

LANNETT CO INC  
Form 10-Q  
May 12, 2009  
Table of Contents

**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 MARCH 31, 2009**

**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**  
(State of Incorporation)

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

Edgar Filing: LANNETT CO INC - Form 10-Q

**9000 State Road**

**Philadelphia, PA 19136**

**(215) 333-9000**

(Address of principal executive offices and telephone number)

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

Indicate by check mark whether the registrant 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 o No o**

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

Class
Common stock, par value \$0.001 per share

Outstanding as of May 8, 2009
24,514,696 shares

Table of Contents

**Table of Contents**

	<b>Page No.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>ITEM 1.</u></b>	<b><u>FINANCIAL STATEMENTS</u></b>
	1
	2
	3
	4
	5
<b><u>ITEM 2.</u></b>	<b><u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u></b>
	30
<b><u>ITEM 3.</u></b>	<b><u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u></b>
	43
<b><u>ITEM 4.</u></b>	<b><u>CONTROLS AND PROCEDURES</u></b>
	43
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>ITEM 1.</u></b>	<b><u>LEGAL PROCEEDINGS</u></b>
	44
<b><u>ITEM 4.</u></b>	<b><u>SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u></b>
	45
<b><u>ITEM 6.</u></b>	<b><u>EXHIBITS</u></b>
	45
<b><u>CERTIFICATION OF PRESIDENT &amp; CHIEF EXECUTIVE OFFICER</u></b>	
<b><u>CERTIFICATION OF INTERIM CHIEF FINANCIAL OFFICER</u></b>	
<b><u>CERTIFICATION PURSUANT TO SECTION 906 OF SARBANES OXLEY ACT OF 2002</u></b>	



Table of Contents

**PART I. FINANCIAL INFORMATION**

*ITEM 1. FINANCIAL STATEMENTS*

## LANNETT COMPANY, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

	(UNAUDITED)	
	March 31, 2009	June 30, 2008
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 15,435,756	\$ 6,256,712
Short term investments		354,155
Trade accounts receivable (net of allowance of \$178,958 and \$207,151, respectively)	29,215,192	34,114,982
Inventories, net	16,031,235	11,617,258
Interest receivable	129,459	51,781
Prepaid taxes	1,156,472	1,598,937
Deferred tax assets	4,150,938	6,997,935
Other current assets	985,517	591,415
<b>Total Current Assets</b>	<b>67,104,569</b>	<b>61,583,175</b>
Property, plant and equipment	40,551,276	39,996,008
Less accumulated depreciation	(17,761,680)	(15,261,905)
	22,789,596	24,734,103
Construction in progress	482,340	458,046
Investment securities - available for sale	1,486,772	2,145,980
Intangible assets - net of accumulated amortization	9,577,063	10,361,835
Deferred tax assets	13,997,628	14,200,771
Other assets	168,269	195,354
<b>Total Assets</b>	<b>\$ 115,606,237</b>	<b>\$ 113,679,264</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Current Liabilities		
Accounts payable	\$ 16,109,987	\$ 13,085,772
Accrued expenses	4,447,679	2,451,783
Deferred revenue	19,329	982,668
Current portion of long-term debt	503,469	791,912
Rebates, chargebacks and returns payable	11,172,174	18,326,417
<b>Total Current Liabilities</b>	<b>32,252,638</b>	<b>35,638,552</b>
Long-term debt, less current portion	7,886,439	8,186,922
Unearned grant funds	500,000	500,000
Other long-term liabilities	47,862	32,001
<b>Total Liabilities</b>	<b>40,686,939</b>	<b>44,357,475</b>
Commitments and contingencies, See notes 10 and 11		
Minority interest in Cody LCI Realty, LLC, net of taxes	86,685	50,309
<b>SHAREHOLDERS' EQUITY</b>		
Common stock - authorized 50,000,000 shares, par value \$0.001; issued and outstanding, 24,506,471 and 24,283,963 shares, respectively	24,506	24,284
Additional paid in capital	75,951,216	74,497,100
Accumulated deficit	(676,971)	(4,790,680)
Accumulated other comprehensive income	23,036	9,722
	75,321,787	69,740,426
Less: Treasury stock at cost - 82,228 and 74,970 shares, respectively	(489,174)	(468,946)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>74,832,613</b>	<b>69,271,480</b>

<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	\$	115,606,237	\$	113,679,264
--	----	-------------	----	-------------

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



Table of Contents

**LANNETT COMPANY, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	Three months ended March 31,		Nine months ended March 31,	
	2009	2008	2009	2008
Net sales	\$ 28,761,316	\$ 16,579,512	\$ 83,553,341	\$ 51,654,484
Cost of sales	16,564,244	12,276,526	50,396,809	36,688,446
Amortization of intangible assets	446,167	446,166	1,338,500	1,338,498
Product royalties	143,877	(40,674)	186,874	196,672
Gross profit	11,607,028	3,897,494	31,631,158	13,430,868
Research and development expenses	1,981,338	1,516,904	5,685,168	3,715,334
Selling, general, and administrative expenses	7,491,583	4,222,103	19,116,199	12,457,030
Gain on sale of assets	38,472		60,481	
Operating income (loss)	2,172,579	(1,841,513)	6,890,272	(2,741,496)
Other income (expense):				
Interest income	77,954	45,239	215,604	170,967
Interest expense	(75,417)	(75,025)	(259,057)	(291,146)
	2,537	(29,786)	(43,453)	(120,179)
Income (loss) before income tax expense (benefit) and minority interest	2,175,116	(1,871,299)	6,846,819	(2,861,675)
Income tax expense (benefit)	851,310	(615,454)	2,696,733	(821,122)
Minority interest in Cody LCI Realty, LLC, net of taxes	(9,324)		(36,377)	
Net income (loss)	\$ 1,314,482	\$ (1,255,845)	\$ 4,113,709	\$ (2,040,553)
Basic income (loss) per common share	\$ 0.05	\$ (0.05)	\$ 0.17	\$ (0.08)
Diluted income (loss) per common share	\$ 0.05	\$ (0.05)	\$ 0.17	\$ (0.08)
Basic weighted average number of shares	24,502,629	24,268,449	24,424,187	24,208,830
Diluted weighted average number of shares	24,756,041	24,268,449	24,524,822	24,208,830

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

Table of Contents

## LANNETT COMPANY, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock		Additional	Accumulated	Treasury	Accum. Other	Shareholders
	Shares	Amount	Paid-in	Deficit	Stock	Other Comp.	Equity
	Issued		Capital			Income	
<b>Balance, June 30, 2008</b>	24,283,963	\$ 24,284	\$ 74,497,100	\$ (4,790,680)	\$ (468,946)	\$ 9,722	\$ 69,271,480
Exercise of stock options	7,800	8	33,714				33,722
Shares issued in connection with employee stock purchase plan	41,106	41	82,054				82,095
Share based compensation Restricted stock			129,021				129,021
Stock options			731,286				731,286
Employee stock purchase plan			70,315				70,315
Shares issued in connection with restricted stock grant	68,602	68	101,331				101,399
Shares issued for contingent consideration for Cody Labs Acquisition	105,000	105	430,395				430,500
Stock options repurchased			(124,000)				(124,000)
Purchase of treasury stock					(20,228)		(20,228)
Other comprehensive income, net of income tax						13,314	13,314
Net income				4,113,709			4,113,709
<b>Balance, March 31, 2009</b>	24,506,471	\$ 24,506	\$ 75,951,216	\$ (676,971)	\$ (489,174)	\$ 23,036	\$ 74,832,613

The accompanying notes to 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 nine months ended March 31,	
	2009	2008
<b>OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 4,113,709	\$ (2,040,553)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,868,662	3,745,611
Deferred tax expense	2,890,589	(821,183)
Stock compensation expense	930,622	768,922
Restricted stock grant	101,399	300,090
Other noncash expenses	15,859	11,418
Gain on sale of assets	(60,481)	
Minority interest in Cody LCI Realty LLC, net of taxes	36,377	
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(4,607,629)	989,194
Inventories	(4,413,977)	2,500,069
Prepaid taxes	442,465	
Prepaid expenses and other assets	(444,695)	(41,362)
Accounts payable	3,024,215	(959,458)
Accrued expenses	4,225,072	(1,021,108)
Deferred revenue	(963,339)	(460,804)
Net cash provided by operating activities	9,158,848	2,970,836
<b>INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment (including construction in progress)	(583,762)	(2,052,276)
Proceeds from sale of fixed assets	1,500	
Proceeds from sale of investment securities - available for sale	7,075,041	1,520,198
Purchase of investment securities - available for sale	(5,979,246)	(600,605)
Net cash provided by (used in) investing activities	513,533	(1,132,683)
<b>FINANCING ACTIVITIES:</b>		
Repayments of debt	(588,926)	(443,214)
Proceeds from issuance of stock	115,817	86,115
Purchase of treasury stock	(20,228)	(74,376)
Net cash used in financing activities	(493,337)	(431,475)
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>9,179,044</b>	<b>1,406,678</b>
<b>CASH AND CASH EQUIVLAENTS, BEGINNING OF PERIOD</b>	<b>6,256,712</b>	<b>5,192,341</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 15,435,756</b>	<b>\$ 6,599,019</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -</b>		
Interest paid	\$ 149,640	\$ 97,114
Income taxes paid	\$ 250,000	\$
Lannett stock issued - acquisition of Cody Labs DEA license	\$ 581,175	\$

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

Table of Contents

**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 and nine month periods ended March 31, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2009. You should read these unaudited financial statements in combination with the other Notes in this section; Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Financial Statements, including the Notes to the Financial Statements, included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2008.

**Note 2. Summary of Significant Accounting Policies**

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

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

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

***Reclassifications*** - The June 30, 2008 Consolidated Balance Sheet, the Consolidated Statements of Operations for the three and nine months ended March 31, 2008 and the Consolidated Statement of Cash Flows for the nine months ended March 31, 2008 have been reclassified to conform to the current year presentation.

***Revenue Recognition*** - The Company recognizes revenue when its products are shipped. At this point, title and risk of loss have transferred to the customer and provisions for estimates, including rebates, promotional adjustments, price adjustments, returns, chargebacks, and other potential adjustments are reasonably



Table of Contents

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 NDC Health, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations.

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

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

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



Table of Contents

**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 nine months ended March 31, 2009 and 2008:

**For the nine months ended March 31, 2009**

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2008	\$ 4,049,407	\$ 632,314	\$ 13,642,589	\$ 2,107	\$ 18,326,417
Actual credits issued related to sales recorded in prior fiscal years	(3,930,992)	(632,314)	(12,246,259)		(16,809,565)
Reserves or (reversals) charged during Fiscal 2009 related to sales in prior fiscal years			2,107	(2,107)	
Reserves charged to net sales during Fiscal 2009 related to sales recorded in Fiscal 2009	24,342,932	8,498,516	3,441,427	208,649	36,491,524
Actual credits issued related to sales recorded in Fiscal 2009	(19,914,114)	(6,754,177)		(167,911)	(26,836,202)
Reserve Balance as of March 31, 2009	\$ 4,547,233	\$ 1,744,339	\$ 4,839,864	\$ 40,738	\$ 11,172,174

**For the nine months ended March 31, 2008**

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of June 30, 2007	\$ 4,649,478	\$ 871,339	\$ 113,313	\$ 52,234	\$ 5,686,364
Actual credits issued related to sales recorded in prior fiscal years	(4,429,923)	(1,741,804)	(146,917)		(6,318,644)
Reserves or (reversals) charged during Fiscal 2008 related to sales in prior fiscal years		870,465	50,000	(50,000)	870,465
Reserves charged to net sales during Fiscal 2008 related to sales recorded in Fiscal 2008	17,985,506	6,240,517	2,200,267	473,423	26,899,713
Actual credits issued related to sales recorded in Fiscal 2008	(14,721,493)	(4,988,844)	(805,702)	(473,552)	(20,989,591)
Reserve Balance as of March 31, 2008	\$ 3,483,568	\$ 1,251,673	\$ 1,410,961	\$ 2,105	\$ 6,148,307

## Edgar Filing: LANNETT CO INC - Form 10-Q

The total reserve for chargebacks, rebates, returns and other adjustments decreased from \$18,326,417 at June 30, 2008 to \$11,172,174 at March 31, 2009. The significant decrease in the returns reserve balance was primarily the result of credits issued during the first nine months of Fiscal 2009 related to the returns of the Prenatal Multivitamin product shipped in Fiscal 2008. It is our expectation that all of the product will be returned based on our inability to have the product specified as a brand equivalent, and information from our customers regarding their intentions to return the product. As of March 31, 2009 approximately \$9,507,000 of the return reserve was applied to accounts receivable for customers who had returned the Prenatal Multivitamin product by that date, leaving a balance of approximately \$1,038,000 of Multivitamin returns reserve on the books at March 31, 2009.

Table of Contents

The increase in chargeback reserves between June 30, 2008 and March 31, 2009 was due primarily to an increase in inventory levels at wholesaler distribution centers.

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

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

**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 market value, and consist of certificates of deposit that are readily converted to cash.

**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.

Table of Contents

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

**Investment Securities** - The Company's investment securities consist of marketable debt securities, primarily in U.S. government and agency obligations. All of the Company's marketable debt securities are classified as available-for-sale and recorded at fair value, based on quoted market prices. Unrealized holding gains and losses are recorded, net of any tax effect, as a separate component of accumulated other comprehensive income. No gains or losses on marketable debt securities are realized until they are sold or a decline in fair value is determined to be other-than-temporary. In accordance with Financial Accounting Standards Board ( FASB ) Staff Position Nos. FAS 115-1 and FAS 124-1 *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* ( FSP 115-1 ), the Company 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 nine months ended March 31, 2009, or the fiscal year ended June 30, 2008.

**Shipping and Handling Costs** - The cost of shipping products to customers is recognized at the time the products are shipped, and is included in Cost of Sales.

**Research and Development** - Research and development expenses are charged to operations as incurred.

**Intangible Assets** - 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 of \$67,040,000 for the exclusive marketing and distribution rights obtained from JSP. The intangible asset was recorded based upon the fair value of the four million (4,000,000) shares at the time of issuance to JSP. During the quarter ended March 31, 2005, the Company recorded a non-cash impairment loss of approximately \$46,093,000 in accordance with SFAS 144, *Accounting for Impairment or Disposal of Long-lived Assets* to reduce the carrying value of the intangible asset to its fair value of approximately \$16,062,000 as of the date of the impairment. As of March 31, 2009 and June 30, 2008, management concluded the carrying value of the intangible asset was less than its fair value and, therefore, no further impairment was required.

The Company will incur annual amortization expense of approximately \$1,785,000 for the intangible asset over the remaining term of the contract. For each nine month period ended March 31, 2009 and 2008, the Company incurred amortization expense of approximately \$1,338,000.

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

Fiscal Year Ending June 30,	Annual Amortization Expense
-----------------------------	-----------------------------

Edgar Filing: LANNETT CO INC - Form 10-Q

2009	\$	447,000
2010		1,785,000
2011		1,785,000
2012		1,785,000
2013		1,785,000
Thereafter		1,337,000
	\$	8,924,000

Table of Contents

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 of Lannett stock to the former owners of Cody Labs, which was completed in October 2008. Therefore, the Company has recorded an intangible asset related to the acquisition of a drug import license in the original amount of \$581,175 to the Intangible Asset account and has recorded a corresponding Deferred Tax Liability in the amount 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 major change in control where a third party is involved, this royalty would be reinstated.

In Fiscal 2008, the Company obtained FDA approval to use the proprietary rights. Accordingly, the Company has capitalized this purchased product right as an indefinite lived intangible asset.

**Advertising Costs** - The Company charges advertising costs to operations as incurred. Advertising expense for the nine months ended March 31, 2009 and 2008 was approximately \$41,000 and \$5,000, respectively.

**Income Taxes** - The Company uses the liability method specified by Statement of Financial Accounting Standards ( SFAS ) No. 109, *Accounting for Income Taxes ( FAS 109 )*. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense/(benefit) is the result of changes in deferred tax assets and liabilities.

**Segment Information** - The Company reports segment information in accordance with Statement of Financial Accounting Standard No. 131, *Disclosures about Segments of an Enterprise and Related Information ( FAS 131 )*. The Company operates one business segment - generic pharmaceuticals; accordingly the Company has one reporting segment. In accordance with FAS 131, the Company aggregates its financial information for all products and reports as one operating segment. The following table identifies the Company's approximate net product sales by medical indication for the three and nine months ended March 31, 2009 and 2008:

Medical Indication	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
	2009	2008	2009	2008
Migraine Headache	\$ 2,483,000	\$ 2,373,000	\$ 7,230,000	\$ 7,815,000
Epilepsy	518,000	816,000	1,402,000	2,787,000
Pre Natal Vitamin	4,890,000		9,449,000	
Heart Failure	3,938,000	1,004,000	15,995,000	3,164,000
Thyroid Deficiency	11,710,000	9,288,000	35,378,000	27,974,000
Antibiotic	1,493,000	846,000	4,514,000	2,402,000

Edgar Filing: LANNETT CO INC - Form 10-Q

Antibacterial	9,000	1,447,000	1,202,000	4,976,000
Other	3,720,000	806,000	8,383,000	2,536,000
Total	\$ 28,761,000	\$ 16,580,000	\$ 83,553,000	\$ 51,654,000

Table of Contents

**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 42%, 11%, 19%, 9% and 3%, respectively of net sales for the nine months ended March 31, 2009. Those same products accounted for 54%, 0%, 6%, 15% and 4% respectively, of net sales for the nine months ended March 31, 2008. For the three months ended March 31, 2009 and 2008, the same five products accounted for 41%, 17%, 14%, 9% and 3%, and 56%, 0%, 6%, 14%, and 4%, respectively, of net sales.

During Lannett's third quarter of 2009, the brand version of the Prenatal vitamin was removed from the marketplace. It is expected that, due to the lack of selling activities by the branded drug company, Lannett will experience a decline in sales for its generic product. Additionally, the Company entered into a settlement agreement with this brand drug company related to the outstanding litigation between the two companies. Pursuant to the settlement, the Company will receive a license to sell the generic version of the drug and will become an authorized generic provider. Lannett will cease offering its prenatal product if and when the brand is restored to the marketplace.

Four of the Company's customers accounted for 45%, 19%, 17%, and 12%, respectively, of net sales for the nine months ended March 31, 2009, and 31%, 8%, 5%, and 7%, respectively, of net sales for the nine months ended March 31, 2008. For the three months ended March 31, 2009 and 2008, these customers accounted for 32%, 11%, 11%, and 9%, and 29%, 6%, 4%, and 10%, respectively, of net sales. At March 31, 2009, these four customers accounted for 62% of the Company's accounts receivable balances. At June 30, 2008, these four customers accounted for 55% of the Company's accounts receivable balances.

**Share-based Compensation** - The Company follows the guidance in FASB SFAS No. 123 (R), *Share-Based Payment* ( FAS 123(R) ). This standard is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board Opinion ( APB ) No. 25, *Accounting for Stock Issued to Employees*. FAS 123(R) addresses the accounting for share-based compensation in which we receive employee services in exchange for our equity instruments. Under the standard, we recognize compensation cost for share-based compensation issued to or purchased by employees, net of estimated forfeitures, under share-based compensation plans using a fair value method.

At March 31, 2009, the Company had three stock-based employee compensation plans (the Old Plan, the 2003 Plan, and the Long-term Incentive Plan, or LTIP ). During the nine months ended March 31, 2009, the Company awarded 30,000 shares of restricted stock under the LTIP which vested immediately. Stock compensation expense of zero and \$ 101,399 was recognized during the three and nine months ended March 31, 2009, related to these shares of restricted stock.

The Company is required to record compensation expense for all awards granted after the date of adoption of FAS 123(R) and for the unvested portion of previously granted awards that remained outstanding as of the beginning of the period of adoption. The Company measures 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 nine months ended March 31:

	Incentive Stock Options FY 2009	Non-qualified Stock Options FY 2009	Incentive Stock Options FY 2008	Non-qualified Stock Options FY 2008
Risk-free interest rate	2.6%	2.5%	4.2%	4.2%
Expected volatility	59.4%	59.4%	56.0%	56.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Forfeiture rate	5.0%	5.0%	5.0%	5.0%



Edgar Filing: LANNETT CO INC - Form 10-Q

Expected term	5.0 years	5.0 years	5.0 years	5.0 years
Weighted average fair value at date of grant	\$1.44	\$1.41	\$2.11	\$2.11

Table of Contents

No options were issued under the LTIP during the three months ended March 31, 2009 and 2008, respectively. Approximately 147,000 and 548,000 options were issued under the LTIP during the nine months ended March 31, 2009 and 2008, respectively. There were 7,800 and zero shares under option that were exercised in the nine months ended March 31, 2009 and 2008, respectively. At March 31, 2009, there were 1,522,581 options outstanding. Of those, 605,900 were options issued under the LTIP, 705,448 were issued under the 2003 Plan, and 211,233 under the Old Plan. There are no further shares authorized to be issued under the Old Plan. 1,125,000 shares were authorized to be issued under the 2003 Plan, with 12,090 shares under option having already been exercised under that plan. 2,500,000 shares were authorized to be issued under the LTIP, with 3,400 shares under option having already been exercised under that plan.

Expected volatility is based on the historical volatility of the price of our common shares over the historical period equal to the expected term of the option. We use historical information to estimate expected term within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using 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 forfeiture rate is 5% at March 31, 2009 and 2008. As the Company continues to grow, this rate is likely to change to match such changes in turnover and hiring rates. Under the provisions of FAS 123R, the Company will incur additional expense if the actual forfeiture rate is lower than originally estimated. A recovery of prior expense will be recorded if the actual rate is higher than originally estimated.

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	2008	2009	2008
Method used to account for share-based compensation	Fair Value	Fair Value	Fair Value	Fair Value
Share based compensation				
Stock options	\$293,293	\$236,876	\$731,286	\$656,626
Employee stock purchase plan	39,023	5,522	70,315	20,389
Restricted stock	43,007	42,889	230,420	91,905

As part of the former CFO's resignation, the Company repurchased all of his 185,000 outstanding stock options. Therefore, the Company recorded, as incremental stock compensation expense, the previously unrecognized compensation cost totaling approximately \$83,000 related to options for which the requisite service period had not been rendered as of the repurchase date. See Note 11 for additional information.

Table of Contents

Options outstanding that have vested and are expected to vest as of March 31, 2009 are as follows:

	Awards	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Options vested	981,670	\$ 9.56	\$ 307,865	5.7
Options expected to vest	513,865	\$ 4.08	798,376	8.6
Total vested and expected to vest	1,495,535	\$ 7.68	\$ 1,106,241	6.7

A summary of nonvested restricted stock award activity as of March 31, 2009 and changes during the nine months then ended, is presented below:

	Awards	Weighted Average Grant Date Fair Value per share
Nonvested at July 1, 2008	124,800	\$ 502,944
Granted	30,000	101,399
Vested	(68,602)	(256,966)
Forfeited	(9,000)	(36,270)
Nonvested at March 31, 2009	77,198	\$ 311,107

Table of Contents

A summary of award activity under the Plans as of March 31, 2009 and 2008, and changes during the nine 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, 2008	991,267	\$ 5.76			703,064	\$ 10.16		
Granted	109,002	\$ 2.79			37,998	\$ 2.80		
Exercised	(7,800)	\$ 4.32						
Forfeited, expired or repurchased	(196,660)	\$ 5.02			(114,290)	\$ 5.75		
Outstanding at March 31, 2009	895,809	\$ 5.58	\$ 924,868	7.5	626,772	\$ 10.52	\$ 223,393	5.8
Outstanding at March 31, 2009 and not yet vested	420,018	\$ 4.03	\$ 661,780	8.7	120,893	\$ 4.23	\$ 178,616	8.5
Exercisable at March 31, 2009	475,791	\$ 6.94	\$ 263,088	6.4	505,879	\$ 12.02	\$ 44,777	5.1

	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, 2007	501,349	\$ 7.48			617,982	\$ 11.00		
Granted	462,918	\$ 4.03			85,082	\$ 4.03		
Exercised								
Forfeited or expired	(6,900)	\$ 5.67						
Outstanding at March 31, 2008	957,367	\$ 5.83	\$ 3,280	8.2	703,064	\$ 10.16		6.8
Outstanding at March 31, 2008 and not yet vested	626,638	\$ 4.57		9.2	183,651	\$ 5.05		8.9
Exercisable at March 31, 2008	330,729	\$ 8.21	\$ 3,280	6.3	519,413	\$ 11.96		6.0

Options with a fair value of \$762,511 vested during the nine months ended March 31, 2009. As of March 31, 2009, there was \$1,212,930 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the Plans. That cost is expected to be recognized over a weighted average period of 1.34 years. As of March 31, 2008, there was approximately \$1,556,000 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the Plans.

Edgar Filing: LANNETT CO INC - Form 10-Q

**Unearned Grant Funds** The Company records all grant funds received as a liability until the Company fulfills all the requirements of the grant funding program.

**Earnings (Loss) per Common Share** SFAS No. 128, *Earnings per Share*, ( FAS 128 ) requires a dual presentation of basic and diluted earnings per share on the face of the Company s consolidated statement of

Table of Contents

operations and a reconciliation of the computation of basic earnings per share to diluted earnings per share. Basic earnings per share excludes the dilutive impact of common stock equivalents and is computed by dividing net income by the weighted-average number of shares of common stock outstanding for the period. Diluted earnings per share include the effect of potential dilution from the exercise of outstanding common stock equivalents into common stock using the treasury stock method; such items would not be considered for diluted loss per share due to their antidilutive effects. Earnings per share amounts for all periods presented have been calculated in accordance with the requirements of FAS 128. A reconciliation of the Company's basic and diluted income (loss) per share follows:

	Three Months Ended March 31,				Nine Months Ended March 31,			
	2009		2008		2009		2008	
	Net Income (Numerator)	Shares (Denominator)	Net Loss (Numerator)	Shares (Denominator)	Net Income (Numerator)	Shares (Denominator)	Net Loss (Numerator)	Shares (Denominator)
Basic income (loss) per share factors	\$ 1,314,482	24,502,629	\$ (1,255,845)	24,268,449	\$ 4,113,709	24,424,187	\$ (2,040,553)	24,208,830
Effect of potentially dilutive option and restricted stock plans		253,412				100,635		
Diluted income (loss) per share factors	\$ 1,314,482	24,756,041	\$ (1,255,845)	24,268,449	\$ 4,113,709	24,524,822	\$ (2,040,553)	24,208,830
Basic income (loss) per share	\$ 0.05		\$ (0.05)		\$ 0.17		\$ (0.08)	
Diluted income (loss) per share	\$ 0.05		\$ (0.05)		\$ 0.17		\$ (0.08)	

The number of anti-dilutive shares that have been excluded in the computation of diluted income (loss) per share for the three and nine months ended March 31, 2009 were 865,642 and 1,470,779, respectively. The number of anti-dilutive shares that have been excluded in the computation of diluted income (loss) per share for the three and nine months ended March 31, 2008 were 1,915,231.

**Note 3. New Accounting Standards**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (FAS 157). This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. In February, 2008, the FASB issued FASB Staff Position 157-1, Application of FASB Statement No. 157 to FASB Statement 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification and Measurement under Statement 13 (FSP FAS 157-1) and FASB Staff Position 157-2, Effective Date of FASB Statement No. 157 (FSP FAS 157-2). FSP FAS 157-1 amends FAS 157 to remove certain leasing transactions from its scope. FSP FAS 157-2 defers the effective date of FAS 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. We adopted the guidance of FAS 157 as it applies to our financial instruments on July 1, 2008. The adoption of FAS 157 did not have a material impact on the company's financial statements. Marketable securities represent the only item recorded on the Company's balance sheets at fair value. Marketable securities are all classified as available-for-sale and values are derived



Table of Contents

solely from level 1 inputs. In October 2008, the FASB issued FASB Staff Position No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active ( FSP FAS 157-3 ). FSP FAS 157-3 clarifies the application of FAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 was effective upon issuance, including for prior periods for which financial statements have not been issued. FSP FAS 157-3 did not impact our financial reporting as we do not hold any such assets.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115 ( FAS 159 ), which allows companies to choose, at specific election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. FAS 159 is effective for our fiscal year beginning July 1, 2008. The adoption of FAS 159 did not have any impact on our consolidated financial statements as we have not elected to apply the fair value option to any of our financial assets and liabilities.

In June 2007, the Emerging Issues Task Force ( EITF ) reached a final consensus on EITF Issue No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities ( EITF 07-3 ). EITF 07-3 is effective for our fiscal year beginning July 1, 2008. EITF 07-3 requires non-refundable advance payments for future research and development activities to be capitalized until the goods have been delivered or related services have been performed. As the guidance in EITF 07-03 is consistent with our existing policy, EITF 07-03 did not have any impact on our financial statements or related disclosures.

In November 2007, the EITF reached a final consensus on EITF Issue No. 07-1, Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property ( EITF 07-1 ). EITF 07-1 will be effective for our fiscal year beginning July 1, 2009 and interim periods within that fiscal year. Adoption is on a retrospective basis to all prior periods presented for all collaborative arrangements existing as of the effective date. We are currently evaluating the impact of adopting EITF 07-1 on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations ( FAS 141(R) ). FAS 141(R) will significantly change the accounting for business combinations in a number of areas including the treatment of contingent consideration, contingencies, acquisition costs, in-process research and development and restructuring costs. In addition, under FAS 141(R), changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. In April 2009, FAS 141(R) was amended by FASB Staff Position FAS 141R-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies, ( FSP FAS 141(R)-1 ) to address application issues regarding the accounting and disclosure provisions for contingencies. FSP FAS 141(R) amends FAS 141R by replacing the guidance on the initial recognition and measurement of assets and liabilities arising from contingencies acquired or assumed in a business combination. FSP FAS 141(R)-1 also amends FAS 141R's subsequent accounting guidance for contingent assets and liabilities recognized at the acquisition date and amends the disclosure requirements for contingencies. FAS 141(R) and FSP FAS 141(R)-1 apply prospectively to business combinations for which the acquisition date is on or after the beginning of the fiscal year beginning July 1, 2009. Early application is not permitted. The effect of these standards on our consolidated financial statements will depend on the nature and terms of any business combinations that occur after their effective date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements ( FAS 160 ). FAS 160 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling (minority) interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated





Table of Contents

entity that should be reported as equity in the consolidated financial statements and establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation. FAS 160 is effective for our fiscal year beginning July 1, 2009. We are currently evaluating the impact the adoption of FAS 160 will have on our consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities ( FAS 161 ). The new standard is intended to help investors better understand how derivative instruments and hedging activities affect an entity's financial position, financial performance and cash flows through enhanced disclosure requirements. The new standard is effective for our fiscal year beginning July 1, 2009 and for all interim periods within that fiscal year. Early adoption is encouraged. We do not expect the adoption of FAS 161 to have a significant impact on our consolidated financial statements as we do not currently have any derivatives within the scope of FAS 161.

In April 2008, the FASB issued FASB Staff Position No. FAS 142-3, Determination of the Useful Life of Intangible Assets ( FSP FAS 142-3 ). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets . The FSP is intended to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under FAS 141(R) and other U.S. generally accepted accounting principles. The new standard is effective for our financial statements issued for fiscal years and interim periods beginning July 1, 2009. We are currently evaluating the impact of FSP FAS 142-3.

In April 2009, the FASB issued FASB Staff Position (FSP) FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, to make the guidance on other-than-temporary impairments of debt securities more operational and improve the financial statement disclosures related to other-than-temporary impairments for debt and equity securities. The FSP clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired.

To evaluate whether a debt security is other-than-temporarily impaired, an entity must first determine whether the fair value of the debt security is less than its amortized cost basis at the balance sheet date. If the fair value is less than the amortized cost basis, then the entity must assess whether it intends to sell the security and whether it is more likely than not that it will be required to sell the debt security before recovery of its amortized cost basis. If an entity determines that it will sell a debt security or that it more likely than not will be required to sell a debt security before recovery of its amortized cost basis, then it must recognize the difference between the fair value and the amortized cost basis of the debt security in earnings. Otherwise, the other-than-temporary impairment must be separated into two components: the amount related to the credit loss and the amount related to all other factors. The amount related to the credit loss must be recognized in earnings, while the other component must be recognized in other comprehensive income, net of tax. The portion of other-than-temporary impairment recognized in earnings would decrease the amortized cost basis of the debt security, and subsequent recoveries in the fair value of the debt security would not result in a write-up of the amortized cost basis.

FSP FAS 115-2 and FAS 124-2 are effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. If an entity adopts either FSP FAS 157-4 or FSP FAS 107-1 and APB 28-1 for periods ending after March 15, 2009, then it must adopt this FSP at the same time. The Company intends to adopt FSP FAS 115-2 and FAS 124-2 effective June 30, 2009.

Table of Contents**Note 4. Inventories**

The Company values its inventory at the lower of cost (determined by the first-in, first-out method) or market, regularly reviews inventory quantities on hand, and records a provision for excess and obsolete inventory based primarily on estimated forecasts of product demand and production requirements. The Company's estimates of future product demand may fluctuate, in which case estimated required reserves for excess and obsolete inventory may increase or decrease. If the Company's inventory is determined to be overvalued, the Company recognizes the amount of the inventory write-down in cost of goods sold at the time of such determination.

Inventories consist of the following:

	March 31, 2009		June 30, 2008
Raw materials	\$ 5,306,828	\$	3,530,951
Work-in-process	2,742,986		1,034,360
Finished goods	7,328,825		6,767,718
Packaging supplies	652,596		284,229
	\$ 16,031,235	\$	11,617,258

The preceding amounts are net of inventory reserves of \$2,384,644 and \$1,642,668 at March 31, 2009 and June 30, 2008, respectively.

**Note 5. Property, Plant and Equipment**



Edgar Filing: LANNETT CO INC - Form 10-Q

Property, plant and equipment are stated at cost. Depreciation expense for financial reporting purposes is provided for by the straight-line method over the estimated useful lives of the assets. Depreciation expense for the three months ended March 31, 2009 and 2008 was approximately \$836,000 and \$768,000, respectively. Depreciation expense for the nine months ended March 31, 2009 and 2008 was approximately \$2,503,000 and \$2,641,000, respectively. Property, plant and equipment consist of the following:

	Useful Lives	March 31, 2009	June 30, 2008
Land		\$ 918,314	\$ 918,314
Building and improvements	10 - 39 years	16,944,908	16,806,057
Machinery and equipment	5 - 10 years	21,813,099	21,434,375
Furniture and fixtures	5 - 7 years	874,955	837,262
		\$ 40,551,276	\$ 39,996,008
Accumulated depreciation		(17,761,680)	(15,261,905)
		\$ 22,789,596	\$ 24,734,103

As of March 31, 2009, substantially all of the Company's property, plant and equipment were pledged as collateral for the Company's loans. See Note 9.

Table of Contents**Note 6. Investment Securities - Available-for-Sale**

The amortized cost, gross unrealized gains and losses, and fair value of the Company's available-for-sale securities are summarized as follows:

	<b>March 31, 2009</b>			
	<b>Available-for-Sale</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
U.S. Government Agency	\$ 928,910	\$ 40,600		\$ 969,510
Asset-Backed Securities	190,038	2,157	(10,694)	181,501
Corporate Bonds	329,431	6,330		335,761
	\$ 1,448,379	\$ 49,087	\$ (10,694)	\$ 1,486,772

	<b>June 30, 2008</b>			
	<b>Available-for-Sale</b>			
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
U.S. Government Agency	\$ 2,036,039	\$ 48,059	\$ (9,854)	\$ 2,074,244
Asset-Backed Securities	447,893	1,013	(23,015)	425,891
	\$ 2,483,932	\$ 49,072	\$ (32,869)	\$ 2,500,135

The amortized cost and fair value of the Company's current available-for-sale securities by contractual maturity at March 31, 2009 and June 30, 2008 are summarized as follows:

	<b>March 31, 2009</b>		<b>June 30, 2008</b>	
	<b>Available for Sale</b>		<b>Available for Sale</b>	
	<b>Amortized</b>	<b>Fair</b>	<b>Amortized</b>	<b>Fair</b>