

LANNETT CO INC  
Form 10-Q  
November 04, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**  
**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2011**

**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**  
(State of Incorporation)

**23-0787699**  
(I.R.S. Employer I.D. No.)

**9000 State Road**  
**Philadelphia, PA 19136**  
**(215) 333-9000**

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(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 2, 2011
Common stock, par value \$0.001 per share	28,373,612 shares

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	(Unaudited)	
	September 30, 2011	June 30, 2011
<b><u>ASSETS</u></b>		
Current Assets		
Cash and cash equivalents	\$ 17,518,514	\$ 5,276,735
Investment securities	6,863,524	19,382,079
Trade accounts receivable (net of allowance of \$123,573 and \$123,573 respectively)	34,635,989	33,464,440
Inventories, net	26,474,801	26,902,521
Income taxes receivable	3,739,693	3,636,306
Deferred tax assets	4,715,949	4,537,881
Other current assets	1,598,045	941,902
<b>Total Current Assets</b>	<b>95,546,515</b>	<b>94,141,864</b>
Property, plant and equipment		
Property, plant and equipment	56,197,069	54,516,229
Less accumulated depreciation	(25,529,042)	(24,586,448)
	30,668,027	29,929,781
Construction in progress		
Construction in progress	4,798,779	5,760,686
Intangible assets (product rights) - net of accumulated amortization	5,839,840	5,909,636
Deferred tax assets	9,953,652	10,446,500
Other assets	1,208,908	1,555,831
<b>Total Assets</b>	<b>\$ 148,015,721</b>	<b>\$ 147,744,298</b>
<b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>		
<b><u>LIABILITIES</u></b>		
Current Liabilities		
Accounts payable	\$ 15,337,436	\$ 18,377,782
Accrued expenses	1,127,202	1,354,095
Accrued payroll and payroll related	1,204,498	934,504
Line of credit	2,000,000	
Current portion of long-term debt	632,206	629,435
Rebates, chargebacks and returns payable	14,350,303	13,564,395
<b>Total Current Liabilities</b>	<b>34,651,645</b>	<b>34,860,211</b>
Long-term debt, less current portion		
Long-term debt, less current portion	7,067,236	7,192,496
Other long-term liabilities	977	2,417
<b>Total Liabilities</b>	<b>41,719,858</b>	<b>42,055,124</b>

Commitment and Contingencies, See notes 9 and 10

**SHAREHOLDERS' EQUITY**

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Common stock - authorized 50,000,000 shares, par value \$0.001; issued and outstanding, 28,446,673 and 28,403,946 shares, respectively	28,447	28,404
Additional paid in capital	97,807,543	97,082,360
Retained earnings	9,493,341	9,287,732
Noncontrolling interest	155,546	139,082
Accumulated other comprehensive income	20,448	23,899
	107,505,325	106,561,477
Less: Treasury stock at cost - 246,692 and 156,611 shares, respectively	(1,209,462)	(872,303)
<b>TOTAL SHAREHOLDERS EQUITY</b>	106,295,863	105,689,174
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	\$ 148,015,721	\$ 147,744,298

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)**

	<b>Three months ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
Net sales	\$ 28,877,904	\$ 25,395,927
Cost of sales	19,742,045	18,900,048
Amortization of intangible assets	468,196	448,667
Product royalties	51,624	143,271
Gross profit	8,616,039	5,903,941
Research and development expenses	2,426,483	2,042,369
Selling, general, and administrative expenses	4,744,513	4,600,681
Operating income (loss)	1,445,043	(739,109)
Other income (expense):		
Foreign currency gain	5,006	2,415
Gain on sale of assets	7,000	
Realized (loss) gain on investments	(172,859)	12,641
Unrealized loss on investments	(826,546)	
Interest and dividend income	53,249	11,231
Interest expense	(77,004)	(70,844)
	(1,011,154)	(44,557)
Income (loss) before income tax expense (benefit)	433,889	(783,666)
Income tax expense (benefit)	211,816	(389,544)
Net income (loss)	222,073	(394,122)
Less net income attributable to noncontrolling interest	(16,464)	(9,439)
Net income (loss) attributable to Lannett Company, Inc.	\$ 205,609	\$ (403,561)
Basic earnings (loss) per common share - Lannett Company, Inc.	\$ 0.01	\$ (0.02)
Diluted earnings (loss) per common share - Lannett Company, Inc.	\$ 0.01	\$ (0.02)
Basic weighted average number of shares	28,431,733	24,899,530
Diluted weighted average number of shares	28,686,644	24,899,530

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	
<b>Balance, June 30, 2011</b>	28,403,946	\$ 28,404	\$ 97,082,360	\$ 9,287,732	\$ (872,303)	\$ 139,082	\$ 23,899	\$ 105,689,174
Shares issued in connection with employee stock purchase plan	12,727	13	53,861					53,874
Share based compensation								
Restricted stock			273,278					273,278
Stock options			388,567					388,567
Employee stock purchase plan			9,507					9,507
Shares issued in connection with restricted stock grant	30,000	30	(30)					
Purchase of treasury stock					(337,159)			(337,159)
Other comprehensive loss, net of income tax							(3,451)	(3,451)
Net income				205,609		16,464		222,073
<b>Balance, September 30, 2011</b>	28,446,673	\$ 28,447	\$ 97,807,543	\$ 9,493,341	\$ (1,209,462)	\$ 155,546	\$ 20,448	\$ 106,295,863

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 CASH FLOWS**  
(UNAUDITED)

	<b>For the three months ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 222,073	\$ (394,122)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	1,417,790	1,219,508
Deferred tax expense	315,203	227,143
Stock compensation expense	671,352	493,486
Realized loss (gain) on investments	172,859	(12,641)
Unrealized loss on investments	826,546	
Gain on sale of assets	(7,000)	
Other noncash expenses (income)	2,750	7,722
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(1,171,549)	7,135,159
Inventories	427,720	(1,979,723)
Prepaid and income taxes payable	(103,387)	(1,977,873)
Prepaid expenses and other assets	(711,810)	344,055
Accounts payable	(3,040,346)	(517,207)
Accrued expenses	(226,893)	(965,319)
Rebates, chargebacks and returns payable	785,908	(1,889,804)
Accrued payroll and payroll related	269,994	(3,817,655)
Net cash used in operating activities	(148,790)	(2,127,271)
<b>INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment (including construction in progress)	(725,933)	(2,462,969)
Proceeds from sale of property, plant and equipment	7,000	
Purchases of investment securities	(4,284,423)	
Proceeds from sale of investment securities	15,802,516	394,721
Net cash provided by (used in) investing activities	10,799,160	(2,068,248)
<b>FINANCING ACTIVITIES:</b>		
Proceeds from issuance of stock	53,874	54,269
Purchase of treasury stock	(337,159)	(85,246)
Repayments of debt	(122,489)	(58,253)
Proceeds from line of credit	2,000,000	
Net cash provided by (used in) financing activities	1,594,226	(89,230)
Effect of foreign currency rates on cash and cash equivalents	(2,817)	13,655
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>12,241,779</b>	<b>(4,271,094)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>5,276,735</b>	<b>21,895,648</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 17,518,514</b>	<b>\$ 17,624,554</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -</b>		
Interest paid	\$ 76,862	\$ 100,856



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Income taxes paid	\$	\$	1,361,186
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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, 2011 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2012. 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, 2011.

**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 parenterals 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 15 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 (loss). 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, 2011 and 2010:

For the three months ended September 30, 2011	Chargebacks	Rebates	Returns	Other	Total
<b><u>Reserve Category</u></b>					
Reserve Balance as of June 30, 2011	\$ 5,496,911	\$ 2,925,477	\$ 5,142,007	\$	\$ 13,564,395
Actual credits issued related to sales recorded in prior fiscal years	(5,262,202)	(2,686,375)	(1,411,915)	(91,924)	(9,452,416)
Reserves or (reversals) charged during Fiscal 2012 related to sales in prior fiscal years	(35,583)	72,023		91,924	128,364
Reserves charged to net sales during Fiscal 2012 related to sales recorded in Fiscal 2012	17,476,537	4,358,341	1,337,155	201,518	23,373,551
Actual credits issued related to sales recorded in Fiscal 2012	(11,118,388)	(1,943,685)		(201,518)	(13,263,591)
Reserve Balance as of September 30, 2011	\$ 6,557,275	\$ 2,725,781	\$ 5,067,247		