PharMerica CORP
Form 10-Q
November 04, 2010

Table of Contents

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, 2010

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 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 29, 2010**
Common stock, $0.01 par value	29,314,968 shares

Table of Contents

PHARMERICA CORPORATION

FORM 10-Q

TABLE OF CONTENTS

		Page
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements (Unaudited)	
	Condensed Consolidated Income Statements For the Three Months and Nine Months Ended September 30, 2009 and 2010	3
	Condensed Consolidated Balance Sheets As of December 31, 2009 and September 30, 2010	4
	Condensed Consolidated Statements of Cash Flows For the Three Months and Nine Months Ended September 30, 2009 and 2010	5
	Condensed Consolidated Statements of Stockholders Equity For the Nine Months Ended September 30, 2010	6
	Notes to Condensed Consolidated Financial Statements	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	33
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	70
Item 4.	Controls and Procedures	70
PART II. OTHER INFORMATION		
Item 1A	Risk Factors	71
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	71
Item 6.	Exhibits	72
SIGNATURES		73
Exhibit Index		74

Table of Contents

PHARMERICA CORPORATION

CONDENSED CONSOLIDATED INCOME STATEMENTS

For the Three Months and Nine Months Ended September 30, 2009 and 2010

(Unaudited)

(In millions, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Revenues	$ 461.0	$ 443.1	$ 1,389.8	$ 1,355.8
Cost of goods sold	393.9	386.3	1,180.9	1,178.1
Gross profit	67.1	56.8	208.9	177.7
Selling, general and administrative expenses	45.0	43.3	144.7	131.1
Amortization expense	2.5	2.2	6.2	6.9
Integration, merger and acquisition related costs and other charges	0.9	2.4	3.5	12.8
Operating income	18.7	8.9	54.5	26.9
Interest expense, net	1.9	0.9	8.4	2.6
Income before income taxes	16.8	8.0	46.1	24.3
Provision for income taxes	2.2	3.2	14.1	9.8
Net income	$ 14.6	$ 4.8	$ 32.0	$ 14.5
Earnings per common share:				
Basic	$ 0.48	$ 0.16	$ 1.06	$ 0.48
Diluted	$ 0.48	$ 0.16	$ 1.05	$ 0.48
Shares used in computing earnings per common share:				
Basic	30,287,709	30,033,618	30,244,014	30,282,566
Diluted	30,508,342	30,122,302	30,373,255	30,423,035

See accompanying Notes to Condensed Consolidated Financial Statements

Table of Contents

PHARMERICA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

As of December 31, 2009 and September 30, 2010

(Unaudited)

(In millions, except share and per share amounts)

	December 31, 2009	September 30, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 51.2	$ 96.7
Accounts receivable, net	215.3	193.8
Inventory	79.8	75.2
Deferred tax assets	39.8	40.8
Prepaids and other assets	23.6	19.2
	409.7	425.7
Equipment and leasehold improvements	119.6	127.2
Accumulated depreciation	(59.0)	(72.2)
	60.6	55.0
Deferred tax assets, net	21.0	10.9
Goodwill	140.1	140.4
Intangible assets, net	90.8	84.8
Other	2.1	4.7
	$ 724.3	$ 721.5
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 59.6	$ 50.3
Salaries, wages and other compensation	30.9	26.4
Other accrued liabilities	6.4	7.1
	96.9	83.8
Long-term debt	240.0	240.0
Other long-term liabilities	16.5	19.5
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, 2009 and September 30, 2010	-	-
Common stock, $0.01 par value per share; 175,000,000 shares authorized; 30,619,830 shares and 30,646,597 shares issued as of December 31, 2009 and September 30, 2010, respectively	0.3	0.3
Capital in excess of par value	344.8	348.1
Retained earnings	25.8	40.3

Treasury stock at cost, 1,331,629 shares at September 30, 2010		-		(10.5)
		370.9		378.2
	$	724.3	$	721.5

See accompanying Notes to Condensed Consolidated Financial Statements

Table of Contents

PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months and Nine Months Ended September 30, 2009 and 2010

(Unaudited)

(In millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2010**	**2009**	**2010**
Cash flows provided by operating activities:				
Net income	$ 14.6	$ 4.8	$ 32.0	$ 14.5
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation	4.5	4.8	13.4	14.1
Amortization	2.5	2.2	6.2	6.9
Integration, merger and acquisition related costs and other charges	-	0.1	0.2	0.6
Stock-based compensation	1.3	0.8	3.2	3.3
Amortization of deferred financing fees	0.1	0.1	0.3	0.4
Deferred income taxes	2.7	3.4	14.3	9.1
Loss on disposition of equipment	-	0.1	0.1	0.2
Other	(0.1)	-	(0.2)	-
Change in operating assets and liabilities:				
Accounts receivable, net	(4.5)	6.7	4.2	21.3
Inventory	(2.4)	3.1	0.1	4.5
Prepaids and other assets	(5.3)	2.2	(2.0)	4.8
Accounts payable	4.8	(4.6)	(3.0)	(9.3)
Salaries, wages and other compensation	1.0	(0.6)	(5.0)	(5.3)
Other accrued liabilities	(2.3)	0.4	(4.2)	3.7
Net cash provided by operating activities	16.9	23.5	59.6	68.8
Cash flows used in investing activities:				
Purchase of equipment and leasehold improvements	(5.8)	(3.7)	(12.3)	(8.8)
Acquisitions	(15.9)	(3.5)	(15.9)	(3.6)
Cash proceeds from sale of assets	-	-	0.1	-
Net cash used in investing activities	(21.7)	(7.2)	(28.1)	(12.4)
Cash flows provided by (used in) financing activities:				
Repayments of capital lease obligations	(0.1)	(0.1)	(0.4)	(0.5)
Issuance of common stock	1.0	-	1.3	0.3
Treasury stock at cost	-	(10.5)	-	(10.5)
Tax windfall (shortfall) from stock-based compensation	-	(0.2)	0.1	(0.2)
Net cash provided by (used in) financing activities	0.9	(10.8)	1.0	(10.9)
Change in cash and cash equivalents	(3.9)	5.5	32.5	45.5
Cash and cash equivalents at beginning of period	77.7	91.2	41.3	51.2

Cash and cash equivalents at end of period	$	73.8	$	96.7	$	73.8	$	96.7
Supplemental information:								
Cash paid for interest	$	3.8	$	0.8	$	10.3	$	2.3
Cash paid for taxes	$	0.2	$	0.1	$	1.6	$	0.4
Supplemental schedule of non-cash activities:								
Capital lease obligations	$	-	$	-	$	1.8	$	0.4
Integrity purchase accounting adjustments	$	-	$	-	$	-	$	0.2

See accompanying Notes to Condensed Consolidated Financial Statements

Table of Contents

PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the Nine Months Ended September 30, 2010

(Unaudited)

(In millions, except share amounts)

	Common Stock		Capital in Excess of	Retained	Treasury	
	Shares	Amount	Par Value	Earnings	Stock	Total
Balance at December 31, 2009	30,619,830	$ 0.3	$ 344.8	$ 25.8	$ -	$ 370.9
Comprehensive income:						
Net income				14.5		14.5
Total comprehensive income				14.5		14.5
Vested performance share units	4,695	-	-	-	-	-
Exercise of stock options and tax components of stock-based awards, net	22,072	-	-	-	-	-
Treasury stock at cost	(1,331,629)	-	-	-	(10.5)	(10.5)
Stock-based compensation - restricted stock	-	-	1.5	-	-	1.5
Stock-based compensation - stock options	-	-	1.8	-	-	1.8
Balance at September 30, 2010	29,314,968	$ 0.3	$ 348.1	$ 40.3	$ (10.5)	$ 378.2

See accompanying Notes to Condensed Consolidated Financial Statements

6

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 pharmacy management services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States, operating 90 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 89 hospitals in the United States.

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, 2009, included in the Corporation s Annual Report on Form 10-K. The balance sheet as of December 31, 2009 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 collectability of accounts receivable, revenue recognition, inventory valuation, supplier rebates, the valuation of long-lived assets and goodwill, accounting for income taxes and stock-based compensation. Actual amounts may differ from these estimates.

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 and/or its customers; the overall financial condition of the Corporation s customers; the effect of new government regulations, executive orders and/or 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/ regulatory inquiries; delays or difficulties in integrating acquired businesses; other contingent liabilities; changes in international 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 manufacturers rebate programs; shifts in demand for generic drug equivalents; 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. The Corporation places its cash in financial institutions that are federally insured. As of December 31, 2009 and September 30, 2010, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets.

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).

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Financial liabilities recorded at fair value at December 31, 2009 and September 30, 2010, are set forth in the tables below (dollars in millions):

As of September 30, 2010	Liabilities	Level 1	Level 2	Level 3	Valuation Technique
Deferred Compensation Plan	$ 3.6	$ -	$ 3.6	$ -	A
Contingent Consideration	$ 1.7	$ -	$ -	$ 1.7	C

As of December 31, 2009	Liabilities	Level 1	Level 2	Level 3	Valuation Technique
Deferred Compensation Plan	$ 2.9	$ -	$ 2.9	$ -	A
Contingent Consideration	$ 1.7	$ -	$ -	$ 1.7	C

The deferred compensation plan liability represents an unfunded obligation associated with the deferred compensation plan offered to eligible employees and members of the Board of Directors 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 contingent consideration represents a future earn-out associated with our acquisition of an institutional pharmacy business based in West Virginia (West Virginia Acquisition). The fair value of the liability associated with the contingent consideration is derived using the income approach with unobservable inputs, which include future gross profit forecast and present value assumptions, and there is little or no market data. There were no transfers between the three-tier fair value hierarchy levels during the period.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, inventory and accounts payable approximate fair value because of the short-term maturity of these instruments. The Corporation s debt approximates fair value due to the terms of the interest being set at variable market interest rates.

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.

9

Table of Contents

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, 2009	September 30, 2010
Institutional healthcare providers	$ 138.7	$ 134.3
Medicare Part D	60.2	40.1
Private payor and other	34.5	37.4
Insured	9.7	8.5
Medicaid	10.9	10.3
Medicare	1.5	1.3
Allowance for doubtful accounts	(40.2)	(38.1)
	$ 215.3	$ 193.8
0 to 60 days	64.9 %	62.9 %
61 to 120 days	17.1 %	19.2 %
Over 120 days	18.0 %	17.9 %
	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, 2009	$ 46.5	$ 3.5	$ 16.6	$ (26.4)	$ 40.2
Nine Months Ended September 30, 2010	$ 40.2	$ -	$ 13.1	$ (15.2)	$ 38.1

The allowance for doubtful accounts for 2009 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.

Concentration of Credit Risk

For the nine months ended September 30, 2009 and 2010, the Corporation derived approximately 13.0% and 15.0%, respectively, 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 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 effective interest method.

Inventory

Inventory is primarily located at the Corporation s institutional pharmacy locations. Inventory consists solely of finished products (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 the end of the quarter at all pharmacy sites. Cost of goods sold is recorded based upon the actual results of the physical inventory counts.

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 or lease term, if shorter as follows (in years):

	Estimated Useful Lives
Leasehold improvements	1-7
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, 2009 and 2010, maintenance and repairs were $1.4 million and $1.6 million, respectively. For the nine months ended September 30, 2009 and 2010, maintenance and repairs were $4.7 million and $4.5 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 for the nine months ended September 30, 2009 or 2010.

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 stage 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, 2009 and 2010, the Corporation capitalized software development costs of $0.8 million and $0.3 million, respectively. For the nine months ended September 30, 2009 and 2010, the Corporation capitalized software development costs of $2.0 million and $1.5 million, respectively. As of December 31, 2009 and September 30, 2010, net capitalized software costs, including amounts for projects which have not been completed, totaled $9.5 million and $9.0 million, respectively.

Goodwill and Other Intangibles

Goodwill represents the excess purchase price 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 last performed its annual impairment tests for goodwill recorded as of December 31, 2009, and did not incur an impairment charge.

The Corporation s finite-lived intangible assets are comprised primarily of trade names, customer relationship assets and non-compete agreements primarily 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. For impairment reviews, intangible assets are reviewed on a specific pharmacy basis or as a group of pharmacies depending on the intangible assets under review. The Corporation s goodwill and intangible assets are further described in Note 4.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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 on historical claims data and inputs from third-party administrators. For the three months ended September 30, 2009 and 2010, the expense for employee health benefits was $5.7 million and $4.8 million, respectively, and for the nine months ended September 30, 2009 and 2010, the expense for employee health benefits was $14.3 million and $14.2 million, respectively. As of December 31, 2009 and September 30, 2010, the Corporation had $2.5 million and $2.7 million, respectively, recorded as a liability for self-insured employee health benefits.

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 of 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, 2009 and 2010, rebates were $12.9 million and $12.4 million, respectively, and for the nine months ended September 30, 2009 and 2010, rebates were $35.0 million and $38.8 million, respectively. The Corporation had $3.0 million and $3.2 million of rebates capitalized in inventory as of December 31, 2009 and September 30, 2010, respectively.

Delivery Expenses

The Corporation incurred delivery expenses of $14.2 million and $13.5 million for the three months ended September 30, 2009 and 2010, respectively, and $41.5 million and $42.8 million for the nine months ended September 30, 2009 and 2010, 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.

Stock Option Accounting

The Corporation recognizes stock-based compensation expense in its condensed consolidated financial statements using the Black-Scholes-Merton option valuation model for non-vested stock options. See 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 tax obligations as appropriate based on facts and circumstances in the various regulatory environments. Deferred tax assets and liabilities are more fully described in Note 10.

Pharmacy Transaction

The Corporation, formerly known as Safari Holding 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).

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS

2009 Acquisitions

Integrity Pharmacy Services Acquisition

On December 31, 2009, the Corporation through a wholly-owned subsidiary, acquired all of the membership interests in Integrity Pharmacy Services, LLC (IPS), and Integrity Medical Supplies, LLC (IMS together with IPS, Integrity), for $38.0 million in cash plus $3.3 million to retire outstanding promissory notes in favor of the sellers. The Corporation s primary purpose in acquiring Integrity was to increase the Corporation s market share in certain regions.

The acquisition of Integrity has been accounted for as a business combination using the acquisition method of accounting. The total purchase price of Integrity was allocated to the net tangible and identifiable intangible assets based upon their fair values on December 31, 2009. The excess of the purchase price over the fair values of the net tangible and identifiable intangible assets was recorded as goodwill. For tax purposes, the transaction was considered an asset acquisition, therefore, the amount of goodwill recorded in the transaction of $12.0 million will be tax deductible to the Corporation. The Corporation believes the resulting amount of goodwill reflects its expectations of the synergistic benefits of being able to fully integrate the Integrity business into its existing institutional pharmacy locations.

Except for identifiable intangible assets, and equipment and leasehold improvements, the assets acquired and liabilities assumed were valued at their respective carrying amounts recorded by Integrity as the Corporation believes that their carrying value amounts approximate their fair value at the acquisition date.

The purchase price allocation was recorded as follows (dollars in millions):

Current assets, net of cash acquired	$	9.8
Equipment and leasehold improvements		1.2
Identifiable intangible assets		20.6
Goodwill		12.0
Total assets		43.6
Current liabilities		(4.4)
Purchase price, net of cash acquired	$	39.2

The following are the fair values of the equipment and leasehold improvements of Integrity acquired at the date of acquisition (dollars in millions):

	Fair Value		Weighted Average Useful Lives
Leasehold improvements	$	0.3	7.0

Equipment and software		0.9	4.0
Total equipment and leasehold improvements acquired	$	1.2	5.1

The following are the fair values of the identifiable intangible assets of Integrity acquired at the date of acquisition (dollars in millions):

	Fair Value		Weighted Average Useful Lives
Non-competition agreement	$	0.2	5.0
Customer relationships		20.4	15.0
Total identifiable intangible assets acquired	$	20.6	14.9

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS (Continued)

West Virginia 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 located mostly in West Virginia. 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 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 under the acquisition method of accounting, 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 Corporation 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.

Other

For the three months ended September 30, 2009 and 2010, the Corporation incurred $0.5 million and $0.9 million, respectively, of acquisition related costs, which have been classified as a component of integration, merger, and acquisition related costs and other charges. For the nine months ended September 30, 2009 and 2010, $0.6 million and $3.8 million, respectively, was incurred for acquisition related costs.

The total amount of goodwill expected to be deductible for tax purposes from past acquisitions of the Corporation was $85.6 million as of September 30, 2010. Deferred tax assets and liabilities are further described in Note 10.

Pro forma

The following unaudited pro forma consolidated financial information is not intended to represent or be indicative of the consolidated results of operations or financial condition of the Corporation that would have been reported had the acquisitions been completed as of the date or for the periods presented, and should not be taken as representative of the future consolidated results of operations or financial condition of the Corporation.

The unaudited pro forma effect of the Integrity and West Virginia acquisitions assuming the acquisitions occurred on January 1, 2009, excluding the integration, merger and acquisition related costs and other charges for the three months and nine months ended September 30, 2009, would be as follows (dollars in millions, except per share amounts):

	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2009
Revenues	$ 479.6	$ 1,452.9
Net income	$ 15.9	$ 35.9
Earnings per common share:		
Basic	$ 0.52	$ 1.18
Diluted	$ 0.52	$ 1.18

14

Table of Contents

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, 2009	September 30, 2010
Leasehold improvements	$ 11.6	$ 12.6
Equipment and software	95.3	101.9
Leased equipment	2.6	3.0
Construction in progress	10.1	9.7
	119.6	127.2
Accumulated depreciation	(59.0)	(72.2)
Total Equipment and leasehold improvements	$ 60.6	$ 55.0

The following is a progression of equipment and leasehold improvements for the period presented (dollars in millions):

	Balance at December 31, 2009	Additions	Disposals	Transfers	Balance at September 30, 2010
Equipment and leasehold improvements:					
Leasehold improvements	$ 11.6	$ 0.6	$ (0.1)	$ 0.5	$ 12.6
Equipment and software	95.3	5.6	(1.5)	2.5	101.9
Leased equipment	2.6	0.4	-		3.0
Construction in progress	10.1	2.6	-	(3.0)	9.7
Sub-Total	119.6	9.2	(1.6)	-	127.2
Accumulated depreciation	(59.0)	(14.1)	0.9	-	(72.2)
Total	$ 60.6	$ (4.9)	$ (0.7)	$ -	$ 55.0

Depreciation expense totaled $4.5 million and $4.8 million for the three months ended September 30, 2009 and 2010, respectively. Depreciation expense totaled $13.4 million and $14.1 million for the nine months ended September 30, 2009 and 2010, respectively.

Total estimated depreciation expense for the Corporation s equipment and leasehold improvements for the current year and next four years and thereafter are as follows (dollars in millions):

Year Ending December 31,

2010	$	18.4	*
2011		14.3	
2012		10.4	
2013		6.3	
2014		4.1	
Thereafter		15.6	
Total	$	69.1	

* The 2010 amount shown includes depreciation expense for the nine months ended September 30, 2010 of $14.1 million.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 GOODWILL AND INTANGIBLES

The following table presents the changes in the carrying amount of goodwill for the nine months ended September 30, 2010 (dollars in millions):

Balance at December 31, 2009	$	140.1
Integrity purchase accounting adjustments		0.3
Balance at September 30, 2010	$	140.4

The Corporation does not have accumulated impairments that reduce the gross value of goodwill.

The following table presents the components of the Corporation s intangible assets (dollars in millions):

Finite Lived Intangible Assets		Balance at December 31, 2009		Additions		Balance at September 30, 2010
Customer relationships	$	76.6	$	-	$	76.6
Trade name		28.5		-		28.5
Non-compete agreement		4.7		0.9		5.6
Sub Total		109.8		0.9		110.7
Accumulated amortization		(19.0)		(6.9)		(25.9)
Net intangible assets	$	90.8	$	(6.0)	$	84.8

Amortization expense relating to finite-lived intangible assets was $2.5 million and $2.2 million for the three months ended September 30, 2009 and 2010, respectively. Amortization expense relating to finite-lived intangible assets was $6.2 million and $6.9 million for the nine months ended September 30, 2009 and 2010, respectively.

Total estimated amortization expense for the Corporation s finite-lived intangible assets for the current year and next four years and thereafter are as follows (dollars in millions):

Year Ending December 31,			
2010	$	9.1	*
2011		7.2	
2012		6.6	
2013		6.5	
2014		6.5	
Thereafter		55.8	

	$	91.7

* The 2010 amount shown includes amortization expense for the nine months ended September 30, 2010 of $6.9 million.

16

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT

The Corporation is a party to a credit agreement among the Corporation, the Lenders named therein, and JPMorgan Chase Bank, N.A. (JPMorgan), as Administrative Agent (the Credit Agreement). The Credit Agreement consists of a $275.0 million term loan facility and a $150.0 million revolving credit facility. As of September 30, 2010, $240.0 million was outstanding under the term loan facility and no amounts were outstanding under the revolving credit facility. Indebtedness under the Credit Agreement matures on July 31, 2012, at which time the commitment of the Lenders to make revolving loans also shall expire. There is no scheduled amortization under the term loan facility but the term loans are subject to certain prepayment obligations relating to asset sales, casualty losses and the incurrence by the Corporation of certain indebtedness.

The table below summarizes the term debt and revolving credit facility of the Corporation (dollars in millions):

Credit Agreement:	December 31, 2009	September 30, 2010
Term Debt - payable to lenders at LIBOR plus applicable margin (1.26% as of September 30, 2010), matures July 31, 2012	$ 240.0	$ 240.0
Revolving Credit Facility payable to lenders, interest at LIBOR plus applicable margin, matures July 31, 2012	-	-
Total debt	$ 240.0	$ 240.0

The maturity of all of the Corporation s long-term debt will occur on July 31, 2012.

The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of September 30, 2010 was $2.0 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $148.0 million as of September 30, 2010. The revolving credit facility contains a $50.0 million accordion feature, which permits the Corporation to increase the size of the credit facility, up to an aggregate of $200.0 million, subject to securing additional commitments from existing or new lenders.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at our option, a base rate plus a margin between 0.0% and 0.75% per annum, or an adjusted London Interbank Offered Rate (LIBO rate or LIBOR) plus a margin between 0.625% and 1.75% per annum, in each case depending on the leverage ratio of the Corporation. The base rate is the higher of the prime lending rate announced by JPMorgan in New York from time to time and the federal funds rate published by the Federal Reserve Bank of New York plus 0.50%. The Credit Agreement also provides for letter of credit participation fees between 0.625% and 1.75%, letter of credit fronting fees of 0.125%, and a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.125% to 0.250%, in each case depending on the leverage ratio of the Corporation.

The obligations of the Corporation under and related to the Credit Agreement are secured by substantially all of its assets. Those obligations are guaranteed by many of the Corporation s wholly owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of our direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries. The Credit Agreement also contains financial and non-financial affirmative and

negative covenants, representations, warranties, and events of default that are customary to facilities of this nature.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

Covenants

The Credit Agreement requires the Corporation to satisfy a fixed charge coverage ratio and a leverage ratio. The minimum fixed charge coverage ratio, which is tested quarterly on a trailing four quarter basis, can be no less than: 2.50:1.00 beginning with January 1, 2010 and thereafter. The maximum total leverage coverage ratio, which also is tested quarterly, cannot exceed 3.00:1.00 beginning with January 1, 2010 and thereafter. The maximum total leverage coverage ratio is not tested when at any time it is less than 2.00:1.00, or both S&P and Moody s have in effect corporate credit ratings for the Corporation that are investment grade. The Corporation remains compliant under the terms of the Credit Agreement. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 3.0% of revenues.

The financial covenant requirements as defined by the Corporation s Credit Agreement are as follows:

	Minimum Fixed Charge Coverage Ratio	Maximum Leverage Ratio	Capital Expenditure
Requirement	> = 2.25 to 1.00	< = 3.50 to 1.00	< = 3.00 %
December 31, 2009	5.09	1.88	1.17 %
Requirement	> = 2.50 to 1.00	< = 3.00 to 1.00	< = 3.00 %
September 30, 2010	5.70	2.48	**

** *Not applicable as the capital expenditures covenant is an annual requirement under the terms of the Credit Agreement.*

In addition, the Credit Agreement contains customary affirmative and negative covenants, which among other things, limit the Corporation s ability to incur additional debt, create liens, pay dividends, effect transactions with the Corporation s affiliates, sell assets, pay subordinated debt, merge, consolidate, enter into acquisitions, and effect sale leaseback transactions.

Deferred Financing Fees

The Corporation capitalized a total of $2.0 million in deferred financing fees associated with the Credit Agreement and recorded them as other assets in the accompanying condensed consolidated balance sheets. As of September 30, 2010, the Corporation had $0.4 million of unamortized deferred financing fees.

NOTE 6 COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

The Corporation is involved in certain legal actions and regulatory investigations arising in the ordinary course of business. None of these legal proceedings are, in the opinion of management, expected to have a material adverse effect on the consolidated financial position, results of operations, or liquidity of the Corporation.

FUL and AMP Changes

The 2010 Health Care Legislation amended the Deficit Reduction Act of 2005 (the DRA) to change the definition of the Federal Upper Limit or FUL by requiring the calculation of the FUL as no less than 175% of the weighted average, based on utilization, of the most recently reported monthly Average Manufacturer s Price (AMP) for pharmaceutically and therapeutically equivalent multi-source drugs available through retail community pharmacies nationally.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

In addition, the definition of AMP changed to reflect net sales only to drug wholesalers that distribute to retail community pharmacies and to retail community pharmacies that directly purchase from drug manufacturers. Further, the 2010 Health Care Legislation continues the current statutory exclusion of prompt pay discounts offered to wholesalers and adds three other exclusions to the AMP definition. In addition to reporting monthly, the manufacturers will be required to report the total number of units used to calculate each monthly AMP. Centers for Medicare & Medicaid Services (CMS) will use this information when it establishes FULs as a result of the new volume-weighted requirements pursuant to the 2010 Health Care Legislation.

The new AMP became effective on October 1, 2010. Manufacturers are required to report pricing by November 30, 2010. CMS can set new FULs any time thereafter.

The Corporation is unable to fully evaluate the impact of the changes in FUL and AMP to its business.

AWP Changes

Average wholesale price, or AWP, is a pricing benchmark published by First DataBank, Inc. in its Blue Book, which provides drug databases, content integration software, and drug reference products. AWP has been widely used to calculate the majority of the Medicaid, Medicare Part A and Medicare Part D drug reimbursements payable to pharmacy providers. In 2005, several pension funds brought an action against First DataBank and another healthcare provider alleging collusion to set AWPs for branded drugs.

On March 30, 2009, the Court approved the settlement of the litigation. Pursuant to the settlement agreement dated September 26, 2009, First DataBank: (i) adjusted its reporting of Blue Book AWP for those prescription drugs (approximately 1,400 National Drug Codes, or NDCs in number) identified in the plaintiffs previously filed complaint by reducing the mark-up factor utilized in connection with the calculation of the Blue Book AWP data field to 1.20 times the Wholesale Acquisition Cost, or WAC, or direct price for those prescription drugs that are on a mark-up basis; and (ii) established a centralized data repository to facilitate reasonable access to discoverable material from First DataBank concerning its drug price reporting practices.

Independent of the settlement and on the same schedule as the Blue Book AWP adjustment noted above, First DataBank has applied the same 1.20 markup factor to all other NDCs, whose Blue Book AWP is set based upon a markup to WAC or direct price in excess of 1.20 times WAC. First DataBank will also independently discontinue publishing the Blue Book AWP data field for all drugs no later than September 26, 2011.

The Corporation and the preponderance of the Corporation s PDPs, third party insurance companies and its Medicare Part A customers have voluntarily agreed to adjust reimbursement so that pricing would not increase or decrease as a result of the changes to AWP; however, the state Medicaid programs have been unwilling to remain price neutral.

Acquisitions

The Corporation has historically acquired the assets of businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, medical, and general professional liabilities, workers compensation liabilities, previous tax liabilities, and unacceptable business practices. Although the Corporation institutes policies designed to conform practices to its standards following completion of acquisitions, there can be no assurance the Corporation will not become liable for past activities that may later be asserted to be improper by private plaintiffs or government agencies.

Although the Corporation generally seeks to obtain indemnification from prospective sellers covering such matters, there can be no assurance that any such matter will be covered by indemnification, or if covered, that such indemnification will be adequate to cover potential losses and fines. In the ordinary course of business, the Corporation enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction such as business acquisitions and disposals of an operating facility. These indemnifications may cover claims against employment-related matters, governmental regulations, environmental issues, tax matters, as well as customer, third party payer, supplier, and contractual relationships. Obligations under these indemnities generally would be initiated by a breach of the terms of the contract or by a third party claim or event.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Prime Vendor Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the Prime Vendor Agreement), with AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen. Pursuant to this agreement, the Corporation has agreed to purchase at least 95% of the Corporation s prescription pharmaceutical drugs from ABDC and to participate in its generic formulary purchase program for a period of five years following the Closing Date. In addition, ABDC will support the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provide inventory management support and packaging services. Unless either party provides certain notice of termination, the agreement will continue on a month-to-month basis upon expiration of the initial five year term. The agreement may be terminated by either party for cause during the initial five year term, and by either party with or without cause thereafter upon 90 days notice. Also under the provisions of the agreement, the Corporation may not undertake any merger, change of ownership, change in control or other transaction without the consent of ABDC unless certain conditions are met.

Information Technology Services Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (KHOI), a wholly owned subsidiary of Kindred (the IT Services Agreement). Pursuant to this agreement, KHOI is the Corporation s exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years, ending on July 31, 2012. The services provided by KHOI include business services necessary to operate, manage, and support certain financial applications the Corporation uses, including enabling and/or supporting technology infrastructure and technology procurement services to support certain business functions. Such services include, among other matters, functions for financial management, systems, and payroll. The Corporation will support internally all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records management, human resources, internal and external customer call center support, and general business systems.

Except for certain services that will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The initial term of the agreement is five years. The agreement will automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior written notice of termination as provided for in the agreement. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation s competitors. Following termination of the IT Services Agreement, KHOI must provide termination and expiration assistance for up to 180 days. The Corporation has incurred $2.9 million and $2.7 million in fees for the three months ended September 30, 2009 and 2010, respectively, under the IT Services Agreement. The Corporation incurred $8.6 million and $8.4 million in fees for the nine months ended September 30, 2009 and 2010, respectively, under the IT Services Agreement.

Employment Agreements

The Corporation has entered into employment agreements with certain of its executive officers. During the employment period, certain executive officers will be eligible to (i) participate in any short-term and long-term incentive programs established or maintained by the Corporation, (ii) participate in all incentive, savings and retirement plans and programs of the Corporation, (iii) participate, along with their dependents, in all welfare benefit plans and programs provided by the Corporation, and (iv) receive four weeks of paid vacation per calendar year.

The type of compensation due to each of the executive officers in the event of the termination of their employment period varies depending on the nature of the termination. The employment agreements do not entitle the executive officers to any additional payment or benefits solely upon the occurrence of a change in control but do provide additional payments or benefits or both upon a termination of employment in connection

with a change in control. Additionally, the vesting of certain equity based grants made to certain executive officers accelerate upon the occurrence of a change in control.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Leases

The Corporation leases real estate properties, buildings, vehicles, and equipment under cancelable and non-cancelable leases. The leases expire at various times and have various renewal options. Certain leases that meet the lease capitalization criteria have been recorded as an asset and liability at the net present value of the minimum lease payments at the inception of the lease. Interest rates used in computing the net present value of the lease payments are based on the Corporation s incremental borrowing rate at the inception of the lease. The Corporation recorded the following lease expense for the periods presented (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Pharmacy locations and administrative offices lease expense	$ 3.5	$ 3.2	$ 10.5	$ 10.4
Office equipment lease expense	0.8	0.5	2.1	1.5
Total lease expense	$ 4.3	$ 3.7	$ 12.6	$ 11.9

Future minimum lease payments for those leases having an initial or remaining non-cancelable lease term in excess of one year are as follows for the years indicated (dollars in millions):

Year Ending December 31,	Operating Leases		Capital Lease Obligations	Total
2010	$ 14.1	*	$ 0.7	$ 14.8
2011	11.2		0.8	12.0
2012	8.1		0.1	8.2
2013	5.9		-	5.9
2014	3.5		-	3.5
Thereafter	7.1		-	7.1
Total	$ 49.9		$ 1.6	$ 51.5

*The 2010 amount shown includes rental expense for Pharmacy locations and administrative offices lease expense of $10.4 million for the nine months ended September 30, 2010.

NOTE 7 REVENUES

The Corporation recognizes revenues at the time services are provided or products are delivered. A significant portion of these revenues are billed to PDPs under Medicare Part D, the state Medicaid programs, long-term care institutions, third party insurance companies, and private payers. Some claims are electronically adjudicated through online processing at the point the prescription is dispensed such that the Corporation s operating system is automatically updated with the actual amount to be reimbursed. As a result, revenues and the associated receivables are based upon the actual reimbursement to be received by the Corporation. For claims that are adjudicated on-line and are rejected or otherwise denied upon submission, the Corporation provides contractual allowances based upon historical trends, contractual reimbursement terms and

other factors which may impact ultimate reimbursement. Amounts are adjusted to actual reimbursed amounts upon cash receipt.

Under the Medicare Part D benefit, payment is determined in accordance with the agreements the Corporation has negotiated with the Medicare Part D Plans. The remainder of the Corporation s billings are paid or reimbursed by individual residents, long-term care facilities (including revenues for residents funded under Medicare Part A), and other third party payers, including Medicaid and private insurers.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 REVENUES (Continued)

The Medicaid and Medicare programs are highly regulated. The failure, even if inadvertent, of the Corporation and/or client facilities to comply with applicable reimbursement regulations could adversely affect the Corporation s reimbursement under these programs and the Corporation s ability to continue to participate in these programs. In addition, failure to comply with these regulations could subject the Corporation to other penalties.

As noted, the Corporation obtains reimbursement for drugs it provides to enrollees of a given Medicare Part D Plan in accordance with the terms of the agreement negotiated between it and that Medicare Part D Plan. The Corporation has entered into such agreements with nearly all Medicare Part D Plan sponsors under which it will provide drugs and associated services to their enrollees. The Corporation in the ordinary course of business has ongoing discussions with Medicare Part D Plans and may, as appropriate, renegotiate agreements.

The Corporation s hospital pharmacy management revenues represent contractually defined management fees and the reimbursement of costs associated with the direct operations of hospital pharmacies, which are primarily comprised of personnel costs.

A summary of revenues by payer type follows (dollars in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009		2010		2009		2010	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Medicare Part D	$ 211.4	45.9 %	$ 204.8	46.2 %	$ 635.9	45.8 %	$ 627.5	46.3 %
Institutional healthcare providers	134.7	29.2	132.8	30.0	414.5	29.8	410.6	30.3
Medicaid	42.1	9.1	39.6	8.9	127.7	9.2	119.7	8.8
Private and other	34.6	7.5	26.7	6.0	94.9	6.8	80.4	6.0
Insured	22.8	5.0	22.0	5.0	68.8	4.9	68.0	5.0
Medicare	1.5	0.3	1.8	0.4	5.2	0.4	5.7	0.4
Hospital management fees	13.9	3.0	15.4	3.5	42.8	3.1	43.9	3.2
Total	$ 461.0	100.0 %	$ 443.1	100.0 %	$ 1,389.8	100.0 %	$ 1,355.8	100.0 %

Co-payments for the Corporation s services can be applicable under Medicare Part D, the state Medicaid programs, and certain third party payers and are typically not collected at the time products are delivered or services are provided. Co-payments under the Medicaid programs and third party plans are generally billed to the responsible party as part of the Corporation s normal billing procedures and are subject to the Corporation s normal collection procedures.

Under Medicare Part D, co-payments related to institutional residents who are both Medicare and Medicaid eligible (dual eligible) are due from the responsible party for up to the first thirty days of a beneficiary s stay in a skilled nursing facility, subsequent to which the PDPs are responsible for reimbursement.

Under certain circumstances, including state-mandated return policies under various Medicaid programs, the Corporation accepts returns of medications and issues a credit memorandum to the applicable payer. Product returns are processed in the period in which the return is accepted by the Corporation. A reserve has been established for such returns based on historical trends.

22

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 INTEGRATION, MERGER AND ACQUISITION RELATED COSTS AND OTHER CHARGES

In fiscal year 2009, we began the integration of our pharmacy operating systems. The Corporation expects to continue to incur costs related to the integration of its pharmacy operating systems during fiscal 2010 and 2011. In addition, the Corporation also incurs and will continue to incur costs related to acquisitions.

The following is a summary of integration, merger and acquisition related costs and other charges incurred by the Corporation (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Integration costs and other charges:				
Pre- Pharmacy Transaction litigation matters	$ -	$ -	$ -	$ 5.0
Professional and advisory fees	-	0.7	-	2.2
General and administrative	0.1	0.1	0.4	0.5
Employee costs	0.2	0.2	1.2	0.4
Severance costs	-	0.4	0.6	0.6
Facility costs	0.1	-	0.7	0.2
Other costs	-	0.1	-	0.1
	0.4	1.5	2.9	9.0
Acquisition costs:				
Professional and advisory fees	0.5	0.5	0.6	1.0
General and administrative	-	0.1	-	1.1
Employee costs	-	-	-	0.2
Facility costs	-	0.1	-	1.3
Other costs	-	0.2	-	0.2
	0.5	0.9	0.6	3.8
Total integration, merger, and acquisition related costs and other charges	$ 0.9	$ 2.4	$ 3.5	$ 12.8
Negative effect on diluted earnings per share	$ (0.02)	$ (0.05)	$ (0.07)	$ (0.25)

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS

Common Stock

Holders of the Corporation s common stock are entitled to one vote for each share held of record on all matters on which stockholders may vote. There are no preemptive, conversion, redemption or sinking fund provisions applicable to our common stock. In the event of liquidation, dissolution or winding up, holders of common stock are entitled to share ratably in the assets available for distribution, subject to any prior rights of any holders of preferred stock then outstanding. Delaware law prohibits the Corporation from paying any dividends unless it has capital surplus or net profits available for this purpose. In addition, the Corporation s Credit Agreement imposes restrictions on its ability to pay dividends.

Preferred Stock

The certificate of incorporation authorizes the issuance of an aggregate of 1.0 million shares of preferred stock. As of September 30, 2010, there were no shares of preferred stock outstanding.

Our board of directors may, from time to time, direct the issuance of shares of preferred stock in series and may, at the time of issuance, determine the designation, powers, rights, preferences and limitations of each series. Satisfaction of any dividend preferences of outstanding preferred stock would reduce the amount of funds available for the payment of dividends on our shares of common stock. Holders of preferred stock may be entitled to receive a preference payment in the event of any liquidation, dissolution or winding-up of the Corporation before any payment is made to the holders of our common stock. Under certain circumstances, the issuance of preferred stock may render more difficult or tend to discourage a merger, tender offer or proxy contest, the assumption of control by a holder of a large block of the Corporation s securities or the removal of incumbent management. The board of directors may issue shares of preferred stock with voting and conversion rights that could adversely affect the holders of shares of our common stock. Specifically, our certificate of incorporation authorizes our board to adopt a rights plan without stockholder approval. This could delay or prevent a change in control of us or the removal of existing management.

Treasury Stock Purchases

In August 2010, the Board of Directors authorized a share repurchase of up to $25.0 million of the Corporation s common stock. Share repurchases under this authorization may be made in the open market through unsolicited or solicited privately negotiated transactions, or in such other appropriate manner, and will be funded from available cash. The amount and timing of the repurchases will be determined by the Corporation s management and will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. Common stock acquired through the share repurchase program will be held as treasury shares and may be used for general corporate purposes, including reissuances in connection with acquisitions, employee stock option exercises or other employee stock plans. The share repurchase program does not have an expiration date and may be limited, terminated or extended at any time without prior notice. During the three months ended September 30, 2010, the Corporation repurchased 1,327,803 shares of common stock for an aggregate purchase price, including commissions, of $10.5 million at an average purchase price of $7.90 per share.

Additionally, the Corporation may redeem shares from employees upon the vesting of the Corporation s stock awards for minimum statutory tax withholding purposes. The Corporation redeemed 3,826 shares of certain vested awards for an aggregate price of less than $0.1 million, during the three months and nine months ended September 30, 2010. These shares have also been designated by the Corporation as treasury stock.

As of September 30, 2010, the Corporation had a total of 1,331,629 shares held as treasury stock.

Amended and Restated 2007 Omnibus Incentive Plan

The Corporation has adopted the Amended and Restated PharMerica Corporation 2007 Omnibus Incentive Plan (as amended and restated, the Omnibus Plan) under which the Corporation is authorized to grant equity-based and other awards to its employees, officers, directors, and consultants. In connection with the Corporation s 2010 Annual Meeting of Stockholders, the stockholders of the Corporation approved and adopted the amended and restated Omnibus Plan to, among other things, implement a fungible share pool effective as of January 1, 2010, and preserve preferential tax treatment as qualified performance-based compensation under Section 162(m) of the Internal Revenue Code.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

The Corporation has reserved 7,237,000 shares of its common stock for awards to be granted under the Omnibus Plan plus 534,642 shares reserved for substitute equity awards for former employees of KPS and PharMerica LTC. Under the fungible share pool, one share of stock will be subtracted from the share limit for each share of stock covered by a stock option or stock appreciation right award and 1.65 shares of stock will be subtracted from the share limit for each share of stock covered by any full-value award, including restricted stock awards, restricted stock units and performance share awards at target. The following shares are not available for re-grant under the Omnibus Plan: (i) shares tendered by a participant or withheld by the Corporation to pay the purchase price of a stock option award or to satisfy taxes owed with respect to an award, (ii) shares subject to a stock appreciation right that are not issued in connection with such award s settlement upon the exercise thereof, and (iii) shares reacquired by the Corporation using cash proceeds received by the Corporation from the exercise of stock options. Effective January 1, 2010, shares subject to an award that is forfeited, expired or settled for cash, are available for re-grant under the Omnibus Plan as one share of stock for each share of stock covered by a stock option or appreciation right and 1.65 shares of stock for each share of stock covered by any other type of award.

The Corporation s Compensation Committee administers the Omnibus Plan and has the authority to determine the recipient of the awards, the types of awards, the number of shares covered, and the terms and conditions of the awards. The Omnibus Plan allows for grants of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock and restricted stock units, deferred shares, performance awards, including cash bonus awards, and other stock-based awards.

Stock options granted to officers and employees under the Omnibus Plan generally vest in four equal annual installments and have a term of seven years. The restricted stock granted to officers and employees generally vests in full upon the three-year anniversary of the date of grant. The restricted stock units granted to officers generally vest in two equal annual installments. The restricted stock grant to members of the board of directors vests in three equal annual installments. The restricted stock units granted to members of the board of directors vest in one annual installment. The performance share units granted under the Omnibus Plan vest based upon the achievement of a target amount of the Corporation s earnings before interest, income taxes, depreciation and amortization, integration, merger and acquisition related costs and other charges, impairment of intangible assets, and any changes in accounting principles, which reinforces the importance of achieving the Corporation s profitability objectives. The performance is generally measured over a three-year period.

As of September 30, 2010, total shares available for grants of stock-based awards pursuant to the Omnibus Plan were 4,144,360 shares.

Stock-Based Compensation Expense

The following is a summary of stock-based compensation incurred by the Corporation (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Stock option compensation expense	$ 0.4	$ 0.6	$ 1.4	$ 1.8
Nonvested stock compensation expense	0.9	0.2	1.8	1.5
Total Stock Compensation Expense	$ 1.3	$ 0.8	$ 3.2	$ 3.3
Negative effect on diluted earnings per share	$ (0.03)	$ (0.01)	$ (0.06)	$ (0.06)

As of September 30, 2010, there was $7.8 million of total unrecognized compensation cost related to the Corporation s stock compensation arrangements. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. The Corporation expects to recognize that cost over weighted average periods ranging from less than one year 2.4 years depending on the type of award granted.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

Total estimated stock-based compensation expense for the Corporation s stock options and nonvested stock awards for the current year and next four years and thereafter are as follows (dollars in millions):

Year Ending December 31,			
2010	$	4.8	*
2011		3.5	
2012		1.6	
2013		1.0	
2014		0.2	
Thereafter		-	
Total	$	11.1	

*The 2010 amount shown includes stock-based compensation expense for the nine months ended September 30, 2010 of $3.3 million.

The following weighted average assumptions were used to estimate the fair value of options granted during 2009 and the nine months ended September 30, 2010, using the Black-Scholes-Merton option valuation model:

	2009	2010
Expected volatility (range)	36.36 - 41.07%	38.53 - 45.54%
Risk free interest rate (range)	0.75 - 2.09%	0.49 - 2.47%
Expected dividends	-	-
Average expected term (years)	2.0 - 5.0	2.0 - 5.0
Average fair value per share of stock options granted based on the Black-Scholes-Merton model	$4.40	$5.79
Weighted average fair value of options granted during the period (in millions)	$2.5	$3.3

Expected Volatility

Volatility is a measure of the tendency of investment returns to vary around a long-term average rate. Historical volatility is an appropriate starting point for setting this assumption. The Corporation also considers how future experience may differ from the past. This may require using other factors to adjust historical volatility, such as implied volatility, peer-group volatility and the range and mean-reversion of volatility estimates over various historical periods. The peer-group utilized consisted of fourteen companies in 2009 and 2010, in the same or similar industries as the Corporation. In addition, if a best estimate cannot be made, management uses the mid-point in the range of reasonable estimates for volatility. The Corporation estimates the volatility of its common stock in conjunction with the Corporation s annual grant and volatility is calculated utilizing the historical volatility of the Corporation and its peer-group. To the extent material grants are made subsequent to the Corporation s annual grant, the volatility calculation is updated through the most recent grant date of the awards.

Risk-Free Interest Rate

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option.

Expected Dividends

The Corporation has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, it uses an expected dividend yield of zero.

Table of Contents

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

Expected Term