$686,000 for the three-month period and six month period ended December 31, 2005, respectively. Total compensation cost related to non-vested awards not yet recognized is \$1,806,000 and the weighted average period over which it is to be recognized is 1.5 years.

**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 and chargebacks 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 rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional and other credits are estimated based on historical payment experience, estimated customer inventory levels, and contract terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks require management to make subjective judgments. Unlike branded innovator companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS Health and NDC Health, in estimating future returns and other credits.

**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. The Company continually monitors the reserve for chargebacks and makes adjustments when management believes that actual chargebacks may differ from estimated reserves.

**Rebates** Rebates are offered to the Company's key customers to promote customer loyalty and encourage greater 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, these rebate programs are tailored to the customers' individual programs. Hence, the reserve will depend on the mix of customers that comprise such rebate programs.

**Returns** Consistent with industry practice, the Company has a product returns policy that allows select 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 and chargebacks 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 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 six months ended December 31, 2005 and 2004:

**For the six months ended December 31, 2005**

<b>Reserve Category</b>	<b>Chargebacks</b>	<b>Rebates</b>	<b>Returns</b>	<b>Other</b>	<b>Total</b>
Reserve Balance as of June 30, 2005	\$ 7,999,700	\$ 1,028,800	\$ 1,692,000	\$ 29,500	\$ 10,750,000
Actual credits issued related to sales recorded in prior fiscal years	(7,383,000 )	(1,300,600 )	(1,204,600 )	(27,200 )	(9,915,400 )
Reserves or (reversals) charged during Fiscal 2006 related to sales recorded in prior fiscal years					
Reserves charged to net sales during fiscal 2006 related to sales recorded in fiscal 2006	12,273,700	1,427,400	463,100	362,600	14,526,800
Actual credits issued related to sales recorded in Fiscal 2006	(4,909,000 )	(866,300 )	(235,000 )	(276,900 )	(6,287,200 )
Reserve Balance as of December 31, 2005	\$ 7,981,400	\$ 289,300	\$ 715,500	\$ 88,000	\$ 9,074,200

**For the six months ended December 31, 2004**

<b>Reserve Category</b>	<b>Chargebacks</b>	<b>Rebates</b>	<b>Returns</b>	<b>Other</b>	<b>Total</b>
Reserve Balance as of June 30, 2004	\$ 6,484,500	\$ 1,864,200	\$ 448,000	\$ 88,300	\$ 8,885,000
Actual credits issued related to sales recorded in prior fiscal years	(4,478,700 )	(1,936,500 )	(408,400 )	(87,000 )	(6,910,600 )
Reserves or (reversals) charged during Fiscal 2005 related to sales recorded in prior fiscal years					
Reserves charged to net sales during fiscal 2005 related to sales recorded in fiscal 2005	9,808,000	5,642,700	737,900	472,800	16,661,400
Actual credits issued related to sales recorded in Fiscal 2005	(4,128,600 )	(3,100,200 )	(467,500 )	(274,500 )	(7,970,800 )
Reserve Balance as of December 31, 2004	\$ 7,685,200	\$ 2,470,200	\$ 310,000	\$ 199,600	\$ 10,665,000

Credits issued during the quarter that relate to prior year sales are charged against the opening balance. Because reserves are assessed and recorded in aggregate, any potential additional reserves or reversals of reserves have historically offset each other. The table above shows the effects of reversals within the rebate and return categories. It is the Company's intention that all reserves be charged to sales in the period that the sale is recognized, however, due to the nature of this estimate, it is possible that the Company may sometimes need to increase or decrease the reserve based on prior period sales. If that were to occur, management would disclose that information at that time. 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.

Because the Company monitors and assesses these reserves in aggregate, the rates of reserves will vary, as well as the category under which the credit falls. This variability comes about when the Company is working with indirect customers to compete with the pricing of other generic companies. The Company is currently working on improving computer systems to improve the accuracy of tracking and processing chargebacks and rebates. Improvements to automate calculation of reserves will not only reduce the potential for human error, but also will result in more in-depth analysis and improved customer interaction for resolution of open credits.



The rate of credits issued is monitored by the Company on a quarterly basis. The Company may change the estimate of future reserves based on the amount of credits processed, or the rate of sales made to indirect customers. Management estimates reserves based on sales mix. A comparison to wholesaler inventory reports is performed quarterly, in order to justify the balance of unclaimed chargebacks and rebates. The Company has historically found a direct correlation between the calculation of the reserve based on sales mix, and the wholesaler inventory analysis.

Because we are unable to independently verify product sales levels at the final customer, wholesaler inventory reports are used to recalculate potential chargebacks and rebates based on known contracted rebate and chargeback rates.

Management performs other types of analysis to ensure reserves are reasonable. This includes ratio analysis of: wholesaler versus direct (or retail) sales mix; revenue reserve to gross sales; comparison of net receivables to net sales; and comparison of gross receivables to gross sales. Through these steps, management is able to ensure that all reserves are reasonably stated.

The chargeback reserve increase to \$7,981,000 at December 31, 2005 compared to the balance at December 31, 2004, is due to an increased level of chargebacks, as a percentage of sales, required by the wholesale distributor market. In many cases, the increasingly competitive generic pharmaceutical market has resulted in decreased prices to Lannett customers. This competitive environment resulted in increased chargeback reserves at the same time sales decreased. The decrease in the rebate reserve to \$289,000 at December 31, 2005 was directly related to the decrease in sales and failure of customers to achieve pre-established volumes and net sales milestones.

Credits issued against the June 30, 2005 accrued rebate balance amount to \$1,300,600, a result of underestimating the rebates due on certain sales. The company has taken additional reserves in fiscal year 2006 to accommodate these rebates, and has taken steps to ensure that rebate reserves are adequately recorded going forward.

The Company ships its products to the warehouses of its wholesale and retail chain customers. When the Company and a customer come to 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 continually 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 resales 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 from 18 months to 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, cost, 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.

**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 the both 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.

The Company also regularly monitors customer Accounts Receivable (AR) balances through a tool known as Days Sales Outstanding ( DSO ). This calculation for Net DSO begins with the Gross AR less the Rebates and Chargeback reserve. This net amount is then divided by the average daily net sales for the period. The table below shows the results of these calculations for the relevant periods.

	<b>Quarter ended 12/31/04</b>	<b>Quarter ended 12/31/05</b>
Net DSO (in days)	80	49
Gross DSO (in days)	71	68

The Gross DSO above shows the result of the same calculation without regard to rebates and chargebacks. It is generally higher than the Net DSO calculation. The Company monitors both Net DSO and Gross DSO as an overall check on collections and reasonableness of reserves. In order to be effective indicators, both types of DSO are evaluated on a quarterly basis. The Gross DSO calculation provides management with an understanding of the frequency of customer payments, and the ability to process customer payments and deductions. The Net DSO calculation provides management with an understanding of the relationship of the A/R balance net of the reserve liability compared to net sales after reserves charged during the period. The improvement in Net DSO at 12/31/05 is due primarily to quicker collections on customer receivables ahead of reserves being taken or applied by wholesalers. The Gross DSO has improved slightly over the prior year.

The Company's payment terms are consistent with the generic industry at 60 days for payment from all customers, including wholesalers. Management expects the DSO calculation to approximate 60 days. Significant variances greater or less than 60 are reviewed and, if necessary, action is taken.

**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 and production requirements. The

Company's estimates of future product demand may prove to be inaccurate, in which case it may have understated or overstated the provision required for excess and obsolete inventory. In the future, if the Company's inventory is determined to be overvalued, the Company would be required to recognize 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 be required to recognize such additional operating income at the time of sale.

An increase in inventories of \$901,802 is due to the build up of new products in preparation for their launch in January SMZ-TMP, Oxycodone, and Morphine Sulfate. As our product offerings increase, higher inventory levels are expected, both in dollars and quantities. This investment in inventory is vital to Lannett's strategy of maintaining our reputation of always in-stock. Separately, sales of Levothyroxine Sodium tablets have exceeded the expectations, resulting in a reduction in our inventory reserve in the second quarter of Fiscal 2006. In the quarter, approximately \$400,000 of previously reserved inventory had been sold to customers, and the related reserve reduced by that amount.

**Results of Operations Three months ended December 31, 2005 compared with three months ended December 31, 2004**

Net sales increased 18% from \$12,919,000 for the three months ended December 31, 2004 ( Second Quarter Fiscal 2005 ) to \$15,229,000 for the three months ended December 31, 2005 ( Second Quarter Fiscal 2006 ). The increase was primarily due to new product sales of \$2.4 million. Fluctuations in the amount of sales through the wholesaler channel will have an impact on the amount of reserve being charged. Due to the fact that wholesale sales result in greater chargebacks, an increase in wholesale sales will result in a higher level of chargebacks. For the first and second quarters of Fiscal 2006, reserves recorded against sales amounted to \$7.5 million and \$7.9 million. Wholesaler sales were \$9.3 million and \$9.9 million, respectively. The increase in the dollar value of the reserve corresponds to the increase in wholesale sales. As new products are introduced, greater incentives often accompany the introduction. New product net sales in the second quarter of Fiscal 2006 amounted to \$1.8 million, net of \$1.0 million in reserves.

Cost of sales (excluding amortization of intangible asset) increased 14% from \$7,085,000 for the Second Quarter Fiscal 2005 to \$8,064,000 for the Second Quarter Fiscal 2006. The increase in cost of sales is due to an increase in direct variable costs such as raw materials and costs of finished goods as a result of higher sales levels. Gross profit margins for the Second Quarter Fiscal 2006 and the Second Quarter Fiscal 2005 were 47% and 45%, respectively. The increase in the gross profit percentage is due to improved product mix from the introduction of new drugs. Also a portion of the increase in profit margin resulted from the benefit of unexpected sales of short-dated product previously written off. Depending on future market conditions for each of the Company's products, changes in the future sales product mix may occur. These changes may affect the gross profit percentage in future periods.

Research and development ( R&D ) expenses increased 142% from \$1,000,000 for the Second Quarter Fiscal 2005 to \$2,421,000 for the Second Quarter Fiscal 2006. The increase is primarily due to an increase in the number of product development projects as well generic bioequivalence tests which are commonly required for ANDA submissions.

Selling, general and administrative expenses increased 24% from \$1,776,000 for the Second Quarter Fiscal 2005 to \$2,205,000 for the Second Quarter Fiscal 2006. The increase is primarily due to the adoption of SFAS 123(R) which contributed stock compensation expense of \$358,000, and an increase of outside services relating to IT and accounting of approximately \$200,000.

Amortization expense for the intangible asset for the three months ended December 31, 2005 and 2004 was approximately \$446,000 and \$1,690,000, respectively. The amortization expense relates to the March 23, 2004 exclusive marketing and distribution rights agreement with JSP.

Management believed that events (as described below) occurred which indicated that the carrying value of the intangible asset was not recoverable. In accordance with Statement of Financial Accounting Standards No. 144 (FAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company engaged a third party valuation specialist to assist in the performance of an impairment test for the quarter ended March 31, 2005. The impairment test was performed by discounting forecasted future net cash flows for the JSP products covered under the agreement and then comparing the discounted present value of those cash flows to the carrying value of the asset (inclusive of the \$1.5 million payable to JSP for the second AB rating). As a result of the testing, the Company has determined that the intangible asset was impaired as of March 31, 2005. In accordance with FAS 144, the Company recorded a non-cash impairment loss of approximately \$46,093,000 to write the asset down to its fair value of approximately \$16,062,000 as of March 31, 2005.

Management believes that several factors contributed to the impairment of this asset. In December 2004, the Levothyroxine Sodium tablet product received the AB rating to Synthroid®. The expected sales increase as a result of the AB rating did not occur in the third quarter of 2005. The delay in receiving the AB rating to Synthroid® caused the Company to be competitively disadvantaged with its Levothyroxine Sodium tablet product and to lose market share to competitors whose products had already received AB ratings to both major brand thyroid deficiency drugs. Additionally, the generic market for thyroid deficiency drugs turned out to be smaller than it was anticipated to be as a result of a lower brand-to-generic substitution rate. Increased competition in the generic drug market, both from existing competitors and new entrants, has resulted in significant pricing pressure on other products supplied by JSP. The combination of these factors has resulted in diminished forecasted future net cash flows which, when discounted, yield a lower present value than the carrying value of the asset before impairment.

For the remaining nine years of the contract, the Company will incur annual amortization expense of approximately \$1,785,000.

As a result of the items discussed above, the Company's financial results increased from an operating income of \$1,366,000 in the Second Quarter Fiscal 2005 to an operating income of \$2,093,000 in the Second Quarter of Fiscal 2006.

The Company's interest expense decreased slightly from approximately \$88,000 in the Second Quarter Fiscal 2005 to approximately \$85,000 in the Second Quarter Fiscal 2006 as a result of the refinancing. Interest income increased from approximately \$34,000 in the Second Quarter Fiscal 2005 to approximately \$99,000 in the Second Quarter Fiscal 2006, as a result of increasing investments of excess cash in marketable securities.

The Company's income tax expense increased from \$525,000 in the Second Quarter Fiscal 2005 to \$843,000 in the Second Quarter Fiscal 2006 as a result of the Company's increased operating income. The effective tax rate held steady at 40% in the Second Quarter Fiscal 2005 to Second Quarter of 2006.

The Company reported net income of \$1,264,000 in the Second Quarter Fiscal 2006, or \$0.05 basic and diluted loss per share, compared to net income of \$787,000 in the Second Quarter Fiscal 2005, or \$0.03 basic and diluted income per share.

**Results of Operations Six months ended December 31, 2005 compared with six months ended December 31 2004**

Net sales increased 3% from \$27,930,000 for the six months ended December 31, 2004 to \$28,870,000 for the six months ended December 31, 2005. The increase was primarily due to new products introduced in the second quarter in combination with better sales across a wider mix of drugs. Overall, new product sales contributed \$3,444,000 to the sales in the current year. Year over year decline in existing product sales were a result unit volume declines of 11% and price increases of 3%. Volume declines are a result of mature products seeing 20% to 25% declines over the previous year. These mature products include Dicyclomine, Digoxin, and Primidone.

Fluctuations in the amount of sales through the wholesaler channel will have an impact on the amount of reserve being charged. Due to the fact that wholesale sales result in greater chargebacks, an increase in wholesale sales will result in a higher level of chargebacks. For the first and second quarters of Fiscal 2006, reserves recorded against sales amounted to \$7.5 million and \$7.9 million. Wholesaler sales were \$9.3 million and \$9.9 million, respectively. The increase in the dollar value of the reserve corresponds to the increase in wholesale sales.

Cost of sales, (excluding amortization of intangible asset), increased 2% from \$14,706,000 for the six months ended December 31, 2004 to \$14,927,000 for the six months ended December 31, 2005. The increase is attributable to increases in quality control, shipping charges, and costs of production totaling \$957,000. Gross profit margins for the six months ended December 31, 2004 and the six months ended December 31, 2005 were 47% and 48%, respectively. The increase in the gross profit percentage is due to improved product mix from the introduction of new drugs and a better sales mix of our customers. Also a portion of the increase in profit margin resulted from the benefit of unexpected sales of short-dated product previously written off. Depending on future market conditions for each of the Company's products, changes in the future sales product mix may occur. These changes may affect the gross profit percentage in future periods.

Research and development ( R&D ) expenses increased 52% from \$2,349,000 for the six months ended December 31, 2004 to \$3,562,000 for the six months ended December 31, 2005. The increase is primarily due to the Company's effort to increase the number of product development projects.

Selling, general and administrative expenses increased 23% from \$3,887,000 for the six months ended December 31, 2004 to \$4,782,000 for the six months ended December 31, 2005. The increase is primarily due to the adoption of SFAS 123(R) which contributed stock compensation expense of \$686,000, and outside projects of approximately \$250,000. Depreciation expense increased \$200,000 compared to the prior year.

Amortization expense for the intangible asset for the six months ended December 31, 2005 and 2004 was approximately \$892,000 and \$3,380,000, respectively. The amortization expense relates to the March 23, 2004 exclusive marketing and distribution rights agreement with JSP.

Management believed that events (as described below) occurred which indicated that the carrying value of the intangible asset was not recoverable. In accordance with Statement of Financial Accounting Standards No. 144 (FAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company engaged a third party valuation specialist to assist in the performance of an impairment test for the quarter ended March 31, 2005. The impairment test was performed by discounting forecasted future net cash flows for the JSP products covered under the agreement and then comparing the discounted present value of those cash flows to the carrying value of the asset (inclusive of the \$1.5 million payable to JSP for the second AB rating). As a result of the testing, the Company has determined that the intangible asset was impaired as of March 31, 2005. In accordance with FAS 144, the Company recorded a non-cash impairment loss of approximately \$46,093,000 to write the asset down to its fair value of approximately \$16,062,000 as of March 31, 2005.

Management believes that several factors contributed to the impairment of this asset. In December 2004, the Levothyroxine Sodium tablet product received the AB rating to Synthroid®. The expected sales increase as a result of the AB rating did not occur in the third quarter of 2005. The delay in receiving the AB rating to Synthroid® caused the Company to be competitively disadvantaged with its Levothyroxine Sodium tablet product and to lose market share to competitors whose products had already received AB ratings to both major brand thyroid deficiency drugs. Additionally, the generic market for thyroid deficiency drugs turned out to be smaller than it was anticipated to be as a result of a lower brand-to-generic substitution rate. Increased competition in the generic drug market, both from existing competitors and new entrants, has resulted in significant pricing pressure on other products supplied by JSP. The combination of these factors has resulted in diminished forecasted future net cash flows which, when discounted, yield a lower present value than the carrying value of the asset before impairment.

For the remaining nine years of the contract, the Company will incur annual amortization expense of approximately \$1,785,000.

As a result of the items discussed above, the Company's financial results increased from an operating income of \$3,608,000 in the six months ended December 31, 2004 to an operating income of \$4,707,000 in the six months ended December 31, 2005.

The Company's interest expense increased from approximately \$149,000 in the six months ended December 31, 2004 to approximately \$193,000 in the six months ended December 31, 2005 primarily as a result of an increase in the Prime Rate and LIBOR rate which the variable rates of the Construction and Equipment loans depend. Interest income increased from approximately \$49,000 in the six months ended December 31, 2004 to approximately \$247,000 in the six months ended December 31, 2005, as a result of increasing investments of excess cash in marketable securities.

The Company's income tax expense increased from \$1,403,000 in the six months ended December 31, 2004 to \$1,896,000 in the six months ended December 31, 2005 as a result of the Company's increased operating income. The effective tax rate held steady at 40% in the six months ended December 31, 2004 to six months ended December 31, 2005.

The Company reported net income of \$2,865,000 in the six months ended December 31, 2005, or \$0.12 basic and diluted loss per share, compared to net income of \$2,105,000 in the six months ended December 31, 2004, or \$0.09 basic and diluted income per share.

#### Liquidity and Capital Resources

**Net cash used in operating activities of \$453,135 for the six months ended December 31, 2005 was attributable to net income of \$2,865,051, as adjusted for the effects of non-cash items of \$2,633,698 and decrease in operating assets and liabilities of \$5,951,884. Significant changes in operating assets and liabilities are comprised of:**

1. An increase in trade accounts receivable of \$8,297,320 due to an increase in November and December gross sales. Also in part to a decrease in reserve for chargebacks attributable to an improved sales and customer mix.
2. An increase in inventories of \$901,802 is partly due to a decrease of inventory obsolescence of \$470,000 of Levothyroxine Sodium tablets in part because of higher than expected sales of Levothyroxine Sodium tablets. Also, in anticipation of new product introduction, inventory increased over the prior period.
3. A decrease in prepaid taxes of \$1,850,688 is attributable to estimated tax payments on net income that offsets previous tax payments that were made during Fiscal 2005 while in a net loss position.

4. An increase in accrued expenses of \$1,097,888 due in part to an increase in consulting fees for Sarbanes Oxley Compliance as well as expenses relating to the legal proceedings. It is also attributable to a performance based bonus.

The Company monitors both Net DSO and Gross DSO as an overall check on collections and reasonableness of reserves. In order to be effective indicators, both types of DSO are evaluated on a quarterly basis. The Gross DSO calculation provides management with an understanding of the frequency of customer payments, and the ability to process customer payments and deductions. The Net DSO calculation provides management with an understanding of the relationship of the A/R balance net of the reserve liability compared to net sales after reserves charged during the period. Standard payment terms offered to customers are consistent with industry practice at 60 days,

For the first and second quarters of Fiscal 2006, this Gross DSO amounted to 64 days and 68 days, respectively. The increase is due to delayed processing of credits from wholesale customers. Some delays were the result of customers failing to report all credits, while some were the responsibility of the Company to act upon.

The Net DSO Calculation provides us with an understanding of the relationship of the A/R balance net of the reserve liability compared to net sales after reserves charged during the period. It eliminates the effect of timing of processing, which is inherent in the Gross DSO calculation. A Net calculation greater than 60 days may indicate under-reserved sales, while an amount less than 60 days may indicate over-reserved sales, among other causes. This figure is expected to approximate 60 days. For the first and second quarters of Fiscal 2006, this Net DSO amounted to 26 days and 49 days, respectively. The fact that the amount is less than 60 days is primarily the result of wholesalers' sell-through of our products being extended past the expected 6 to 8 week timeframe. As of June 30, 2005, several wholesale customers actually had zero or close to zero A/R balances. At the same time, they maintained inventory of Lannett products, for which accrued reserve balances were necessary. The credits were issued to these customers once they were able to finalize their transactions, and claim the actual chargeback credits owed to them. The increase in Net DSO days each quarter has been determined to be the result of improvement in the wholesalers' sell-through rates throughout the year, resulting in a fiscal year end calculation of near 60 days.

The net cash used in investing activities of \$2,429,166 for the six months ended December 31, 2005 was attributable to the Company's purchase of a \$2,000,000 note receivable and \$2,678,847 in capital expenditures to expand production and R&D space. This was partially offset by the sale of a portion of the Company's investment securities, which consist primarily of U. S. government and agency marketable debt securities.

The following table summarizes the remaining repayments of debt, including sinking fund requirements as of December 31, 2005 for the subsequent twelve month periods:

Twelve Month Periods	Amounts Payable to Institutions
2006	\$ 1,037,087
2007	1,054,588
2008	393,336
2009	316,330
2010	4,576,929
Thereafter	892,996
	\$ 8,271,266

The Company has a \$3,000,000 line of credit from Wachovia Bank, N.A. that bears interest at the prime interest rate less 0.25% (7.00% at December 31, 2005). The line of credit was renewed and extended to November 30, 2006. At December 31, 2005 and 2004, the Company had \$0 outstanding and \$3,000,000 available under the line of credit. The line of credit is collateralized by substantially all of the Company's assets. The Company currently has no plans to borrow under this line of credit.

The terms of the line of credit, the loan agreement, the related letter of credit, the 2003 Loan Financing, and the new PIDC/PIDA loan agreements require that the Company meet certain financial covenants and reporting standards, including the attainment of standard financial liquidity and net worth ratios. As of December 31, 2005, the Company has complied with such terms, and successfully met its financial covenants.

In July 2004, the Company received \$500,000 of grant funding from the Commonwealth of Pennsylvania, acting through the Department of Community and Economic Development. The grant funding program requires the Company to use the funds for machinery and equipment located at their Pennsylvania locations, hire an additional 100 full-time employees by June 30, 2006, operate its Pennsylvania locations a minimum of five years and meet certain matching investment requirements. If the Company fails to comply with any of the requirements above, the Company would be liable to the full amount of the grant funding (\$500,000). The Company records the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program. On a quarterly basis, the Company will monitor its progress in fulfilling the requirements of the grant funding program and will determine the status of the liability. As of December 31, 2005, the Company has recognized the grant funding as a current liability under the caption of Unearned Grant Funds.

Except as set forth in this report, the Company is not aware of any trends, events or uncertainties that have or are reasonably likely to have a material adverse impact on the Company's short-term or long-term liquidity or financial condition.

#### **Prospects for the Future**

The Company has several generic products under development. These products are all orally-administered, products designed to be generic equivalents to brand named innovator drugs. The Company's developmental drug products are intended to treat a diverse range of indications. As the oldest generic drug manufacturer in the country, formed in 1942, Lannett currently owns several ANDAs for products which it does not manufacture and market. These ANDAs are simply dormant on the Company's records. Occasionally, the Company reviews such ANDAs to determine if the market potential for any of these older drugs has recently changed, so as to make it attractive for Lannett to reconsider manufacturing and selling it. If the Company makes the determination to introduce one of these products into the consumer marketplace, it must review the ANDA and related documentation to ensure that the approved product specifications, formulation and other factors meet current FDA requirements for the marketing of that drug. Generally, in these situations, the Company must file a supplement to the FDA for the applicable ANDA, informing the FDA of any significant changes in the manufacturing process, the formulation, or the raw material supplier of the previously-approved ANDA. The Company would then redevelop the product and submit it to the FDA for supplemental approval. The FDA's approval process for ANDA supplements is similar to that of a new ANDA.

A majority of the products in development represent either previously approved ANDAs that the Company is planning to reintroduce (ANDA supplements), or new formulations (new ANDAs). The products under development are at various stages in the development cycle-formulation, scale-up, and/or clinical testing. Depending on the complexity of the active ingredient's chemical characteristics, the cost of the raw material, the FDA-mandated requirement of bioequivalence studies, the cost of such studies and other developmental factors, the cost to develop a new generic product varies. It can range from \$100,000 to \$1 million. Some of Lannett's



developmental products will require bioequivalence studies, while others will not depending on the FDA's Orange Book classification. Since the Company has no control over the FDA review process, management is unable to anticipate whether or when it will be able to begin producing and shipping additional products.

In addition to the efforts of its internal product development group, Lannett has contracted with an outside firm for the formulation and development of several new generic drug products. These outsourced R&D products are at various stages in the development cycle-formulation, analytical method development and testing and manufacturing scale-up. These products are orally-administered solid dosage products intended to treat a diverse range of medical indications. It is the Company's intention to ultimately transfer the formulation technology and manufacturing process for all of these R&D products to the Company's own commercial manufacturing sites. The Company initiated these outsourced R&D efforts to compliment the progress of its own internal R&D efforts.

Occasionally the Company will work on developing a drug product that does not require FDA approval. The FDA allows generic manufacturers to manufacture and sell products which are equivalent to innovator drugs which are grand-fathered, under FDA rules, prior to the passage of the Hatch-Waxman Act of 1984. The FDA allows generic manufacturers to produce and sell generic versions of such grand-fathered products by simply performing and internally documenting the product's stability over a period of time. Under this scenario, a generic company can forego the time required for FDA ANDA approval.

The Company has also contracted with Spectrum Pharmaceuticals Inc., based in California, to market generic products developed and manufactured by Spectrum and/or its partners. The first applicable product under this agreement is ciprofloxacin tablets, the generic version of Cipro®, an anti-bacterial drug, marketed by Bayer Corporation, prescribed to treat infections. The Company has also initiated discussions with UniChem, of India, and Orion Pharma, of Finland, for similar new product initiatives, in which Lannett will market and distribute products manufactured by third parties. Lannett intends to use its strong customer relationships to build its market share for such products, and increase future revenues and income.

The majority of the Company's R&D projects are being developed in-house under Lannett's direct supervision and with Company personnel. Management believes the future spending on product development, including bio equivalency studies, will likely increase in future periods. Hence, the Company does not believe that its outside contracts for product development and manufacturing supply, including Spectrum Pharmaceuticals Inc., are material in nature, nor is the Company substantially dependent on the services rendered by such outside firms. Since the Company has no control over the FDA review process, management is unable to anticipate whether or when it will be able to begin producing and shipping such additional products.

The Company plans to enhance relationships with strategic business partners, including providers of product development research, raw materials, active pharmaceutical ingredients as well as finished goods. Management believes that mutually beneficial strategic relationships in such areas, including potential financing arrangements, partnerships, joint ventures or acquisitions, could allow for potential competitive advantages in the generic pharmaceutical market. For example, the Company has entered into prepayment arrangements in exchange for discounted purchase prices on certain active pharmaceutical ingredients (API) and oral dosage forms. The Company has also arranged for a loan to a certain API provider that should facilitate the availability of difficult to source material in the future. The Company plans to continue to explore such areas for potential opportunities to enhance shareholder value.

**PART I. FINANCIAL INFORMATION**

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management necessarily applies its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management's control objectives.

With the participation of management, the Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures at the conclusion of the six months ended December 31, 2005. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective in ensuring that material information required to be disclosed is included in the reports that it files with the Securities and Exchange Commission.

**Changes in Internal Controls**

There were no significant changes in the Company's internal controls or, to the knowledge of management of the Company, in other factors that could significantly affect internal controls subsequent to the date of the Company's most recent evaluation of its disclosure controls and procedures utilized to compile information included in this filing.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

**Regulatory Proceedings**

The Company is engaged in an industry which is subject to considerable government regulation relating to the development, manufacturing and marketing of pharmaceutical products. Accordingly, incidental to its business, the Company periodically responds to inquiries or engages in administrative and judicial proceedings involving regulatory authorities, particularly the FDA and the Drug Enforcement Agency.

**DES Cases**

The Company is currently engaged in several civil actions as a co-defendant with many other manufacturers of Diethylstilbestrol ( DES ), a synthetic hormone. Prior litigation established that the Company's pro rata share of any liability is less than one-tenth of one percent. The Company was represented in many of these actions by the insurance company with which the Company maintained coverage during the time period that damages were alleged to have occurred. The insurance company denies coverage for actions alleging involvement of the Company filed after January 1, 1992. With respect to these actions, the Company paid nominal damages or stipulated to its pro rata share of any liability. The Company has either settled or is currently defending over 500 such claims. At this time, management is unable to estimate a range of loss, if any, related to these actions. Management believes that the outcome of these cases will not have a material adverse impact on the financial position or results of operations of the Company.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) A list of the exhibits required by Item 601 of Regulation S-K to be filed as a part of this Form 10-Q/A is shown on the Exhibit Index filed herewith.

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**Exhibit Index**

31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith

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