

LANNETT CO INC
Form 10-Q
November 12, 2010
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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, 2010

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

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(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 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. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

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

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 4, 2010 |
|---|------------------------------------|
| Common stock, par value \$0.001 per share | 25,298,503 shares |

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****LANNETT COMPANY, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

| | (Unaudited) | |
|--|-----------------------|-----------------------|
| | September 30, 2010 | June 30, 2010 |
| <u>ASSETS</u> | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 17,624,554 | \$ 21,895,648 |
| Investment securities - available for sale | 212,757 | 604,464 |
| Trade accounts receivable (net of allowance of \$123,192 and \$123,192 respectively) | 31,189,099 | 38,324,258 |
| Inventories, net | 21,036,591 | 19,056,868 |
| Interest receivable | 9,371 | 9,631 |
| Prepaid taxes | 498,215 | |
| Deferred tax assets | 5,133,873 | 5,337,391 |
| Other current assets | 2,162,319 | 2,506,114 |
| Total Current Assets | 77,866,779 | 87,734,374 |
| Property, plant and equipment | 51,882,758 | 50,160,114 |
| Less accumulated depreciation | (22,293,000) | (21,531,845) |
| | 29,589,758 | 28,628,269 |
| Construction in progress | 3,680,223 | 2,939,898 |
| Investment securities - available for sale | 183,771 | 183,742 |
| Intangible assets (product rights) - net of accumulated amortization | 7,326,945 | 7,785,298 |
| Deferred tax assets | 12,524,544 | 12,544,330 |
| Other assets | 138,858 | 147,886 |
| Total Assets | \$ 131,310,878 | \$ 139,963,797 |
| <u>LIABILITIES AND SHAREHOLDERS' EQUITY</u> | | |
| <u>LIABILITIES</u> | | |
| Current Liabilities | | |
| Accounts payable | \$ 15,763,468 | \$ 16,280,675 |
| Accrued expenses | 2,498,862 | 3,464,181 |
| Accrued payroll and payroll related | 2,486,810 | 6,304,465 |
| Income taxes payable | | 1,479,658 |
| Current portion of long-term debt | 4,826,601 | 4,851,278 |
| Rebates, chargebacks and returns payable | 13,359,608 | 15,249,412 |
| Total Current Liabilities | 38,935,349 | 47,629,669 |
| Long-term debt, less current portion | 2,834,973 | 2,868,549 |
| Unearned grant funds | 500,000 | 500,000 |
| Other long-term liabilities | 6,558 | 7,864 |
| Total Liabilities | 42,276,880 | 51,006,082 |
| Commitment and Contingencies, See notes 10 and 11 | | |

SHAREHOLDERS EQUITY

| | | |
|--|-----------------------|-----------------------|
| Common stock - authorized 50,000,000 shares, par value \$0.001; issued and outstanding, 24,929,131 and 24,882,123 shares, respectively | 24,929 | 24,882 |
| Additional paid in capital | 80,410,648 | 79,862,940 |
| Retained earnings | 9,161,071 | 9,564,632 |
| Noncontrolling interest | 121,421 | 111,982 |
| Accumulated other comprehensive income | 52,588 | 44,692 |
| | 89,770,657 | 89,609,128 |
| Less: Treasury stock at cost - 130,118 and 110,108 shares, respectively | (736,659) | (651,413) |
| TOTAL SHAREHOLDERS EQUITY | 89,033,998 | 88,957,715 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 131,310,878 | \$ 139,963,797 |

The accompanying notes to the 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, | |
|--|-------------------------------------|---------------|
| | 2010 | 2009 |
| Net sales | \$ 25,395,927 | \$ 31,434,989 |
| Cost of sales | 18,900,048 | 19,012,318 |
| Amortization of intangible assets | 448,667 | 448,667 |
| Product royalties | 143,271 | 439,774 |
| Gross profit | 5,903,941 | 11,534,230 |
| Research and development expenses | 2,042,369 | 3,027,841 |
| Selling, general, and administrative expenses | 4,600,681 | 3,763,161 |
| Gain on sale of investments | (12,641) | |
| Operating (loss) income | (726,468) | 4,743,228 |
| Other income (expense): | | |
| Foreign currency gain | 2,415 | |
| Interest income | 11,231 | 23,099 |
| Interest expense | (70,844) | (70,413) |
| | (57,198) | (47,314) |
| (Loss) income before income tax (benefit) expense | (783,666) | 4,695,914 |
| Income tax (benefit) expense | (389,544) | 1,827,650 |
| Net (loss) income | (394,122) | 2,868,264 |
| Less net income attributable to noncontrolling interest | (9,439) | (10,894) |
| Net (loss) income attributable to Lannett Company, Inc. | \$ (403,561) | \$ 2,857,370 |
| Basic (loss) income per common share - Lannett Company, Inc. | \$ (0.02) | \$ 0.12 |
| Diluted (loss) income per common share - Lannett Company, Inc. | \$ (0.02) | \$ 0.11 |
| Basic weighted average number of shares | 24,899,530 | 24,533,562 |
| Diluted weighted average number of shares | 24,899,530 | 25,054,661 |

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

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LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

| | Common Stock | | Additional | Retained | Treasury | Noncontrolling | Accum. Other | Shareholders |
|---|--------------|-----------|---------------|--------------|--------------|----------------|---------------|---------------|
| | Shares | Amount | Paid-in | Earnings | Stock | Interest | Comprehensive | Equity |
| | Issued | | Capital | | | | Income | |
| Balance, June 30, 2010 | 24,882,123 | \$ 24,882 | \$ 79,862,940 | \$ 9,564,632 | \$ (651,413) | \$ 111,982 | \$ 44,692 | \$ 88,957,715 |
| Shares issued in connection with employee stock purchase plan | 14,610 | 15 | 54,254 | | | | | 54,269 |
| Share based compensation | | | | | | | | |
| Restricted stock | | | 174,755 | | | | | 174,755 |
| Stock options | | | 306,232 | | | | | 306,232 |
| Employee stock purchase plan | | | 12,499 | | | | | 12,499 |
| Shares issued in connection with restricted stock grant | 32,398 | 32 | (32) | | | | | |
| Purchase of treasury stock | | | | | (85,246) | | | (85,246) |
| Other comprehensive income, net of income tax | | | | | | | 7,896 | 7,896 |
| Net (loss) income | | | | (403,561) | | 9,439 | | (394,122) |
| Balance, September 30, 2010 | 24,929,131 | \$ 24,929 | \$ 80,410,648 | \$ 9,161,071 | \$ (736,659) | \$ 121,421 | \$ 52,588 | \$ 89,033,998 |

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

Table of Contents**LANNETT COMPANY, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(UNAUDITED)

| | For the three months ended September 30, | |
|--|---|----------------------|
| | 2010 | 2009 |
| OPERATING ACTIVITIES: | | |
| Net (loss) income | \$ (394,122) | \$ 2,868,264 |
| Adjustments to reconcile net (loss) income to net cash used in operating activities: | | |
| Depreciation and amortization | 1,219,508 | 1,166,604 |
| Deferred tax expense | 227,143 | 388,427 |
| Stock compensation expense | 493,486 | 297,315 |
| Other noncash expenses (income) | 7,722 | (26,391) |
| Gain on sale of assets | (12,641) | |
| Changes in assets and liabilities which provided (used) cash: | | |
| Trade accounts receivable | 7,135,159 | (1,152,466) |
| Inventories | (1,979,723) | (814,863) |
| Prepaid and income taxes payable | (1,977,873) | 513,590 |
| Prepaid expenses and other assets | 344,055 | 58,142 |
| Accounts payable | (517,207) | (1,155,783) |
| Accrued expenses | (965,319) | 289,880 |
| Rebates, chargebacks and returns payable | (1,889,804) | (871,703) |
| Accrued payroll and payroll related | (3,817,655) | (2,195,495) |
| Net cash used in operating activities | (2,127,271) | (634,479) |
| INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment (including construction in progress) | (2,462,969) | (1,067,261) |
| Purchase of intangible asset (product rights) | | (500,000) |
| Proceeds from sale of investment securities - available for sale | 394,721 | |
| Net cash used in investing activities | (2,068,248) | (1,567,261) |
| FINANCING ACTIVITIES: | | |
| Repayments of debt | (58,253) | (136,285) |
| Proceeds from issuance of stock | 54,269 | 185,943 |
| Purchase of treasury stock | (85,246) | (69,120) |
| Net cash used in financing activities | (89,230) | (19,462) |
| Effect of foreign currency rates on cash and cash equivalents | 13,655 | |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (4,271,094) | (2,221,202) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 21,895,648 | 25,832,456 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 17,624,554 | \$ 23,611,254 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION - | | |
| Interest paid | \$ 100,856 | \$ 41,762 |
| Income taxes paid | \$ 1,361,186 | \$ 925,633 |

The accompanying notes to the 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 months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2011. 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, 2010.

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 manufactures solid oral dosage forms, including tablets and capsules, topical and oral solutions, and is pursuing partnerships and research contracts for the development and production of other dosage forms, including ophthalmic, nasal and injectable products.

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

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

Foreign Currency Translation - The local currency is the functional currency of its foreign subsidiary. Assets and liabilities of the foreign subsidiary are translated into U.S. dollars at the period-end currency exchange rate and revenues and expenses are translated at an average currency exchange rate for the period. The resulting translation adjustment is recorded in a separate component of shareholders' equity and changes to such are included in comprehensive income. Exchange adjustments resulting from transactions denominated in foreign currencies are recognized in the consolidated statements of operations.

Reclassifications - Certain prior year amounts have been reclassified to conform to the current year financial statement 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

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determinable. Accruals for these provisions are presented in the consolidated financial statements as rebates, chargebacks and returns payable and reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for 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 Wolters Kluwer, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations.

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, chargebacks and returns payable account on the balance sheet.

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Other Adjustments Other adjustments consist primarily of price adjustments, also known as shelf stock adjustments, which are credits issued to reflect decreases in the selling prices of the Company's products that customers have remaining in their inventories at the time of the price reduction. Decreases in selling prices are discretionary decisions made by management to reflect competitive market conditions. Amounts recorded for estimated shelf stock adjustments are based upon specified terms with direct customers, estimated declines in market prices, and estimates of inventory held by customers. The Company regularly monitors these and other factors and evaluates the reserve as additional information becomes available. Other adjustments are included in the rebates, chargebacks and returns 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, 2010 and 2009:

For the three months ended September 30, 2010

| Reserve Category | Chargebacks | Rebates | Returns | Other | Total |
|---|--------------|--------------|--------------|-------------|---------------|
| Reserve Balance as of June 30, 2010 | \$ 6,282,127 | \$ 3,566,031 | \$ 5,401,254 | \$ | \$ 15,249,412 |
| Actual credits issued related to sales recorded in prior fiscal years | (6,112,838) | (2,558,582) | (1,151,174) | | (9,822,594) |
| Reserves or (reversals) charged during Fiscal 2011 related to sales in prior fiscal years | | | | | |
| Reserves charged to net sales during Fiscal 2011 related to sales recorded in Fiscal 2011 | 11,960,878 | 3,776,169 | 2,987,308 | 1,663,371 | 20,387,726 |
| Actual credits issued related to sales recorded in Fiscal 2011 | (7,056,592) | (2,347,273) | (1,387,700) | (1,663,371) | (12,454,936) |
| Reserve Balance as of September 30, 2010 | \$ 5,073,575 | \$ 2,436,345 | \$ 5,849,688 | \$ | \$ 13,359,608 |

For the three months ended September 30, 2009

| Reserve Category | Chargebacks | Rebates | Returns | Other | Total |
|---|--------------|--------------|--------------|-----------|---------------|
| Reserve Balance as of June 30, 2009 | \$ 6,089,802 | \$ 2,537,746 | \$ 5,106,992 | \$ | \$ 13,734,540 |
| Actual credits issued related to sales recorded in prior fiscal years | (4,767,581) | (1,852,708) | (1,147,720) | | (7,768,009) |
| Reserves or (reversals) charged during Fiscal 2010 related to sales in prior fiscal years | | | | | |
| Reserves charged to net sales during Fiscal 2010 related to sales recorded in Fiscal 2010 | 10,272,936 | 4,066,855 | 1,140,128 | 407,784 | 15,887,703 |
| Actual credits issued related to sales recorded in Fiscal 2010 | (7,000,389) | (1,789,955) | | (407,784) | (9,198,128) |
| Reserve Balance as of September 30, 2009 | \$ 4,594,768 | \$ 2,961,938 | \$ 5,099,400 | \$ | \$ 12,656,106 |

The total reserve for chargebacks, rebates, returns and other adjustments decreased from \$15,249,412 at June 30, 2010 to \$13,359,608 at September 30, 2010. The decrease in total reserves was due to a decrease in the rebates reserve as a result of a decrease in overall sales, and a decrease in chargeback reserves due primarily to a decrease in inventory levels at wholesaler distribution centers.

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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 generally have 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. 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.

Cash and cash equivalents - The Company considers all highly liquid securities purchased with original maturities of 90 days or less to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value, and consist of certificates of deposit that are readily convertible to cash. The Company maintains cash and cash equivalents with several major financial institutions. Such amounts frequently exceed Federal Deposit Insurance Corporation (FDIC) limits.

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

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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.

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. The Company 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 during the three months ended September 30, 2010 or the fiscal year ended June 30, 2010.

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 - In March 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 for the exclusive marketing and distribution rights obtained from JSP. As of September 30, 2010 and June 30, 2010, management concluded the carrying value of the intangible asset was less than its fair value and, therefore, no impairment was required. The Company will incur annual amortization expense of approximately \$1,785,000 for the JSP intangible asset over the remaining term of the agreement.

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 triggered the payment of 105,000 shares (87.5% of the 120,000 shares to be issued as the Company already owned 12.5% of Cody) of Lannett stock to the former owners of Cody Labs, which was completed in October 2008. Therefore, the Company recorded an intangible asset related to the acquisition of a drug import license in the original amount of \$581,175 and recorded a corresponding deferred tax liability of approximately \$150,700 due to the non-deductibility of the amortization for tax purposes. The Company has assigned a 15 year life to this intangible asset based on average life cycles of Lannett products.

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased for \$100,000 and future royalty payments the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. owned the ANDA. In May 2008, the Company and Pharmeral waived their rights to any royalty payments on the sales of the drug by Lannett under Lannett's current ownership structure. Should Lannett undergo a change in control transaction with a third party, this royalty will be reinstated. In Fiscal 2008, the Company obtained FDA approval to use these proprietary rights. Accordingly, the Company originally capitalized these purchased product rights as an indefinite lived intangible asset and tested this asset for impairment at least on an annual basis. During the fourth quarter of fiscal 2009, it was determined that

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this intangible asset no longer has an indefinite life. No impairment existed because the estimated fair value exceeded the carrying amount on that date. Accordingly, the \$100,000 carrying amount of this intangible asset is being amortized on a straight line basis prospectively over its 10 year remaining estimated useful life.

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In August 2009, the Company acquired eight new ANDAs covering three separate product lines from another generic drug manufacturer for a purchase price of \$500,000. The Company began shipping one of these product lines in October 2010 and it is expected that the Company will be able to produce the other two product lines by the second half of Fiscal 2011. Amortization will begin when the Company starts shipping these products. An intangible asset that is not subject to amortization shall be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. An impairment loss is measured as the excess of the asset's carrying value over its fair value, calculated using a discounted future cash flow method. Our discounted cash flow models are highly reliant on various assumptions which are considered level 3 inputs, including estimates of future cash flow (including long-term growth rates), discount rate, and expectations about variations in the amount and timing of cash flows and the probability of achieving the estimated cash flows. As of September 30 and June 30, 2010, no impairment existed with respect to these assets.

For the three months ended September 30, 2010 and 2009, the Company incurred amortization expense of approximately \$458,000 and \$458,000, respectively. As of September 30, 2010 and June 30, 2010, accumulated amortization totaled approximately \$9,916,000 and \$9,458,000, respectively.

Future annual amortization expense consists of the following as of September 30, 2010:

| Fiscal Year Ending June 30, | Annual Amortization Expense | |
|-----------------------------|--------------------------------|-----------|
| 2011 | \$ | 1,375,059 |
| 2012 | | 1,833,412 |
| 2013 | | 1,833,412 |
| 2014 | | 1,387,245 |
| 2015 | | 48,745 |
| Thereafter | | 349,072 |
| | \$ | 6,826,945 |

The amounts above do not include the ANDAs purchased in August 2009 for \$500,000 as amortization will begin when the Company starts shipping these products. As noted above, the Company began shipping one of these product lines in October 2010.

Advertising Costs - The Company charges advertising costs to operations as incurred. Advertising expense for the three months ended September 30, 2010 and 2009 was approximately \$19,000 and \$10,000, respectively.

Income Taxes - The Company uses the liability method to account for income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense/(benefit) is the result of changes in deferred tax assets and liabilities. The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative standards issued by the FASB also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

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Segment Information - The Company operates one business segment - generic pharmaceuticals; accordingly the Company has one reporting segment. 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, 2010 and 2009:

| Medical Indication | For the Three Months Ended September 30, | |
|----------------------|---|---------------|
| | 2010 | 2009 |
| Migraine Headache | \$ 2,525,000 | \$ 2,663,000 |
| Epilepsy | 521,000 | 611,000 |
| Prescription Vitamin | 869,000 | 1,489,000 |
| Heart Failure | 3,229,000 | 4,852,000 |
| Thyroid Deficiency | 10,336,000 | 13,024,000 |
| Antibiotic | 1,381,000 | 1,661,000 |
| Pain Management | 2,900,000 | 3,880,000 |
| Other | 3,635,000 | 3,255,000 |
| Total | \$ 25,396,000 | \$ 31,435,000 |

Concentration of Market and Credit Risk - Five of the Company's products, defined as generics containing the same active ingredient or combination of ingredients, accounted for approximately 41%, 13%, 10%, 4% and 3%, respectively of net sales for the three months ended September 30, 2010. Those same products accounted for 41%, 15%, 8%, 3% and 5% respectively, of net sales for the three months ended September 30, 2009.

Four of the Company's customers accounted for 23%, 13%, 9%, and 9%, respectively, of net sales for the three months ended September 30, 2010, and 25%, 12%, 8%, and 8%, respectively, of net sales for the three months ended September 30, 2009. At September 30, 2010, four customers accounted for 64% of the Company's accounts receivable balances. At June 30, 2010, four customers accounted for 69% of the Company's accounts receivable balances.

Share-based Compensation - The Company recognizes 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, 2010, the Company had three stock-based employee compensation plans (the Old Plan, the 2003 Plan, and the 2006 Long-term Incentive Plan, or 2006 LTIP).

At September 30, 2010, there were 2,058,851 options outstanding. Of those, 1,032,925 were options issued under the 2006 LTIP, 820,693 were issued under the 2003 Plan, and 205,233 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 49,365 shares under options having already been exercised under that plan since its inception, leaving a balance of 254,942 shares in that plan for future issuances. 2,500,000 shares were authorized to be issued under the 2006 LTIP, with 94,725 shares under options having already been exercised under that plan since its inception. At September 30, 2010, there were 237,500 nonvested restricted shares outstanding which were issued under the 2006 LTIP, with 372,689 shares having already vested under that plan since its inception. At September 30, 2010, a balance of 762,161 shares is available in the 2006 LTIP for future issuances.

During the fiscal year ended June 30, 2010, the Company awarded 237,500 shares of restricted stock to management employees under the 2006 LTIP which vest in equal portions on October 29, 2010, 2011 and 2012.

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Stock compensation expense of \$144,787 was recognized during the three months ended September 30, 2010 related to these shares of restricted stock.

During the fiscal year ended June 30, 2008, the Company awarded 209,264 shares of restricted stock to management employees under the 2006 LTIP, of which 74,464 of these shares vested 100% on January 1, 2008, and the remainder vested in equal portions on September 18, 2008, 2009 and 2010. Stock compensation expense of \$29,968 and \$43,007 was recognized during the three months ended September 30, 2010 and 2009, respectively, related to these shares of restricted stock.

The Company measures the fair value of 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:

| | Incentive Stock Options FY 2011 | Non-qualified Stock Options FY 2011 | Incentive Stock Options FY 2010 | Non-qualified Stock Options FY 2010 |
|--|---------------------------------------|---|---------------------------------------|---|
| Risk-free interest rate | % | % | 2.4% | % |
| Expected volatility | % | % | 67.1% | % |
| Expected dividend yield | % | % | % | % |
| Forfeiture rate | % | % | 5.0% | % |
| Expected term | n/a | n/a | 5.0 years | n/a |
| Weighted average fair value at date of grant | \$ | \$ | \$ 4.86 | \$ |

Expected volatility is based on the historical volatility of the price of our common shares since the date we commenced trading on the NYSE-Amex, April 2002, or a historical period equal to the expected term of the option, whichever is shorter. 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 the 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 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.

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The following table presents all share-based compensation costs recognized in our statements of operations, substantially all of which is reflected in the selling, general and administrative expense line:

| | Three Months Ended September 30, | |
|-------------------------------|-------------------------------------|------------|
| | 2010 | 2009 |
| Share based compensation | | |
| Stock options | \$ 306,232 | \$ 232,868 |
| Employee stock purchase plan | 12,499 | 21,440 |
| Restricted stock | 174,755 | 43,007 |
| Tax benefit at statutory rate | 31,467 | 27,604 |

Options outstanding that have vested and are expected to vest as of September 30, 2010 are as follows:

| | Awards | Weighted - Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Life |
|-----------------------------------|-----------|--|---------------------------------|---|
| Options vested | 1,306,240 | \$ 7.96 | \$ 330,755 | 5.1 |
| Options expected to vest | 694,084 | \$ 6.55 | \$ 106,299 | 9.0 |
| Total vested and expected to vest | 2,000,324 | \$ 7.47 | \$ 437,054 | 6.5 |

A summary of nonvested restricted stock award activity as of September 30, 2010 and changes during the three months then ended, is presented below:

| | Awards | Weighted Average Grant Date Fair Value |
|---------------------------------|----------|--|
| Nonvested at July 1, 2010 | 269,898 | \$ 1,778,814 |
| Granted | | |
| Vested | (32,398) | (130,564) |
| Forfeited | | |
| Nonvested at September 30, 2010 | 237,500 | \$ 1,648,250 |

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A summary of award activity under the Plans as of September 30, 2010 and 2009, and changes during the three months then ended, is presented below:

| | Incentive Stock Options | | | | Nonqualified Stock Options | | | |
|--|-------------------------|---------------------------------|---------------------------|---|----------------------------|---------------------------------|---------------------------|---|
| | Awards | Weighted-Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Life | Awards | Weighted-Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Remaining Contractual Life |
| Outstanding at July 1, 2010 | 1,309,254 | \$ 6.11 | | | 749,597 | \$ 9.77 | | |
| Granted | | \$ | | | | \$ | | |
| Exercised | | \$ | | | | \$ | | |
| Forfeited, expired or repurchased | | \$ | | | | \$ | | |
| Outstanding at September 30, 2010 | 1,309,254 | \$ 6.11 | \$ 353,362 | 7.3 | 749,597 | \$ 9.77 | \$ 89,926 | 5.2 |
| Outstanding at September 30, 2010 and not yet vested | 599,953 | \$ 6.45 | \$ 112,533 | 8.9 | 152,658 | \$ 6.99 | \$ | 9.1 |
| Exercisable at September 30, 2010 | 709,301 | \$ 5.83 | \$ 240,829 | 5.9 | 596,939 | \$ 10.48 | \$ 89,926 | 4.2 |

| Incentive Stock Options | | | | Nonqualified Stock Options | |
|-------------------------|-----------|----------------------------|------------------|----------------------------|--|
| Weighted-Average | Aggregate | Weighted Average Remaining | Weighted-Average | Weighted Average | |