LANNETT CO INC
Form 10-Q
May 15, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2008

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM TO .

Commission File No. 001-31298

LANNETT COMPANY, INC.

(Exact Name of Registrant as Specified in its Charter)

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

9000 State Road
Philadelphia, PA 19136
(215) 333-9000
(Address of principal executive offices and telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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

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

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

Yes o **No x**

As of May 13, 2008, there were 24,283,963 shares of the issuer s common stock, $.001 par value, outstanding.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	March 31, 2008 (unaudited)	June 30, 2007
ASSETS		
Current Assets		
Cash	$ 6,599,019	$ 5,192,341
Trade accounts receivable (net of allowance of $438,000 and $250,000, respectively)	18,946,727	19,473,978
Inventories	12,018,415	14,518,484
Interest receivable	69,483	36,260
Prepaid taxes	3,193,685	3,193,685
Deferred tax assets - current portion	1,590,175	1,258,930
Other current assets	536,368	611,512
Total Current Assets	42,953,872	44,285,190
Property, plant, and equipment	39,310,358	39,260,689
Less accumulated depreciation	(14,224,639)	(11,817,528)
	25,085,719	27,443,161
Construction in progress	923,545	176,003
Investment securities - available for sale	2,502,755	3,320,632
Intangible asset (product rights) - net of accumulated amortization	10,808,001	12,046,502
Deferred tax assets	18,877,745	17,150,174
Other assets	204,382	234,438
TOTAL ASSETS	$ 101,356,019	$ 104,656,100
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES		
Current Liabilities		
Accounts payable	$ 8,787,457	$ 7,013,985
Accrued expenses	2,965,743	6,719,782
Deferred revenue	1,177,189	1,637,993
Unearned grant funds	500,000	500,000
Current portion of long term debt	703,570	692,119
Rebates and chargebacks payable	6,148,307	5,686,364
Total Current Liabilities	20,282,266	22,250,243
Long term debt, less current portion	8,533,181	8,987,846
Deferred tax liabilities	3,226,090	3,202,835
Other long term liabilities	30,080	32,001
TOTAL LIABILITIES	32,071,617	34,472,925
SHAREHOLDERS EQUITY		
Common stock - authorized 50,000,000 shares, par value $0.001; issued and outstanding - 24,270,577 and 24,171,217 shares, respectively	24,271	24,171
Additional paid-in capital	74,208,805	73,053,778
Accumulated deficit	(4,513,174)	(2,472,621)
Accumulated other comprehensive income (loss)	33,446	(27,583)
	69,753,348	70,577,745
Less: Treasury stock at cost - 74,970 shares and 50,900 shares, respectively	(468,946)	(394,570)
TOTAL SHAREHOLDERS EQUITY	69,284,402	70,183,175
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 101,356,019	$ 104,656,100

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

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three months ended March 31,		Nine months ended March 31,	
	2008	**2007**	**2008**	**2007**
Net sales	$ 16,579,512	$ 20,302,576	$ 51,654,484	$ 65,186,747
Cost of sales	12,276,526	14,127,421	36,688,446	44,770,101
Amortization of intangible assets	446,166	446,166	1,338,498	1,338,498
Product Royalties	(40,674)	516,576	196,672	1,746,200
Gross profit	3,897,494	5,212,413	13,430,868	17,331,948
Research and development expenses	1,516,904	2,269,677	3,715,334	5,586,213
Selling, general, and administrative expenses	4,222,103	2,615,910	12,457,030	7,739,524
Loss on impairment		7,775,890		7,775,890
Operating loss	(1,841,513)	(7,449,064)	(2,741,496)	(3,769,679)
OTHER INCOME(EXPENSE):				
Interest income	45,239	99,000	170,967	309,805
Interest expense	(75,025)	(76,102)	(291,146)	(208,497)
	(29,786)	22,898	(120,179)	101,308
Loss before income tax (benefit) expense	(1,871,299)	(7,426,166)	(2,861,675)	(3,668,371)
Income tax (benefit) expense	(615,454)	(818,807)	(821,122)	685,791
Net loss	$ (1,255,845)	$ (6,607,359)	$ (2,040,553)	$ (4,354,162)
Basic loss per common share	$ (0.05)	$ (0.27)	$ (0.08)	$ (0.18)
Diluted loss per common share	$ (0.05)	$ (0.27)	$ (0.08)	$ (0.18)
Basic weighted average number of shares	24,268,449	24,164,385	24,208,830	24,155,556
Diluted weighted average number of shares	24,268,449	24,164,385	24,208,830	24,155,556

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

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock Shares Issued	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accum. Other Comp. (Loss) Income	Shareholders Equity
Balance, June 30, 2007	24,171,217	$ 24,171	$ 73,053,778	$ (2,472,621)	$ (394,570)	$ (27,583)	$ 70,183,175
Shares issued in connection with employee stock purchase plan	24,896	25	106,479				106,504
Share based compensation							
Restricted stock			91,905				91,905
Stock options			656,628				656,628
Shares issued in connection with restricted stock grant	74,464	75	300,015				300,090
Purchase of treasury stock					(74,376)		(74,376)
Other comprehensive income, net of income tax						61,029	61,029
Net loss				(2,040,553)			(2,040,553)
Balance, March 31, 2008	24,270,577	$ 24,271	$ 74,208,805	$ (4,513,174)	$ (468,946)	$ 33,446	$ 69,284,402

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

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the nine months ended March 31, 2008	2007
OPERATING ACTIVITIES:		
Net loss	$ (2,040,553)	$ (4,354,162)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	3,745,611	3,293,232
Deferred tax expense	(821,183)	704,125
Stock compensation expense	768,922	856,868
Gain from sale of asset		(8,208)
Restricted stock grant	300,090	
Loss on impairment		7,775,890
Other noncash expenses	11,418	
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	989,194	(5,188,226)
Inventories	2,500,069	(935,028)
Prepaid taxes		366,488
Prepaid expenses and other assets	(41,362)	(134,053)
Accounts payable	1,773,472	8,639,319
Accrued expenses	(3,754,038)	519,154
Deferred revenue	(460,804)	
Net cash provided by operating activities	2,970,836	11,535,399
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment (including construction in progress)	(2,052,276)	(1,949,407)
Proceeds from sale of asset		10,000
Proceeds from sale of investment securities - available for sale	1,520,198	1,876,617
Purchase of investment securities - available for sale	(600,605)	
Issuance of note receivable		(7,327,238)
Net cash used in investing activities	(1,132,683)	(7,390,028)
FINANCING ACTIVITIES:		
Repayments of debt	(443,214)	(406,260)
Proceeds from issuance of stock	86,115	109,379
Treasury stock transactions	(74,376)	
Net cash used in financing activities	(431,475)	(296,881)
NET INCREASE IN CASH	1,406,678	3,848,490
CASH, BEGINNING OF PERIOD	5,192,341	468,359
CASH, END OF PERIOD	$ 6,599,019	$ 4,316,849
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -		
Interest paid	$ 97,114	$ 121,833
Income taxes paid	$	$ 650,000

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 and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations, and cash flows for the periods presented. In the opinion of management, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. Operating results for the three month and nine month periods ended March 31, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2008. You should read these unaudited financial statements in combination with the other Notes in this section; Management s Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Financial Statements, including the Notes to the Financial Statements, included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007.

Note 2. Summary of Significant Accounting Policies

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

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

Principles of Consolidation - The consolidated financial statements include the accounts of the operating parent company, Lannett Company, Inc., and its wholly owned subsidiaries, Lannett Holdings, Inc. and Cody Laboratories, Inc. (Cody). Cody includes the consolidation of Cody LCI Realty, LLC, a variable interest entity, as a result of the acquisition of Cody, April 10, 2007. See Note 17 about the consolidation of this variable interest entity. All intercompany accounts and transactions have been eliminated.

Reclassifications - Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

Revenue Recognition - The Company recognizes revenue when its products are shipped to the customer. 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 accruals as they are the primary recipient of

chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS and Wolters Kluwer, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations. The chargeback/rebate reserve is reviewed on a monthly basis by management using several ratios and calculated metrics. While the Company may continue to improve its processes related to estimating and verifying its liabilities related to these provisions, Lannett s methodology for estimating reserves has been consistent with previous periods.

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 expected chargebacks on actual sales may differ from actual chargeback reserves.

Rebates Rebates are offered to the Company s key chain drug store, distributor and wholesaler customers to promote customer loyalty and increase product sales. These rebate programs provide customers with rebate credits upon attainment of pre-established volumes or attainment of net sales milestones for a specified period. Other promotional programs are incentive programs offered to the customers. At the time of shipment, the Company estimates reserves for rebates and other promotional credit programs based on the specific terms in each agreement. The reserve for rebates increases as sales to certain wholesale and retail customers increase. However, since these rebate programs are not identical for all customers, the size of the reserve will depend on the mix of customers that are eligible to receive rebates.

Returns Consistent with industry practice, the Company has a product returns policy that allows customers to return product within a specified period prior to and subsequent to the product s lot expiration date in exchange for a credit to be applied to future purchases. The Company s policy requires that the customer obtain pre-approval from the Company for any qualifying return. The Company estimates its provision for returns based on historical experience, changes to business practices, and credit terms. While such experience has allowed for reasonable estimations in the past, history may not always be an accurate indicator of future returns. The Company continually monitors the provisions for returns and makes adjustments when management believes that actual product returns may differ from established reserves. Generally, the reserve for returns increases as net sales increase. The reserve for returns is included in the rebates 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 nine months ended March 31, 2008 and 2007:

For the nine months ended March 31, 2008

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2007	$ 4,649,478	$ 871,339	$ 113,313	$ 52,234	$ 5,686,364
Actual credits issued related to sales recorded in prior fiscal years	(4,429,923)	(1,741,804)	(146,917)		(6,318,644)
Reserves or (reversals) charged during Fiscal 2008 related to sales in prior fiscal years		870,465	50,000	(50,000)	870,465
Reserves charged to net sales during Fiscal 2008 related to sales recorded in Fiscal 2008	17,985,506	6,240,517	2,200,267	473,423	26,899,713
Actual credits issued related to sales recorded in Fiscal 2008	(14,721,493)	(4,988,844)	(805,702)	(473,552)	(20,989,591)
Reserve Balance as of March 31, 2008	$ 3,483,568	$ 1,251,673	$ 1,410,961	$ 2,105	$ 6,148,307

For the nine months ended March 31, 2007

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve balance as of June 30, 2006	$ 10,137,400	$ 2,183,100	$ 416,000	$ 275,600	$ 13,012,100
Actual credits issued related to sales recorded in prior fiscal years	(10,170,000)	(1,800,000)	(890,000)	(250,000)	(13,110,000)
Reserves or (reversals) charged during Fiscal 2007 related to sales in prior fiscal years		(300,000)	460,000		160,000
Reserves charged to net sales during Fiscal 2007 related to sales recorded in Fiscal 2007	24,340,700	8,832,300	986,400	1,033,100	35,192,500
Actual credits issued related to sales recorded in Fiscal 2007	(17,065,500)	(5,122,200)	(954,700)	(265,000)	(23,407,400)
Reserve Balance as of March 31, 2007	$ 7,242,600	$ 3,793,200	$ 17,700	$ 793,700	$ 11,847,200

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 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

7

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

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

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.

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 remaining 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.

Fair Value of Financial Instruments - The Company s financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and debt obligations. The carrying values of these assets and liabilities approximate fair value based upon the short-term nature of these instruments. The Company has estimated that the fair value of long-term debt associated with the 20 year mortgage on its land and building in Cody, Wyoming approximates the discounted amount of future payments to the mortgage-holder. There is no market for this type of financial liability. The Company estimates that the fair value of the mortgage liability is less than the carrying value of the property.

Investment Securities - The Company s investment securities consist of marketable debt securities, primarily in U.S. government and agency obligations. All of the Company s marketable debt securities are classified as available-for-sale and recorded at fair value, based on quoted market prices. Unrealized holding gains and losses are recorded, net of any tax effect, as a separate component of accumulated other comprehensive loss. 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.

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

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

Intangible Assets On March 23, 2004, the Company entered into an agreement with Jerome Stevens Pharmaceuticals, Inc. (JSP) for the exclusive marketing and distribution rights in the United States to the current line of JSP products in exchange for four million (4,000,000) shares of the Company s common stock. As a result of the JSP agreement, the Company recorded an intangible asset of $67,040,000 for the exclusive marketing and distribution rights obtained from JSP. The intangible asset was recorded based upon the fair value of the four million (4,000,000) shares at the time of issuance to JSP.

In June 2004, JSP s Levothyroxine Sodium tablet product received from the FDA an AB rating to the brand drug Levoxyl®. In December 2004, the product received from the FDA a second AB rating to the brand drug Synthroid®. As a result of the dual AB ratings, the Company was required to pay JSP an additional $1.5 million in cash to reimburse JSP for expenses related to obtaining the AB ratings. As of June 30, 2005, the Company had recorded an addition to the intangible asset of $1.5 million.

During Fiscal 2005, events occurred (as described in subsequent paragraphs) 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 had 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 the date of the impairment. This impairment loss was shown on the statement of operations as a component of operating loss. Management concluded that, as of March 31, 2008, the intangible asset was correctly stated at net realizable value of approximately $10,708,000 and, therefore, no adjustment was required.

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 resulted in diminished forecasted future net cash flow which, when

discounted, yield a lower present value than the carrying value of the asset before impairment.

The Company will incur annual amortization expense of approximately $1,785,000 for the intangible asset over the remaining term of the contract. For each nine month period ended March 31, 2008 and 2007, the Company incurred amortization expense of approximately $1,338,000.

Future annual amortization expense of the JSP intangible asset consists of approximately the following:

Fiscal Year Ending June 30,	Annual Amortization Expense
2008	$ 446,000
2009	1,785,000
2010	1,785,000
2011	1,785,000
2012	1,785,000
Thereafter	3,122,000
	$ 10,708,000

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased for $100,000 and future royalty payments the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. owned the Abbreviated New Drug Application (ANDA). In Fiscal 2008, the Company obtained FDA approval to use the proprietary rights. Accordingly, the Company has capitalized this purchased product right as an indefinite lived intangible asset and the value will be subject to impairment tests in the future.

Advertising Costs - The Company charges advertising costs to operations as incurred. Advertising expense for the nine months ended March 31, 2008 and 2007 was approximately $5,000 and $49,000, respectively.

Income Taxes - The Company uses the liability method specified by Statement of Financial Accounting Standards No. 109 (FAS), *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 as one operating segment. The following table identifies the Company s approximate net product sales by medical indication for the three and nine months ended March 31, 2008 and 2007:

	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
Medical Indication	2008	2007	2008	2007
Migraine Headache	$ 2,373,000	$ 2,851,000	$ 7,815,000	$ 8,013,000
Epilepsy	816,000	2,071,000	2,787,000	6,544,000
Heart Failure	1,004,000	1,029,000	3,164,000	3,532,000

Thyroid Deficiency	9,288,000	8,338,000	27,974,000	26,617,000
Antibiotic	2,293,000	5,310,000	7,378,000	17,512,000
Other	806,000	704,000	2,536,000	2,969,000
Total	$ 16,580,000	$ 20,303,000	$ 51,654,000	$ 65,187,000

Concentration of Market and Credit Risk - Six of the Company s products, defined as generics containing the same active ingredient or combination of ingredients, accounted for approximately 54%, 10%, 8%, 7%, 6% and 5% of net sales for the nine months ended March 31, 2008. Those same products accounted for 41%, 23%, 7%, 5%, 5% and 10%, respectively, of net sales for the nine months ended March 31, 2007. For the three months ended March 31, 2008 and 2007, the same six products accounted for 56%, 9%, 8%, 7%, 6% and 5%, and 41%, 23%, 10%, 9%, 6% and 5% of net sales, respectively.

Four of the Company s customers accounted for 32%, 9%, 5%, and 5%, respectively, of net sales for the nine months ended March 31, 2008, and 16%, 8%, 20%, and 3%, respectively, of net sales for the nine months ended March 31, 2007. The same four customers accounted for 29%, 6%, 5%, and 4%, respectively, of net sales for the three months ended March 31, 2008 of this year, and 15%, 8%, 13%, and 3%, respectively, of net sales for the three months ended March 31, 2007. At March 31, 2008, these four customers accounted for 58% of the Company s accounts receivable balances. At June 30, 2007, these four customers accounted for 53% of the Company s accounts receivable balances.

Share-based Compensation - The Company follows the guidance in Financial Accounting Standards Board (FASB) 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 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 March 31, 2008, the Company had three stock-based employee compensation plans (the Old Plan, the 2003 Plan, and the Long-term Incentive Plan, or LTIP). During the nine months ended March 31, 2008, the Company awarded 209,264 shares of restricted stock under the LTIP of which, 74,464 of these shares vested 100% on January 1, 2008, the remainder vest in equal portions on September 18, 2008, 2009 and 2010. Stock compensation expense of $42,889 and $91,905 was recognized during the three-months and nine months ended March 31, 2008, respectively, related to these shares of restricted stock.

The Company is required to record compensation expense for all awards granted after the date of adoption of SFAS 123(R) and for the unvested portion of previously granted awards that remain outstanding as of the beginning of the period of adoption. The Company measures share-based compensation cost for options using the Black-Scholes option pricing model. The following table presents the weighted average assumptions used to estimate fair values of the stock options granted and the estimated forfeiture rates during the nine months ended March 31:

	Incentive Stock Options FY 2008	Non-qualified Stock Options FY 2008	Incentive Stock Options FY 2007	Non-qualified Stock Options FY 2007
Risk-free interest rate	4.2%	4.2%	4.7%	4.8%
Expected volatility	56.0%	56.0		