LANNETT CO INC
Form 10-Q
November 14, 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 SEPTEMBER 30, 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Yes o **No** x

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

Class	Outstanding as of November 12, 2008
Common stock, par value $0.001 per share	24,486,032 shares

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	(UNAUDITED) September 30, 2008	June 30, 2008
ASSETS		
Current Assets		
Cash	$ 15,132,426	$ 6,256,712
Trade accounts receivable (net of allowance of $225,000 and $207,151, respectively)	25,779,954	34,114,982
Inventories, net	11,322,687	11,617,258
Interest receivable	66,606	51,781
Prepaid taxes	814,928	1,598,937
Deferred tax assets	6,198,694	6,997,935
Other current assets	691,807	591,415
Total Current Assets	60,007,102	61,229,020
Property, plant and equipment	40,165,146	39,996,008
Less accumulated depreciation	(16,099,355)	(15,261,905)
	24,065,791	24,734,103
Construction in progress	498,118	458,046
Investment securities - available for sale	2,490,356	2,500,135
Intangible assets - net of accumulated amortization	10,346,168	10,361,835
Deferred tax assets	17,225,418	17,380,115
Other assets	186,325	195,354
Total Assets	$ 114,819,278	$ 116,858,608
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES		
Current Liabilities		
Accounts payable	$ 11,826,657	$ 13,085,772
Accrued expenses	3,438,625	2,451,783
Deferred revenue	724,385	982,668
Current portion of long term debt	714,862	791,912
Rebates, chargebacks and returns payable	15,352,751	18,326,417
Total Current Liabilities	32,057,280	35,638,552
Long term debt, less current portion	8,116,389	8,186,922
Deferred tax liabilities	3,140,395	3,179,344
Unearned grant funds	500,000	500,000
Other long term liabilities	33,950	32,001
Total Liabilities	43,848,014	47,536,819

Commitment and contingencies, See notes 9 and 10				
Minority interest in Cody LCI Realty, LLC, net of taxes		67,815		50,309
SHAREHOLDERS EQUITY				
Common stock - authorized 50,000,000 shares, par value $0.001;				
issued and outstanding, 24,367,404 and 24,283,963 shares, respectively		24,367		24,284
Additional paid in capital		74,918,095		74,497,100
Accumulated deficit		(3,564,515)		(4,790,680)
Accumulated other comprehensive income		14,398		9,722
		71,392,345		69,740,426
Less: Treasury stock at cost - 82,095 and 74,970 shares, respectively		(488,896)		(468,946)
TOTAL SHAREHOLDERS EQUITY		70,903,449		69,271,480
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	114,819,278	$	116,858,608

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

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LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three months ended September 30, 2008	Three months ended September 30, 2007
Net sales	$ 25,567,653	$ 17,540,030
Cost of sales	16,120,195	11,792,536
Amortization of intangible assets	446,166	446,166
Product royalties		195,570
Gross profit	9,001,292	5,105,758
Research and development expenses	1,863,113	1,252,148
Selling, general, and administrative expenses	4,949,144	3,979,710
Loss on sale of assets	(4,931)	
Operating income (loss)	2,184,104	(126,100)
OTHER INCOME(EXPENSE):		
Interest income	45,767	57,122
Interest expense	(66,209)	(103,868)
	(20,442)	(46,746)
Income (loss) before income tax expense (benefit) and minority interest	2,163,662	(172,846)
Income tax expense (benefit)	919,990	(45,685)
Minority interest in Cody LCI Realty, LLC	(17,507)	
Net income (loss)	$ 1,226,165	$ (127,161)
Basic income (loss) per common share	$ 0.05	$ (0.01)
Diluted income (loss) per common share	$ 0.05	$ (0.01)
Basic weighted average number of shares	24,306,488	24,175,643
Diluted weighted average number of shares	24,382,951	24,175,643

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 CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock Shares Issued	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accum. Other Comp. Income	Shareholders Equity
Balance, June 30, 2008	24,283,963	$ 24,284	$ 74,497,100	$ (4,790,680)	$ (468,946)	$ 9,722	$ 69,271,480
Shares issued in connection with employee stock purchase plan	14,839	15	31,266				31,281
Share based compensation							
Restricted stock			43,007				43,007
Stock options			218,800				218,800
Employee stock purchase plan			26,591				26,591
Shares issued in connection with restricted stock grant	68,602	68	101,331				101,399
Purchase of treasury stock					(19,950)		(19,950)
Other comprehensive income, net of income tax						4,676	4,676
Net income				1,226,165			1,226,165
Balance, September 30, 2008	24,367,404	$ 24,367	$ 74,918,095	$ (3,564,515)	$ (488,896)	$ 14,398	$ 70,903,449

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

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LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the three months ended September 30, 2008	2007
OPERATING ACTIVITIES:		
Net income (loss)	$ 1,226,165	$ (127,161)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	1,283,617	1,332,946
Deferred tax expense	911,872	230,975
Stock compensation expense	288,398	187,480
Restricted stock grant	101,399	
Other noncash expenses	1,949	
Minority interest in Cody LCI Realty LLC, net of taxes	17,506	
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	5,341,230	(2,192,425)
Inventories	294,571	1,524,632
Prepaid taxes	784,009	(266,570)
Prepaid expenses and other assets	(106,188)	(80,260)
Accounts payable	(1,259,114)	(3,673,823)
Accrued expenses	576,474	(26,296)
Deferred revenue	(258,283)	(273,479)
Net cash provided by (used in) operating activities	9,203,605	(3,363,981)
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment (including construction in progress)	(209,210)	(900,405)
Proceeds from sale of investment securities - available for sale	316,099	91,454
Purchase of investment securities - available for sale	(298,528)	(103,071)
Net cash used in investing activities	(191,639)	(912,022)
FINANCING ACTIVITIES:		
Repayments of debt	(147,583)	(146,833)
Proceeds from issuance of stock	31,281	25,933
Treasury stock transactions	(19,950)	
Net cash used in financing activities	(136,252)	(120,900)
NET INCREASE (DECREASE) IN CASH	8,875,714	(4,396,903)
CASH, BEGINNING OF PERIOD	6,256,712	5,192,341
CASH, END OF PERIOD	$ 15,132,426	$ 795,438
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -		
Interest paid	$ 64,852	$ 76,213
Income taxes paid	$ 250,000	$
Unpaid acquisition of intangible asset	$ 430,500	$

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

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LANNETT COMPANY, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for presentation of interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations, and cash flows for the periods presented. In the opinion of management, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. Operating results for the three month period ended September 30, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2009. 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, 2008.

Note 2. Summary of Significant Accounting Policies

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

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. As applicable to these consolidated financial statements, the most significant estimates and assumptions relate to sales reserves and allowances, income taxes, inventories, contingencies and valuation of intangible assets.

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

Reclassifications - The 2007 Consolidated Balance Sheet and the Consolidated Statement of Cash Flows have been reclassified to conform to the current year 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

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not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS and NDC Health, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations.

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

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

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

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discretionary decisions made by management to reflect competitive market conditions. Amounts recorded for estimated shelf stock adjustments are based upon specified terms with direct customers, estimated declines in market prices, and estimates of inventory held by customers. The Company regularly monitors these and other factors and evaluates the reserve as additional information becomes available. Other adjustments are included in the rebates and chargebacks payable account on the balance sheet.

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the three months ended September 30, 2008 and 2007:

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

For the three months ended September 30, 2007 **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	(2,750,584)	(399,088)	(140,759)		(3,290,431)
Reserves or (reversals) charged during Fiscal 2008 related to sales in prior fiscal years			50,000	(50,000)	
Reserves charged to net sales during Fiscal 2008 related to sales recorded in Fiscal 2008	8,810,312	2,475,014	483,713	110,000	11,879,039
Actual credits issued related to sales recorded in Fiscal 2008	(5,967,397)	(1,472,936)	(6,158)	(110,129)	(7,556,620)
Reserve Balance as of September 30, 2007	$ 4,741,809	$ 1,474,329	$ 500,109	$ 2,105	$ 6,718,352

The total reserve for chargebacks, rebates, returns and other adjustments decreased from $18,326,417 at June 30, 2008 to $15,352,751 at September 30, 2008. The increase in chargeback and rebate reserves between June 30, 2008 and September 30, 2008 was due to an increase in inventory levels at wholesaler distribution centers. The significant decrease in the returns reserve balance was primarily the result of credits issued during the first quarter of 2009 related to the returns of the Prenatal Multivitamin product shipped in Fiscal 2008. It is our expectation that all of the product will be returned based on our inability to have the product specified as a brand equivalent, and information from our customers regarding their intentions to return the product. As of September 30, 2008 approximately $5.6 million of the return reserve was applied to accounts receivable for customers who had returned the Prenatal Multivitamin product by that date.

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The Company ships its products to the warehouses of its wholesale and retail chain customers. When the Company and a customer enter into an agreement for the supply of a product, the customer will generally continue to purchase the product, stock its warehouse(s), and resell the product to its own customers. The Company s customer will reorder the product as its warehouse is depleted. The Company generally has no minimum size orders for its customers. Additionally, most warehousing customers prefer not to stock excess inventory levels due to the additional carrying costs and inefficiencies created by holding excess inventory. As such, the Company s customers continually reorder the Company s products. It is common for the Company s customers to order the same products on a monthly basis. For generic pharmaceutical manufacturers, it is critical to ensure that customers warehouses are adequately stocked with its products. This is important due to the fact that several generic competitors compete for the consumer demand for a given product. Availability of inventory ensures that a manufacturer s product is considered. Otherwise, retail prescriptions would be filled with competitors products. For this reason, the Company periodically offers incentives to its customers to purchase its products. These incentives are generally up-front discounts off its standard prices at the beginning of a generic campaign launch for a newly-approved or newly-introduced product, or when a customer purchases a Lannett product for the first time. Customers generally inform the Company that such purchases represent an estimate of expected resale for a period of time. This period of time is generally up to three months. The Company records this revenue, net of any discounts offered and accepted by its customers at the time of shipment. The Company s products have either 24 months or 36 months of shelf-life at the time of manufacture. The Company monitors its customers purchasing trends to attempt to identify any significant lapses in purchasing activity. If the Company observes a lack of recent activity, inquiries will be made to such customer regarding the success of the customer s resale efforts. The Company attempts to minimize any potential return (or shelf life issues) by maintaining an active dialogue with the customers.

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

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

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

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Investment Securities - The Company s investment securities consist of marketable debt securities, primarily in U.S. government and agency obligations. All of the Company s marketable debt securities are classified as available-for-sale and recorded at fair value, based on quoted market prices. Unrealized holding gains and losses are recorded, net of any tax effect, as a separate component of accumulated other comprehensive income. No gains or losses on marketable debt securities are realized until they are sold or a decline in fair value is determined to be other-than-temporary. In accordance with Financial Accounting Standards Board (FASB) Staff Position Nos. FAS 115-1 and FAS 124-1 The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP 115-1), the Company periodically reviews its marketable securities and determines whether the investments are other-than-temporarily impaired. If the investments are deemed to be other-than-temporarily impaired, the investments are written down to their then current fair market value with a new cost basis being established. There were no securities determined by management to be other-than-temporarily impaired for the quarter ended September 30, 2008, or the fiscal year ended June 30, 2008.

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 September 30, 2008, the intangible asset was correctly stated at net realizable value of approximately $9,816,000 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

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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 three month period ended September 30, 2008 and 2007, the Company incurred amortization expense of approximately $446,000.

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

Fiscal Year Ending June 30,		**Annual Amortization Expense**
2009	$	1,785,000
2010		1,785,000
2011		1,785,000
2012		1,785,000
2013		1,785,000
Thereafter		891,000
	$	9,816,000

On April 10, 2007, the Company entered into a Stock Purchase Agreement to acquire Cody by purchasing all of the remaining shares of common stock of Cody. The consideration for the April 10, 2007 acquisition was approximately $4,438,000, which represented the fair value of the tangible net assets acquired. The agreement also required Lannett to issue to the sellers up to 120,000 shares of unregistered common stock of the Company contingent upon the receipt of a license from a regulatory agency. This license was subsequently received in July 2008 and therefore the Company has recorded an intangible asset related to the acquisition of a drug import license in the amount of $430,500 to the Intangible Asset account and has assigned a 15 year life to this intangible asset.

Advertising Costs - The Company charges advertising costs to operations as incurred. Advertising expense for the three months ended September 30, 2008 and 2007 was approximately $13,000 and $4,000, respectively.

Income Taxes - The Company uses the liability method specified by Statement of Financial Accounting Standards No. 109 , *Accounting for Income Taxes (FAS 109).* 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, *Disclosures about Segments of an Enterprise and Related Information* (FAS 131*)*. 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 months ended September 30, 2008 and 2007:

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Medical Indication	For the Three Months Ended September 30, 2008		2007	
Migraine Headache	$	2,319,000	$	2,648,000
Epilepsy		680,000		1,124,000
Heart Failure		6,348,000		1,089,000
Thyroid Deficiency		11,466,000		9,092,000
Antibiotic		1,496,000		2,706,000
Other		3,259,000		881,000
Total	$	25,568,000	$	17,540,000

Concentration of Market and Credit Risk - Four of the Company s products, defined as generics containing the same active ingredient or combination of ingredients, accounted for approximately 45%, 25%, 5%, and 5% of net sales for the three months ended September 30, 2008. Those same products accounted for 52%, 6%, 10%, and 8%, respectively, of net sales for the three months ended September 30, 2007.

Four of the Company s customers accounted for 29%, 8%, 7%, and 5%, respectively, of net sales for the three months ended September 30, 2008, and 31%, 7%, 13%, and 5%, respectively, of net sales for the three months ended September 30, 2007. At September 30, 2008, these four customers accounted for 63% of the Company s accounts receivable balances. At June 30, 2008, these four customers accounted for 55% 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 September 30, 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 three months ended September 30, 2008, the Company awarded 30,000 shares of restricted stock under the LTIP which vested immediately. Stock compensation expense of $101,300 was recognized during the three months ended September 30, 2008, 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 remained 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 three months ended September 30:

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	Incentive Stock Options FY 2009	Non-qualified Stock Options FY 2009	Incentive Stock Options FY 2008	Non-qualified Stock Options FY 2008
Risk-free interest rate	2.5%	2.5%	4.2%	4.2%
Expected volatility	56.5%	56.5%	56.0%	56.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Forfeiture rate	5.0%	5.0%	5.0%	5.0%
Expected term	5.0 years	5.0 years	5.0 years	5.0 years
Weighted average fair value at date of grant	$ 1.41	$ 1.41	$ 2.11	$ 2.11

Approximately 100,000 options were issued under the LTIP during the three months ended September 30, 2008. Approximately 548,000 options were issued under the LTIP during the three months ended September 30, 2007. There were no shares under option that were exercised in the three months ended September 30, 2008 or 2007. At September 30, 2008, there were 1,727,331 options outstanding. Of those, 666,900 were options issued under the LTIP, 849,198 were issued under the 2003 Plan, and 211,233 under the Old Plan. There are no further shares authorized to be issued under the Old Plan. 1,125,000 shares were authorized to be issued under the 2003 Plan, with 7,690 shares under option having already been exercised under that plan. 2,500,000 shares were authorized to be issued under the LTIP, with no shares under option having yet been exercised under that plan.

Expected volatility is based on the historical volatility of the price of our common shares over a historical period equal to the expected term of the option. We use historical information to estimate expected term within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using 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 are expected to be forfeited during the vesting period. This assumption is based on our historical forfeiture rate. Periodically, management will assess whether it is necessary to adjust the estimated rate to reflect changes in actual forfeitures or changes in expectations. For example, adjustments may be needed if forfeitures were affected by turnover that resulted from a business restructuring that is not expected to recur. The forfeiture rate is 5% at September 30, 2008 and 2007. As the Company continues to grow, this rate is likely to change to match such changes in turnover and hiring rates. Under the provisions of FAS 123R, the Company will incur additional expense if the actual forfeiture rate is lower than originally estimated. A recovery of prior expense will be recorded if the actual rate is higher than originally estimated.

The following table presents all share-based compensation costs recognized in our statements of operations as part of selling, general and administrative expenses:

	Three Months Ended September 30, 2008 Fair Value	2007 Fair Value
Method used to account for share-based compensation		
Share based compensation		
Stock options	$ 218,800	$ 171,585
Employee stock purchase plan	$ 26,591	$ 9,769
Restricted stock	$ 43,007	$ 6,127
Tax benefit at effective rate	$ 22,180	$ 21,388

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Options outstanding that have vested and are expected to vest as of September 30, 2008 are as follows: