PharMerica CORP
Form 10-Q
October 29, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2009

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________.

Commission File Number: 001-33380

PHARMERICA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**87-0792558**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

1901 Campus Place

Louisville, KY	**40299**
(Address of Principal Executive Offices)	**(Zip Code)**

(502) 627-7000

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x Yes ¨ No

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes x No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class of Common Stock	**Outstanding at October 23, 2009**
Common stock, $0.01 par value	30,612,465 shares

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED INCOME STATEMENTS

For the Three Months and Nine Months Ended September 30, 2008 and 2009

(Unaudited)

(In millions, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Revenues	$ 486.2	$ 461.0	$ 1,467.6	$ 1,389.8
Cost of goods sold	415.9	394.8	1,254.0	1,183.4
Gross profit	70.3	66.2	213.6	206.4
Selling, general and administrative expenses	50.5	44.1	161.8	142.2
Amortization expense	1.6	2.5	4.8	6.2
Integration, merger and acquisition related costs and other charges	7.1	0.9	17.8	3.5
Operating income	11.1	18.7	29.2	54.5
Interest expense, net	3.4	1.9	10.6	8.4
Income before income taxes	7.7	16.8	18.6	46.1
Provision for income taxes	3.4	2.2	8.1	14.1
Net income	$ 4.3	$ 14.6	$ 10.5	$ 32.0
Earnings per common share:				
Basic	$ 0.14	$ 0.48	$ 0.35	$ 1.06
Diluted	$ 0.14	$ 0.48	$ 0.35	$ 1.05
Shares used in computing earnings per common share:				
Basic	30,105,157	30,287,709	30,081,596	30,244,014
Diluted	30,391,484	30,508,342	30,195,009	30,373,255

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

As of December 31, 2008 and September 30, 2009

(Unaudited)

(In millions, except share and per share amounts)

	December 31, 2008	September 30, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41.3	$ 73.8
Accounts receivable, net	219.3	215.3
Inventory	73.4	73.4
Deferred tax assets	24.9	33.0
Prepaids and other assets	16.7	19.4
	375.6	414.9
Equipment and leasehold improvements	97.1	109.9
Accumulated depreciation	(43.1)	(55.4)
	54.0	54.5
Deferred tax assets, net	59.4	33.3
Goodwill	113.7	128.5
Intangible assets, net	73.4	72.3
Other	3.1	2.4
	$ 679.2	$ 705.9
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 54.4	$ 51.1
Salaries, wages and other compensation	36.3	34.6
Other accrued liabilities	12.6	5.5
	103.3	91.2
Long-term debt	240.0	240.0
Other long-term liabilities	16.1	15.5
Commitments and contingencies (See Note 6)		
Stockholders equity:		
Preferred stock, $0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2008 and September 30, 2009		
Common stock, $0.01 par value per share; 175,000,000 shares authorized; 30,477,558 shares and 30,608,362 shares issued and outstanding as of December 31, 2008 and September 30, 2009, respectively.	0.3	0.3
Capital in excess of par value	338.7	343.3
Accumulated other comprehensive loss	(2.8)	

Retained (deficit) earnings		(16.4)		15.6
		319.8		359.2
	$	679.2	$	705.9

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months and Nine Months Ended September 30, 2008 and 2009

(Unaudited)

(In millions)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Cash flows provided by (used in) operating activities:				
Net income	$ 4.3	$ 14.6	$ 10.5	$ 32.0
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation	5.3	4.5	16.8	13.4
Amortization	1.6	2.5	4.8	6.2
Integration, merger and acquisition related costs and other charges	0.6		1.5	0.2
Stock-based compensation	1.4	1.3	3.5	3.2
Amortization of deferred financing fees	0.1	0.1	0.3	0.3
Deferred income taxes	2.8	2.7	6.9	14.3
Loss on disposition of equipment	0.2		0.8	0.1
Other	(0.3)	(0.1)	(0.3)	(0.2)
Change in operating assets and liabilities:				
Accounts receivable, net	(4.8)	(4.5)	(8.7)	4.2
Inventory and other assets	(1.6)	(2.4)		0.1
Prepaids and other assets	0.1	(5.3)	4.5	(2.0)
Accounts payable	8.1	4.8	1.9	(3.0)
Salaries, wages and other compensation	0.9	1.0	(1.6)	(5.0)
Other accrued liabilities	(1.2)	(2.3)	0.8	(4.2)
Net cash provided by operating activities	17.5	16.9	41.7	59.6
Cash flows provided by (used in) investing activities:				
Purchase of equipment and leasehold improvements	(6.0)	(5.8)	(17.8)	(12.3)
Acquisitions	(4.4)	(15.9)	(4.4)	(15.9)
Cash proceeds from sale of assets	0.1		0.3	0.1
Net cash used in investing activities	(10.3)	(21.7)	(21.9)	(28.1)
Cash flows provided by (used in) financing activities:				
Repayments of long-term debt and capital lease obligations		(0.1)	(10.0)	(0.4)
Issuance of common stock	0.5	1.0	0.7	1.3
Cash contributions received from minority shareholders			0.1	
Tax benefit from stock-based compensation				0.1
Net cash provided by (used in) financing activities	0.5	0.9	(9.2)	1.0
Change in cash and cash equivalents	7.7	(3.9)	10.6	32.5
Cash and cash equivalents at beginning of period	34.9	77.7	32.0	41.3
Cash and cash equivalents at end of period	$ 42.6	$ 73.8	$ 42.6	$ 73.8

Supplemental information:				
Cash paid for interest	$ 3.6	$ 3.8	$ 11.1	$ 10.3
Cash paid for taxes	$ 0.5	$ 0.2	$ 1.4	$ 1.6
Supplemental schedule of non-cash activities:				
Fair value of assets acquired	$	$	$ (1.4)	$
Fair value of liabilities assumed or incurred	$	$	$ (1.4)	$
Capital lease obligations	$	$	$	$ 1.8

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the Nine Months Ended September 30, 2009

(Unaudited)

(In millions, except share amounts)

	Common Stock Shares	Common Stock Amount	Capital in Excess of Par Value	Accumulated Other Comprehensive Income (Loss) (AOCI)	Retained (Deficit) Earnings	Total
Balance at December 31, 2008	30,477,558	$ 0.3	$ 338.7	$ (2.8)	$ (16.4)	$ 319.8
Comprehensive income:						
Net income					32.0	32.0
Change in fair value of interest rate swap, net				2.8		2.8
Total comprehensive income				2.8	32.0	34.8
Grant and forfeiture of non-vested restricted stock	31,865					
Exercise of stock options	98,939		1.3			1.3
Stock-based compensation - restricted stock			1.8			1.8
Stock-based compensation - stock options			1.4			1.4
Income tax benefit in connection with the issuance of common stock under stock-based compensation plans			0.1			0.1
Balance at September 30, 2009	30,608,362	$ 0.3	$ 343.3	$	$ 15.6	$ 359.2

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

PharMerica Corporation (the Corporation) is an institutional pharmacy services company that services healthcare facilities and provides management pharmacy services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States, operating 97 institutional pharmacies in 41 states. The Corporation s customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings and generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 85 hospitals in the United States.

Pharmacy Transaction

The Corporation was formed on October 23, 2006 by Kindred Healthcare, Inc. (Kindred or Former Parent) and AmerisourceBergen Corporation (AmerisourceBergen) for the purpose of consummating the transactions contemplated by the Master Transaction Agreement dated October 25, 2006, as amended (the Master Agreement). Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through a series of transactions (collectively, the Pharmacy Transaction), spun-off and combined their respective institutional pharmacy businesses, Kindred Pharmacy Services (KPS) and PharMerica Long-Term Care (PharMerica LTC), into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007 (the Closing Date).

Principles of Consolidation

All intercompany transactions have been eliminated.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Corporation and related footnotes for the year ended December 31, 2008, included in the Corporation s Annual Report on Form 10-K. The balance sheet as of December 31, 2008 has been derived from the audited consolidated financial statements as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

The results of operations for the interim periods are not necessarily indicative of results of operations for a full year. It is the opinion of management that all necessary adjustments for a fair presentation of the condensed consolidated income statements, balance sheets, cash flows, and stockholders equity for the interim periods have been made and are of a normal recurring nature.

Use of Estimates

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. GAAP, which require management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates are involved in revenue recognition, collectibility of accounts receivable, inventory valuation, supplier rebates, stock based compensation, accounting for income taxes, and the valuation of long-lived assets and goodwill. Actual amounts may differ from these estimates.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Potential risks and uncertainties, many of which are beyond the control of the Corporation, include, but are not necessarily limited to, such factors as overall economic, financial and business conditions; delays and reductions in reimbursement by the government and other payers to the Corporation or its customers; the overall financial condition of the Corporation s customers; the effect of new government regulations, executive orders and legislative initiatives, including those relating to reimbursement and drug pricing policies and changes in the interpretation and application of such policies; efforts by payers to control costs; the outcome of litigation; the outcome of audit, compliance, administrative or investigatory reviews, including governmental or regulatory inquiries; other contingent liabilities; changes in economic and political conditions; changes in interest rates; changes in the valuation of the Corporation s financial instruments; changes in tax laws and regulations; access to capital and financing; the demand for the Corporation s products and services; pricing and other competitive factors in the industry; changes in insurance claims experience and related assumptions; variations in costs or expenses; and changes in accounting rules and standards.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and cash equivalents with original maturities of three months or less. As of September 30, 2009, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets given current economic conditions.

Fair Value of Financial Instruments

Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based upon assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, the Corporation follows a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1: Observable inputs such as quoted prices in active markets;

Level 2: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly; and

Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Assets and liabilities measured at fair value are based on one or more of the following three valuation techniques:

A. *Market approach:* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

B. *Cost approach:* Amount that would be required to replace the service capacity of an asset (replacement cost).

C.

Income approach: Techniques to convert future amounts to a single present amount based upon market expectations (including present value techniques, option-pricing and excess earnings models).

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Financial liabilities disclosed at fair value at September 30, 2009, are set forth in the table below (in millions):

	Assets/ (Liabilities)	Level 1	Level 2	Level 3	Valuation Technique
Deferred Compensation Plan	$ (2.7)	$	$ (2.7)	$	A
Contingent Consideration	$ (1.7)	$	$	$ (1.7)	C

The Corporation s Level 2 liability represent an unfunded obligation associated with a deferred compensation plan offered to eligible employees and Board members of the Corporation. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for similar assets or liabilities generated by market transactions. The Corporation s Level 3 liability represents a contingent consideration associated with our August 10, 2009 institutional pharmacy acquisition (the 2009 Acquisition). The fair value of the liability associated with the contingent consideration is derived using the income approach with unobservable inputs in which there is little or no market data.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, inventory, accounts payable and debt approximate fair value because of the nature or short-term maturity of these instruments.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily consist of amounts due from Prescription Drug Plans (PDPs) under Medicare Part D, institutional healthcare providers, the respective state Medicaid programs, third party insurance companies, and private payers. The Corporation s ability to collect outstanding receivables is critical to its results of operations and cash flows. To provide for accounts receivable that could become uncollectible in the future, the Corporation establishes an allowance for doubtful accounts to reduce the carrying value of such receivables to the extent it is probable that a portion or all of a particular account will not be collected.

The Corporation has an established process to determine the adequacy of the allowance for doubtful accounts, which relies on analytical tools, specific identification, and benchmarks to arrive at a reasonable allowance. No single statistic or measurement determines the adequacy of the allowance for doubtful accounts. In evaluating the collectibility of accounts receivable, the Corporation considers a number of factors, which include, but are not limited to, the impact of changes in the regulatory and payer environment, historical trends, the financial viability of the payer, contractual reimbursement terms and other factors that may impact ultimate reimbursement. Accounts receivable are written off after collection efforts have been completed in accordance with the Corporation s policies.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Corporation s accounts receivable accounts and summarized aging categories are as follows (dollars in millions):

	December 31, 2008	September 30, 2009
Institutional healthcare providers	$ 148.0	$ 142.3
Medicare Part D	59.5	59.2
Private payor and other	35.9	39.7
Insured	10.4	9.9
Medicaid	9.4	9.2
Medicare	2.6	1.3
Allowance for doubtful accounts	(46.5)	(46.3)
	$ 219.3	$ 215.3
0 to 60 days	64.1%	63.6%
61 to 120 days	18.1%	17.1%
Over 120 days	17.8%	19.3%
	100.0%	100.0%

The following is a summary of activity in the Corporation s allowance for doubtful accounts (dollars in millions):

	Beginning Balance	Acquisitions/ Transfers	Charges to Costs and Expenses	Write-offs	Ending Balance
Allowance for doubtful accounts:					
Year Ended December 31, 2008	$ 43.4	$ 0.3	$ 24.7	$ (21.9)	$ 46.5
Nine Months Ended September 30, 2009	$ 46.5	$ 3.5	$ 13.2	$ (16.9)	$ 46.3

The allowance for doubtful accounts included a transfer of reserves on contractual adjustments into the allowance for doubtful accounts during the period. The reclassification did not impact the provision for bad debt for the current period.

Concentration of Credit Risk

For the three months and nine months ended September 30, 2009, the Corporation derived approximately 13.0% of its revenues from a single customer, including all payer sources associated with the residents of its long-term care facilities.

Deferred Financing Fees

The Corporation capitalizes deferred financing fees related to acquiring or issuing new debt instruments. These expenditures include bank fees and premiums, legal costs, and filing fees. The Corporation amortizes these deferred financing fees using the straight-line method.

Inventory

Inventory is located at the Corporation s institutional pharmacy locations. Inventory consists solely of finished product (primarily prescription drugs) and is valued at the lower of first-in, first-out cost (FIFO) or market. Physical inventories are performed on a quarterly basis at all pharmacy sites. Cost of goods sold is recorded based upon the actual results of the physical inventory counts, and is estimated when a physical inventory is not performed in a particular month. Historically, no significant adjustments have resulted from reconciliations with the quarterly physical inventories.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Equipment and leasehold improvements

Equipment and leasehold improvements are recorded at cost at the acquisition date and are depreciated using the straight-line method over their estimated useful lives as follows (in years):

	Estimated Useful Lives
Leasehold improvements	1-5
Equipment and software	3-10
Leased equipment	1-5

Expenditures for maintenance, repairs, and renewals of minor items are expensed as incurred. Major rebuilds and improvements are capitalized. For the three months ended September 30, 2008 and 2009, maintenance and repairs were approximately $1.7 million and $1.4 million, respectively. For the nine months ended September 30, 2008 and 2009, maintenance and repairs were approximately $5.5 million and $4.7 million, respectively.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset to the estimated future undiscounted net cash flows expected to be generated by the asset. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset to its then fair value. The Corporation did not record impairment charges on equipment and leasehold improvements or intangibles for the three months and nine months ended September 30, 2008 and 2009.

The Corporation s equipment and leasehold improvements are further described in Note 3.

Capitalization of Internal Software Costs

The Corporation capitalizes the costs incurred during the application development stage, which include costs to design the software configuration and interfaces, coding, installation, and testing. Costs incurred during the preliminary project along with post-implementation stages of internal use computer software are expensed as incurred. Capitalized development costs are amortized over various periods up to three years and are subject to impairment evaluations. Costs incurred to maintain existing software development are expensed as incurred. The capitalization and ongoing assessment of recoverability of development costs requires judgment by management with respect to certain external factors, including, but not limited to, technological and economic feasibility and estimated economic life. For the three months ended September 30, 2008 and 2009, the Corporation capitalized software development costs of $0.4 million and $0.8 million, respectively. For the nine months ended September 30, 2008 and 2009 the Corporation capitalized software development costs of $1.5 million and $2.0 million, respectively. As of December 31, 2008 and September 30, 2009, net capitalized internal software costs and purchased software costs totaled $7.5 million and $6.1 million, respectively.

Goodwill and Other Intangibles

Goodwill represents the excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. Goodwill and intangible assets with indefinite lives are reviewed by the Corporation at least annually for impairment each of which are reviewed separately for impairment. The Corporation s business is comprised of two reporting units, institutional pharmacy and hospital management, each of which are reviewed separately for impairment. The Corporation performed its annual impairment tests for goodwill as of December 31, 2008 and did not incur an impairment charge.

The Corporation s finite lived intangible assets are comprised primarily of trade names, customer relationships, and non-compete agreements originating from business acquisitions. Finite lived intangible assets are amortized on a straight-line basis over the terms of the agreements ranging from 5 to 20 years. The Corporation s goodwill and intangible assets are further described in Note 4.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

During the fourth quarter 2008, the Corporation recorded a pre-tax impairment charge of $14.8 million related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. The impairment was related to intangible assets acquired in acquisitions by KPS during the years ended December 31, 2005 and 2006. These asset groups were assessed for recoverability and management determined the finite lived customer relationship assets to be impaired, but no other assets within the asset groups were deemed to be impaired. Using an undiscounted cash flow analysis, the Corporation determined the pre-tax impairment charge of $14.8 million was required to write the carrying value down to the fair value, resulting in a loss per diluted share impact of $0.30. The Corporation recognized the impairment as a permanent write-down of the cost basis and accumulated amortization of the affected assets.

Self-Insured Employee Health Benefits

The Corporation is self-insured for employee health benefits. The Corporation s self-insurance for employee health benefits includes a stop-loss policy to limit the maximum potential liability of the Corporation for both individual and aggregate claims per year. The Corporation records a monthly expense for self-insurance based upon historical claims data and inputs from third-party administrators. As of December 31, 2008 and September 30, 2009, the Corporation had approximately $2.6 million and $2.3 million, respectively, recorded as a liability for self-insured employee health benefits.

On September 5, 2008 the Corporation received a $2.1 million refund as a result of over charges on self-insured employee health benefits, of which approximately $1.2 million related to 2007. For the three months ended September 30, 2008, employee benefits classified in costs of goods sold and selling, general and administrative expenses were reduced by $1.5 million and $0.6 million, respectively.

Supplier Rebates

The Corporation receives rebates on purchases from its vendors and suppliers. The Corporation generally accounts for these rebates and other incentives received from its vendors and suppliers, relating to the purchase or distribution of inventory, as a reduction to cost of goods sold and inventory. The Corporation considers these rebates to represent product discounts, and as a result, the rebates are capitalized as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory. For the three months ended September 30, 2008 and 2009, rebates were $12.1 million and $12.9 million, respectively, and for the nine months ended September 30, 2008 and 2009 rebates were $38.7 million and $35.0 million, respectively, and recorded as a reduction of cost of goods sold in the accompanying condensed consolidated income statements. The Corporation had approximately $2.8 million and $2.6 million of rebates capitalized in inventory as of December 31, 2008 and September 30, 2009, respectively.

Delivery Expenses

The Corporation incurred delivery expenses totaling approximately $15.9 million and $14.2 million for the three months ended September 30, 2008 and 2009, respectively, and $47.3 million and $41.5 million for the nine months ended September 30, 2008 and 2009, respectively, to deliver products sold to its customers. Delivery expenses are reported as a component of cost of goods sold in the accompanying condensed consolidated income statements.

Accumulated Comprehensive Income (Loss)

On July 31, 2007, the Corporation entered into an interest rate swap agreement, which the Corporation designated as a cash flow hedge. The swap expired on July 31, 2009. The Corporation recognizes all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. Depending on the nature of the hedge, changes in the fair value of the derivative are either offset against the change in fair value of assets and liabilities through earnings or recognized in accumulated other comprehensive income (loss) until the hedged item is recognized into earnings. The ineffective portion of a derivative s change in fair value, if any, is immediately recognized into earnings. As of December 31, 2008, accumulated other comprehensive loss was $2.8 million. The Corporation did not have accumulated other comprehensive income (loss) as of September 30, 2009 due to the expiration of the swap on July 31, 2009.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Based Compensation

The Corporation recognizes compensation expense based on the grant date fair value. The following table summarizes stock-based compensation expense of the Corporation for the periods presented (dollars in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Nonvested stock and stock option expense	$ 1.4	$ 1.3	$ 3.5	$ 3.2
Income tax benefit	$ 0.6	$ 0.5	$ 1.5	$ 1.3
Negative effect on diluted earnings per share	$ (0.03)	$ (0.03)	$ (0.07)	$ (0.06)

Stock based compensation is more fully described in Note 9.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Corporation accrues for probable tax obligations as required by facts and circumstances in the various regulatory environments. Deferred tax assets and liabilities are more fully described in Note 10.

Impact of Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162* (SFAS 168). SFAS 168 provides for the FASB Accounting Standards Codification (the Codification) to become the single official source of authoritative, non-governmental U.S. GAAP. The Codification did not change U.S. GAAP but reorganizes the literature. The Corporation has adopted SFAS 168 and the adoption did not have a material effect on the Corporation s financial statements.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications have no impact on the Corporation s total assets, liabilities, stockholders equity, net income, or cash flows.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 2 ACQUISITIONS

2009 Acquisition

On August 10, 2009, the Corporation acquired certain assets and assumed certain liabilities of an institutional pharmacy business providing medications, pharmacy and medical supplies and services to residents of long-term care facilities. The Corporation paid $15.9 million in cash for the business, with an additional amount not to exceed $10.0 million in the form of a contingent consideration to be paid at the end of a three year period based upon the cumulative achievement of certain financial performance measures. The transaction was accounted for as a business combination, in which the preliminary purchase price was allocated based upon the fair value of the assets acquired and liabilities assumed with the difference recorded as goodwill. As a result of the acquisition the Company recorded $4.4 million as finite lived intangible assets and $12.6 million of goodwill. The contingent consideration was recorded at fair value at the acquisition date in the amount of $1.7 million. The contingent consideration will be adjusted to fair value through earnings until the final amount is determined.

For the three months and nine months ended September 30, 2009, the Corporation has incurred costs of $0.5 million and $0.6 million, respectively, of acquisition related costs, which have been classified as a component of integration, merger, acquisition related costs and other charges. Prior to January 1, 2009, costs associated with acquisitions were capitalized as a part of the respective purchase price.

2008 Acquisitions

On November 1, 2008, the Corporation acquired certain assets and assumed certain liabilities of an institutional pharmacy business providing medications, pharmacy, and medical supplies and services to residents of long-term care facilities for $21.5 million in cash. The transaction was accounted for as a purchase, in which the purchase price was allocated based upon the fair value of the assets acquired and liabilities assumed with the difference recorded as goodwill. As a result of the acquisition the Corporation recorded $17.2 million as a finite lived intangible customer relationship and $2.0 million as goodwill.

On July 9, 2008, the Corporation purchased the 49.0% minority interest held by a third-party in the Corporation s joint ventures. The Corporation paid approximately $4.4 million in cash for the minority interest share of the joint ventures. The amount paid for the minority interest share of the joint ventures approximates fair value and resulted in the recognition of $0.2 million in goodwill as a result of the transaction, of which approximately $0.1 million included professional fees capitalized as part of the purchase price.

Other

The total amount of goodwill expected to be deductible for tax purposes from past acquisitions of the Corporation was $108.5 million as of September 30, 2009. Deferred tax assets and liabilities are further described in Note 10.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consist of the following (dollars in millions):

	December 31, 2008	September 30, 2009
Leasehold improvements	$	