

PharMerica CORP
Form 10-Q
August 03, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2009

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____.

Commission File Number: 001-33380

PHARMERICA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

87-0792558
(I.R.S. Employer
Identification No.)

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1901 Campus Place

Louisville, KY
(Address of Principal Executive Offices)

(502) 627-7000

40299
(Zip Code)

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer 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-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class of Common Stock
Common stock, \$0.01 par value

Outstanding at July 29, 2009
30,539,153 shares

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PHARMERICA CORPORATION

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Table of Contents**PHARMERICA CORPORATION****CONDENSED CONSOLIDATED INCOME STATEMENTS****For the Three Months and Six Months Ended June 30, 2008 and 2009****(Unaudited)****(In millions, except share and per share amounts)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Revenues	\$ 486.3	\$ 460.6	\$ 981.4	\$ 928.8
Cost of goods sold	415.5	391.8	838.1	788.6
Gross profit	70.8	68.8	143.3	140.2
Selling, general and administrative expenses	54.0	47.2	111.3	98.1
Amortization expense	1.6	1.9	3.2	3.7
Integration, merger and acquisition related costs and other charges	6.6	0.6	10.7	2.6
Operating income	8.6	19.1	18.1	35.8
Interest expense, net	3.5	3.3	7.2	6.5
Income before income taxes	5.1	15.8	10.9	29.3
Provision for income taxes	2.2	6.6	4.7	11.9
Net income	\$ 2.9	\$ 9.2	\$ 6.2	\$ 17.4
Earnings per common share:				
Basic	\$ 0.10	\$ 0.30	\$ 0.21	\$ 0.58
Diluted	\$ 0.10	\$ 0.30	\$ 0.21	\$ 0.57
Shares used in computing earnings per common share:				
Basic	30,074,443	30,231,797	30,069,686	30,221,804
Diluted	30,176,592	30,366,640	30,125,668	30,330,992

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

As of December 31, 2008 and June 30, 2009

(Unaudited)

(In millions, except share and per share amounts)

	December 31, 2008	June 30, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 41.3	\$ 77.7
Accounts receivable, net	219.3	210.2
Inventory	73.4	70.9
Deferred tax assets	24.9	39.5
Prepays and other assets	16.7	14.0
	375.6	412.3
Equipment and leasehold improvements	97.1	104.8
Accumulated depreciation	(43.1)	(51.6)
	54.0	53.2
Deferred tax assets, net	59.4	29.9
Goodwill	113.7	115.6
Intangible assets, net	73.4	69.9
Other	3.1	3.3
	\$ 679.2	\$ 684.2
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 54.4	\$ 46.6
Salaries, wages and other compensation	36.3	32.9
Other accrued liabilities	12.6	8.6
	103.3	88.1
Long-term debt	240.0	240.0
Other long-term liabilities	16.1	14.2
Commitments and contingencies (See Note 6)		
Stockholders' equity:		
Preferred stock, \$0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2008 and June 30, 2009		
Common stock, \$0.01 par value per share; 175,000,000 shares authorized; 30,477,558 shares and 30,535,208 shares issued and outstanding as of December 31, 2008 and June 30, 2009, respectively.	0.3	0.3
Capital in excess of par value	338.7	341.0
Accumulated other comprehensive loss	(2.8)	(0.4)
Retained (deficit) earnings	(16.4)	1.0

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319.8 341.9

\$ 679.2 \$ 684.2

See accompanying Notes to Condensed Consolidated Financial Statements

Table of Contents**PHARMERICA CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Three Months and Six Months Ended June 30, 2008 and 2009****(Unaudited)****(In millions)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Cash flows provided by (used in) operating activities:				
Net income	\$ 2.9	\$ 9.2	\$ 6.2	\$ 17.4
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation	5.6	4.2	11.5	8.9
Amortization	1.6	1.9	3.2	3.7
Integration, merger and acquisition related costs and other charges	0.4		0.9	0.2
Stock-based compensation	1.1	1.3	2.1	1.9
Amortization of deferred financing fees	0.1	0.1	0.2	0.2
Deferred income taxes	1.6	6.8	4.1	11.6
Loss on disposition of equipment	0.6		0.6	0.1
Other	0.3			(0.1)
Change in operating assets and liabilities:				
Accounts receivable, net	0.5	8.1	(3.9)	8.7
Inventory and other assets	4.0	1.1	1.6	2.5
Prepays and other assets	(0.5)	0.2	4.4	3.3
Accounts payable	(7.4)	0.2	(6.2)	(7.8)
Salaries, wages and other compensation	(0.1)	(1.0)	(2.5)	(6.0)
Other accrued liabilities	2.3	(3.3)	2.0	(1.9)
Net cash provided by operating activities	13.0	28.8	24.2	42.7
Cash flows provided by (used in) investing activities:				
Purchase of equipment and leasehold improvements	(3.6)	(3.3)	(11.8)	(6.5)
Cash proceeds from sale of assets	0.1	0.1	0.2	0.1
Net cash used in investing activities	(3.5)	(3.2)	(11.6)	(6.4)
Cash flows provided by (used in) financing activities:				
Repayments of long-term debt and capital lease obligations		(0.2)	(10.0)	(0.3)
Issuance of common stock	0.2	0.2	0.2	0.3
Cash contributions received from minority shareholders			0.1	
Tax benefit from stock-based compensation				0.1
Net cash provided by (used in) financing activities	0.2		(9.7)	0.1
Change in cash and cash equivalents	9.7	25.6	2.9	36.4
Cash and cash equivalents at beginning of period	25.2	52.1	32.0	41.3
Cash and cash equivalents at end of period	\$ 34.9	\$ 77.7	\$ 34.9	\$ 77.7

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Supplemental information:								
Cash paid for interest	\$	3.5	\$	3.2	\$	7.5	\$	6.5
Cash paid for taxes	\$	0.6	\$	1.1	\$	0.9	\$	1.4
Supplemental schedule of non-cash activities:								
Fair value of assets acquired	\$		\$		\$	(1.4)	\$	
Fair value of liabilities assumed or incurred	\$		\$		\$	(1.4)	\$	
Capital lease obligations	\$		\$		\$		\$	1.8

See accompanying Notes to Condensed Consolidated Financial Statements

Table of Contents**PHARMERICA CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY****For the Period Ended June 30, 2009****(Unaudited)****(In millions, except share amounts)**

	Common Stock		Capital in	Accumulated	Retained	Total
	Shares	Amount	Excess of	Other	Earnings	
			Par Value	Income (Loss) (AOCI)	(Deficit)	
Balance at December 31, 2008	30,477,558	\$ 0.3	\$ 338.7	\$ (2.8)	\$ (16.4)	\$ 319.8
Comprehensive income:						
Net income					17.4	17.4
Change in fair value of interest rate swap, net				2.4		2.4
Total comprehensive income				2.4	17.4	19.8
Grant and forfeiture of non-vested restricted stock	31,865					
Exercise of stock options	25,785		0.3			0.3
Stock-based compensation - restricted stock			1.0			1.0
Stock-based compensation - stock options			0.9			0.9
Income tax benefit in connection with the issuance of common stock under stock-based compensation plans			0.1			0.1
Balance at June 30, 2009	30,535,208	\$ 0.3	\$ 341.0	\$ (0.4)	\$ 1.0	\$ 341.9

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

PharMerica Corporation (the Corporation) is an institutional pharmacy services company that services healthcare facilities and provides management pharmacy services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States, operating 95 institutional pharmacies in 40 states. The Corporation's customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings and generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 85 hospitals in the United States.

Pharmacy Transaction

The Corporation was formed on October 23, 2006 by Kindred Healthcare, Inc. (Kindred or Former Parent) and AmerisourceBergen Corporation (AmerisourceBergen) for the purpose of consummating the transactions contemplated by the Master Transaction Agreement dated October 25, 2006, as amended (the Master Agreement). Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through a series of transactions (collectively, the Pharmacy Transaction), spun-off and combined their respective institutional pharmacy businesses, Kindred Pharmacy Services (KPS) and PharMerica Long-Term Care (PharMerica LTC), into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007 (the Closing Date).

Principles of Consolidation

All intercompany transactions have been eliminated.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Corporation and related footnotes for the year ended December 31, 2008, included in the Corporation's Annual Report on Form 10-K. The balance sheet as of December 31, 2008 has been derived from the audited consolidated financial statements as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

The results of operations for the interim periods are not necessarily indicative of results of operations for a full year. It is the opinion of management that all necessary adjustments for a fair presentation of the condensed consolidated income statements, balance sheets, cash flows, and stockholders' equity for the interim periods have been made and are of a normal recurring nature.

Use of Estimates

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. GAAP, which require management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates are involved in revenue recognition, collectibility of accounts receivable, inventory valuation, supplier rebates, stock based compensation, accounting for income taxes, and the valuation of long-lived assets and goodwill. Actual amounts may differ from these estimates.

Potential risks and uncertainties, many of which are beyond the control of the Corporation, include, but are not necessarily limited to, such factors as overall economic, financial and business conditions; delays and reductions in reimbursement by the government and other payers to the Corporation or its customers; the overall financial condition of the Corporation's customers; the effect of new government regulations, executive orders and legislative initiatives, including those relating to reimbursement and drug pricing policies and changes in the interpretation

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and application of such policies; efforts by payers to control costs; the outcome of litigation; the outcome of audit, compliance, administrative or investigatory reviews, including governmental or regulatory inquiries; other contingent liabilities; changes in economic and political conditions; changes in interest rates; changes in the valuation of the Corporation's financial instruments, including the swap agreement; changes in tax laws and regulations; access to capital and financing; the demand for the Corporation's products and services; pricing and other competitive factors in the industry; changes in insurance claims experience and related assumptions; variations in costs or expenses; and changes in accounting rules and standards.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and cash equivalents with original maturities of three months or less. As of June 30, 2009, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets given current economic conditions.

Derivative Instruments

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 161 (SFAS 161), *Disclosures About Derivative Instruments and Hedging Activities*, an amendment of SFAS No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*. SFAS 161 requires entities that use derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. SFAS 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of SFAS 133 have been applied, and the impact that hedges have on an entity's financial position, financial performance, and cash flows. The Corporation adopted the provisions of SFAS 161 effective January 1, 2009.

The Corporation from time to time uses derivative instruments to protect against the risk of interest rate movements on future cash flows under the Corporation's credit agreement. In accordance with SFAS 133, derivative instruments are reported at fair value on the accompanying condensed consolidated balance sheets. For interest rate exposures, derivatives are used primarily to fix the rate on debt based on floating-rate indices and to manage the cost of borrowing obligations. The Corporation currently has an interest rate swap to manage interest rate risk. The Corporation prohibits the use of derivative instruments for trading or speculative purposes. Changes in the fair value of derivatives deemed to be eligible for hedge accounting are reported in accumulated other comprehensive income (loss) exclusive of ineffective amounts which are reported in interest expense. The fair value of the Corporation's interest rate swap agreement is the amount at which it could be settled, based on estimates obtained from the counterparty, JPMorgan Chase Bank, N.A. (JPMorgan). The interest rate swap is further described in Note 5.

Fair Value of Financial Instruments

In September 2006, the FASB issued SFAS No. 157 (SFAS 157), *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and enhances disclosure about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. On February 2, 2008, the FASB issued FASB Staff Position (FSP) No. FAS 157-2 (FSP FAS 157-2) which delayed the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Where the measurement objective specifically requires the use of fair value, the Corporation has adopted the provisions of SFAS 157 related to financial assets and financial liabilities as of January 1, 2008. The Corporation also adopted the provisions of FSP FAS 157-2 related to nonfinancial assets and nonfinancial liabilities effective January 1, 2009.

SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based upon assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1: Observable inputs such as quoted prices in active markets;

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- Level 2: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly; and
- Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

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Assets and liabilities measured at fair value are based on one or more of the following three valuation techniques noted in SFAS 157:

- A. *Market approach:* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- B. *Cost approach:* Amount that would be required to replace the service capacity of an asset (replacement cost).
- C. *Income approach:* Techniques to convert future amounts to a single present amount based upon market expectations (including present value techniques, option-pricing and excess earnings models).

Financial liabilities disclosed at fair value at June 30, 2009, are set forth in the table below (in millions):

	Assets/ (Liabilities)	Level 1	Level 2	Level 3	Valuation Technique
Derivative financial instrument	\$ (0.7)	\$	\$ (0.7)	\$	C
Deferred compensation plan	\$ (2.4)	\$	\$ (2.4)	\$	A

The Corporation's Level 2 liabilities represent a derivative financial instrument (interest rate swap) and an unfunded obligation associated with a deferred compensation plan offered to eligible employees and Board members of the Corporation. The interest rate swap is recorded at the amount at which it could be settled, based upon estimates obtained from the counterparty and internal analysis performed by the Corporation. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for similar assets or liabilities generated by market transactions. In accordance with FSP FAS 157-2, the Corporation will utilize the fair value framework as described in SFAS 157 when performing the annual goodwill impairment test and the valuation of assets acquired or liabilities assumed from any future business combinations. In addition, to the extent any triggering events occur related to intangible or other long-lived asset groups, the SFAS 157 fair value framework will be applied for the purpose of determining the amount of an impairment loss, if applicable.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, inventory, accounts payable and debt approximate fair value because of the nature or short-term maturity of these instruments.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily consist of amounts due from Prescription Drug Plans (PDPs) under Medicare Part D, institutional healthcare providers, the respective state Medicaid programs, third party insurance companies, and private payers. The Corporation's ability to collect outstanding receivables is critical to its results of operations and cash flows. To provide for accounts receivable that could become uncollectible in the future, the Corporation establishes an allowance for doubtful accounts to reduce the carrying value of such receivables to the extent it is probable that a portion or all of a particular account will not be collected.

The Corporation has an established process to determine the adequacy of the allowance for doubtful accounts, which relies on analytical tools, specific identification, and benchmarks to arrive at a reasonable allowance. No single statistic or measurement determines the adequacy of the allowance for doubtful accounts. In evaluating the collectibility of accounts receivable, the Corporation considers a number of factors, which include, but are not limited to, the impact of changes in the regulatory and payer environment, historical trends, the financial viability of the

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payer, contractual reimbursement terms and other factors that may impact ultimate reimbursement. Accounts receivable are written off after collection efforts have been completed in accordance with the Corporation's policies.

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The Corporation's accounts receivable accounts and summarized aging categories are as follows (dollars in millions):

	December 31, 2008	June 30, 2009
Institutional healthcare providers	\$ 148.0	\$ 145.6
Medicare Part D	59.5	54.9
Private payor and other	35.9	38.8
Insured	10.4	10.5
Medicaid	9.4	9.9
Medicare	2.6	0.9
Allowance for doubtful accounts	(46.5)	(50.4)
	\$ 219.3	\$ 210.2
0 to 60 days	64.1 %	64.3 %
61 to 120 days	18.1 %	17.0 %
Over 120 days	17.8 %	18.7 %
	100.0%	100.0 %

The following is a summary of activity in the Corporation's allowance for doubtful accounts (dollars in millions):

	Beginning Balance	Acquisitions/ Transfers	Charges to Costs and Expenses	Write-offs	Ending Balance
Allowance for doubtful accounts:					
Year Ended December 31, 2008	\$ 43.4	\$ 0.3	\$ 24.7	\$ (21.9)	\$ 46.5
Six Months Ended June 30, 2009	\$ 46.5	\$ 3.5	\$ 10.7	\$ (10.3)	\$ 50.4

The allowance for doubtful accounts for the second quarter of 2009 increased partially as a result of the transfer of reserves on contractuals from accounts receivable into the allowance for doubtful accounts. The reclassification did not impact the provision for bad debt for the current period.

Concentration of Credit Risk

For the three months and six months ended June 30, 2009, the Corporation derived approximately 13.0% of its revenues from a single customer, including all payer sources associated with the residents of its long-term care facilities.

Deferred Financing Fees

The Corporation capitalizes deferred financing fees related to acquiring or issuing new debt instruments. These expenditures include bank fees and premiums, legal costs, and filing fees. The Corporation amortizes these deferred financing fees over the life of the respective debt instrument

using the straight-line method.

Inventory

Inventory is located at the Corporation's institutional pharmacy locations. Inventory consists solely of finished product (primarily prescription drugs) and is valued at the lower of first-in, first-out cost (FIFO) or market. Physical inventories are performed on a quarterly basis at all pharmacy sites. Cost of goods sold is recorded based upon the actual results of the physical inventory counts, and is estimated when a physical inventory is not performed in a particular month. Historically, no significant adjustments have resulted from reconciliations with the quarterly physical inventories.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***Equipment and leasehold improvements*

Equipment and leasehold improvements are recorded at cost at the acquisition date and are depreciated using the straight-line method over their estimated useful lives as follows (in years):

	Estimated Useful Lives
Leasehold improvements	1-5
Equipment and software	3-10
Leased equipment	1-5

Expenditures for maintenance, repairs, and renewals of minor items are expensed as incurred. Major rebuilds and improvements are capitalized. For the three months ended June 30, 2008 and 2009, maintenance and repairs were approximately \$1.8 million and \$1.7 million, respectively. For the six months ended June 30, 2008 and 2009, maintenance and repairs were approximately \$3.8 million and \$3.3 million, respectively.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset to the estimated future undiscounted net cash flows expected to be generated by the asset. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset to its then fair value. The Corporation did not record impairment charges on equipment and leasehold improvements or intangibles for the three months and six months ended June 30, 2008 and 2009.

The Corporation's equipment and leasehold improvements are further described in Note 3.

Capitalization of Internal Software Costs

The Corporation capitalizes the costs incurred during the application development stage, which include costs to design the software configuration and interfaces, coding, installation, and testing. Costs incurred during the preliminary project along with post-implementation stages of internal use computer software are expensed as incurred. Capitalized development costs are amortized over various periods up to three years and are subject to impairment evaluations. Costs incurred to maintain existing software development are expensed as incurred. The capitalization and ongoing assessment of recoverability of development costs requires judgment by management with respect to certain external factors, including, but not limited to, technological and economic feasibility and estimated economic life. For the three months ended June 30, 2008 and 2009, the Corporation capitalized software development costs of \$0.8 million and \$0.7 million, respectively. For the six months ended June 30, 2008 and 2009 the Corporation capitalized software development costs of \$1.1 million and \$1.2 million, respectively. As of December 31, 2008 and June 30, 2009, net capitalized internal software costs and purchased software costs totaled \$7.5 million and \$6.6 million, respectively.

Goodwill and Other Intangibles

The Corporation accounts for its acquisitions in accordance with SFAS No. 141 (revised 2007) (SFAS 141(R)), *Business Combinations*, using the purchase method of accounting. Goodwill represents the excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. Goodwill and intangible assets with indefinite lives are reviewed by the Corporation at least annually for impairment each of which are reviewed separately for impairment. The Corporation's business is comprised of two reporting units, institutional pharmacy and hospital management, each of which are reviewed separately for impairment. The Corporation performed its annual impairment

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tests for goodwill as of December 31, 2008 and did not incur an impairment charge.

The Corporation's finite lived intangible assets are comprised primarily of trade names, customer relationships, and non-compete agreements originating from business acquisitions. Finite lived intangible assets are amortized on a straight-line basis over the terms of the agreements ranging from 5 to 18 years. The Corporation's goodwill and intangible assets are further described in Note 4.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

During the fourth quarter 2008, the Corporation recorded a pre-tax impairment charge of \$14.8 million related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy segment, was incurred when the reporting unit experienced a higher than expected loss of licensed beds. The impairment was related to intangible assets acquired in acquisitions by KPS during the years ended December 31, 2005 and 2006. These asset groups were assessed for recoverability and management determined the finite lived customer relationship assets to be impaired, but no other assets within the asset groups were deemed to be impaired. Using an undiscounted cash flow analysis, the Corporation determined the pre-tax impairment charge of \$14.8 million was required to write the carrying value down to the fair value, resulting in a loss per diluted share impact of \$0.30. The Corporation recognized the impairment as a permanent write-down of the cost basis and accumulated amortization of the affected assets.

Self-Insured Employee Health Benefits

The Corporation is self-insured for employee health benefits. The Corporation's self-insurance for employee health benefits includes a stop-loss policy to limit the maximum potential liability of the Corporation for both individual and aggregate claims per year. The Corporation records a monthly expense for self-insurance based upon historical claims data and inputs from third-party administrators. As of December 31, 2008 and June 30, 2009, the Corporation had approximately \$2.6 million and \$2.5, respectively, recorded as a liability for self-insured employee health benefits.

Supplier Rebates

The Corporation receives rebates on purchases from its vendors and suppliers. The Corporation generally accounts for these rebates and other incentives received from its vendors and suppliers, relating to the purchase or distribution of inventory, as a reduction to cost of goods sold and inventory. The Corporation considers these rebates to represent product discounts, and as a result, the rebates are capitalized as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory. For the three months ended June 30, 2008 and 2009, rebates were \$13.9 million and \$11.6 million, respectively, and for the six months ended June 30, 2008 and 2009 rebates were \$26.6 million and \$22.1 million, respectively, and recorded as a reduction of cost of goods sold in the accompanying condensed consolidated income statements. The Corporation had approximately \$2.8 million and \$2.3 million of rebates capitalized in inventory as of December 31, 2008 and June 30, 2009, respectively.

Delivery Expenses

The Corporation incurred delivery expenses totaling approximately \$15.8 million and \$13.7 million for the three months ended June 30, 2008 and 2009, respectively, and \$31.4 million and \$27.3 million for the six months ended June 30, 2008 and 2009, respectively, to deliver products sold to its customers. Delivery expenses are reported as a component of cost of goods sold in the accompanying condensed consolidated income statements.

Accumulated Comprehensive Income (Loss)

The Corporation entered into an interest rate swap agreement, which the Corporation has designated as a cash flow hedge. The Corporation recognizes all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative meets the hedge criteria as defined by SFAS 133, depending on the nature of the hedge, changes in the fair value of the derivative are either offset against the change in fair value of assets and liabilities through earnings or recognized in accumulated other comprehensive income (loss) until the hedged item is recognized into earnings. The ineffective portion of a derivative's change in fair value, if any, is immediately recognized into earnings.

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The changes in the fair value of the interest rate swap for the six months ended June 30, 2009, resulted in comprehensive income of \$2.4 million, net of income taxes. As of December 31, 2008 and June 30, 2009, the Corporation recorded a deferred tax asset of \$2.1 million and \$0.3 million, respectively, for the interest rate swap. Accumulated other comprehensive loss at June 30, 2009, was \$0.4 million. The interest rate swap is described more fully in Note 5.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***Stock Based Compensation*

The Corporation recognizes compensation expense based on the grant date fair value. The following table summarizes stock-based compensation expense of the Corporation for the periods presented (dollars in millions, except per share amounts):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2008	2009	2008	2009
Nonvested stock and stock option expense	\$ 1.1	\$ 1.3	\$ 2.1	\$ 1.9
Income tax benefit	\$ 0.5	\$ 0.5	\$ 0.9	\$ 0.8
Negative effect on diluted earnings per share	\$ 0.02	\$ 0.03	\$ 0.04	\$ 0.04

Stock based compensation is more fully described in Note 9.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Corporation accrues for probable tax obligations as required by facts and circumstances in the various regulatory environments. Deferred tax assets and liabilities are more fully described in Note 10.

Impact of Recent Accounting Pronouncements

In April 2008, the FASB issued FSP FAS No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP FAS 142-3), which 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 SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The intent of FSP FAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and U.S. GAAP. FSP FAS 142-3 requires an entity to disclose information for a recognized intangible asset that enables users of the financial statements to assess the extent to which the expected future cash flows associated with the asset are affected by the entity's intent or ability to renew or extend the arrangement. FSP FAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The requirements for determining the useful life of intangible assets apply to intangible assets acquired after January 1, 2009. The disclosure requirements will be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. The adoption of FSP FAS 142-3 will have an effect on the Corporation's results of operations and financial position to the extent the Corporation has future acquisitions.

The FASB issued FSP FAS No. 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* (FSP FAS 141(R)-1). FSP FAS141(R)-1 amends the guidance in SFAS 141 (Revised December 2007), *Business Combinations*, to: (i) Require that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would generally be recognized in accordance with SFAS No. 5, *Accounting for Contingencies* (SFAS 5), and FASB Interpretation (FIN) No. 14, *Reasonable Estimation of the Amount of a Loss*. The FASB decided to remove the subsequent accounting guidance for assets and liabilities arising from contingencies from SFAS 141(R), and carry forward without significant revision the guidance in FASB Statement No. 141, *Business Combinations*; (ii) Eliminate the requirement to disclose an estimate of the range of outcomes of recognized contingencies at the

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acquisition date. For unrecognized contingencies, the FASB decided to require that entities include only the disclosures required by SFAS 5 and that those disclosures be included in the business combination footnote; and (iii) Require that contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination be treated as contingent consideration of the acquirer and should be initially and subsequently measured at fair value in accordance with SFAS 141(R).

FSP FAS 141(R)-1 is effective for assets or liabilities arising from contingencies in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2009 for the Corporation. FSP FAS 141(R)-1 will prospectively impact the Corporation's financial statements to the extent acquisitions are recorded.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165). This standard is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, this standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 is effective for fiscal years and interim periods ended after June 15, 2009. The Corporation adopted this standard effective June 15, 2009 and has evaluated all of the subsequent events through the date of this filing. The Corporation does not believe there are any material subsequent events which would require further disclosure.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162* (SFAS 168). SFAS 168 provides for the FASB Accounting Standards Codification (the Codification) to become the single official source of authoritative, nongovernmental U.S. GAAP. The Codification did not change U.S. GAAP but reorganizes the literature. SFAS 168 is effective for interim and annual periods ending after September 15, 2009, which is the quarter ending September 30, 2009 for the Corporation.

In April 2009, the FASB issued FSP FAS No. 107-1 and APB No. 28-1, *Interim Financial Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1), which amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. FSP FAS 107-1 also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in summarized financial information at interim reporting periods. In addition, the FSP requires certain additional disclosures regarding the methods and significant assumptions used to estimate the fair value of financial instruments. This interpretation is effective for interim reporting periods ending after June 15, 2009. During the quarter ended June 30, 2009, the Corporation adopted FSP FAS 107-1 which did not have a significant impact on our condensed consolidated financial statements and related footnotes.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications have no impact on the Corporation's total assets, liabilities, stockholders' equity, net income, or cash flows.

NOTE 2 ACQUISITIONS

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations*. This statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as true mergers or mergers of equals and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to: i) the formation of a joint venture; ii) the acquisition of an asset or a group of assets that does not constitute a business; iii) a combination between entities or businesses under common control; iv) a combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The adoption of SFAS No. 141(R), prospectively, will have a material effect on the Corporation's results of operations and financial position to the extent the Corporation has acquisitions, as costs that have historically been capitalized as part of the purchase price will now be expensed, such as accounting, legal and other professional fees. For the three months and six months ended June 30, 2009, management has incurred costs of \$0.1 million related to pending acquisitions which have been classified as a component of integration, merger, acquisition related costs and other charges.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 2 ACQUISITIONS (Continued)***2008 Acquisitions*

On November 1, 2008, the Corporation acquired certain assets and assumed certain liabilities of an institutional pharmacy business providing medications, pharmacy, and medical supplies and services to residents of skilled nursing homes for \$21.5 million in cash. The transaction was accounted for as a purchase, in which the purchase price was allocated based upon the fair value of the assets acquired and liabilities assumed with the difference recorded as goodwill. As a result of the acquisition the Corporation recorded \$17.2 million as a finite lived intangible customer relationship and \$2.0 million as goodwill.

On July 9, 2008, the Corporation purchased the 49.0% minority interest held by a third-party in the Corporation's joint ventures. The Corporation paid approximately \$4.4 million in cash for the minority interest share of the joint ventures. The amount paid for the minority interest share of the joint ventures approximates fair value and resulted in the recognition of \$0.2 million in goodwill as a result of the transaction, of which approximately \$0.1 million included professional fees capitalized as part of the purchase price.

Other

The total amount of goodwill expected to be deductible for tax purposes from past acquisitions of the Corporation was \$101.1 million as of June 30, 2009. Deferred tax assets and liabilities are further described in Note 10.

The following pro forma consolidated financial information is not intended to represent or be indicative of the consolidated results of operations or financial condition of the Corporation that would have been reported had the 2008 acquisitions been completed as of the date or for the periods presented, and should not be taken as representative of the future consolidated results of operations or financial condition of the Corporation.

The pro forma effect of the acquisitions assuming the transactions occurred on January 1, 2008, excluding integration, merger and acquisition related costs, and other charges, would be as follows (dollars in millions, except per share amounts):

	Three Months Ended June 30, 2008	Six Months Ended June 30, 2008
Revenues	\$ 493.1	\$ 994.9
Net income	\$ 7.5	\$ 13.7
Earnings per common share:		
Basic	\$ 0.25	\$ 0.46
Diluted	\$ 0.25	\$ 0.46

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements consist of the following (dollars in millions):

	December 31, 2008	June 30, 2009
Leasehold improvements	\$ 8.9	\$ 9.0
Equipment and software	83.2	87.5

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Leased equipment	0.7	2.5
Construction in progress	4.3	5.8
	97.1	104.8
Accumulated depreciation	(43.1)	(51.6)
	\$ 54.0	\$ 53.2

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS (Continued)**

	Balance at December 31, 2008	Additions	Disposals	Transfers	Balance at June 30, 2009
Equipment and leasehold improvements:					
Leasehold improvements	\$ 8.9	\$ 0.4	\$ (0.3)	\$	\$ 9.0
Equipment and software	83.2	3.8	(0.5)	1.0	87.5
Leased equipment	0.7	1.8			2.5
Construction in progress	4.3	2.5		(1.0)	5.8
SubTotal	97.1	8.5	(0.8)		104.8
Accumulated depreciation	(43.1)	(8.9)	0.4		(51.6)
Total	\$ 54.0	\$ (0.4)	\$ (0.4)	\$	\$ 53.2

Depreciation expense totaled approximately \$5.6 million and \$4.2 million for the three months ended June 30, 2008 and 2009, respectively. Depreciation expense totaled approximately \$11.5 million and \$8.9 million for the six months ended June 30, 2008 and 2009, respectively.

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

Year Ending December 31,	
2009	\$ 17.0
2010	14.0
2011	9.6
2012	6.3
2013	3.3
Thereafter	3.8
Total	\$ 54.0

NOTE 4 GOODWILL AND INTANGIBLES

The following table presents the components of the Corporation's goodwill (dollars in millions):

Balance at December 31, 2008	\$ 113.7
Tax related adjustment associated with Pharmacy Transaction	1.4
Release of escrow deposit from 2008 acquisition	0.5

Balance at June 30, 2009

\$ 115.6

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 4 GOODWILL AND INTANGIBLES (Continued)**

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

	Balance at December 31, 2008	Balance at June 30, 2009
Finite Lived Intangible Assets		
Customer relationships	\$ 53.1	\$ 53.1
Trade name	27.9	27.9
Non-compete agreement	2.4	2.6
 Sub Total	 83.4	 83.6
Accumulated amortization	(10.0)	(13.7)
 Net intangible	 \$ 73.4	 \$ 69.9

Amortization expense relating to finite lived intangible assets was approximately \$1.6 million and \$1.9 million for the three months ended June 30, 2008 and 2009, respectively. Amortization expense was approximately \$3.2 million and \$3.7 million for the six months ended June 30, 2008 and 2009, respectively.

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

Year Ending December 31,	
2009	\$ 8.3
2010	6.0
2011	4.7
2012	4.7
2013	4.7
Thereafter	45.0
	 \$ 73.4

NOTE 5 CREDIT AGREEMENT

On July 31, 2007, the Corporation entered into a credit agreement among the Corporation, the Lenders named therein, and JPMorgan, as Administrative Agent (the "Credit Agreement"). The Credit Agreement consists of a \$275.0 million term loan facility and a \$150.0 million revolving credit facility; as of June 30, 2009, \$240.0 million was outstanding under the term loan facility and no amounts were outstanding under the revolving credit facility. Indebtedness under the Credit Agreement matures on July 31, 2012, at which time the commitment of the Lenders to make revolving loans also shall expire. There is no scheduled amortization under the term loan facility but the term loans are subject to certain prepayment obligations relating to asset sales, casualty losses, and the incurrence by the Corporation of certain indebtedness.

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

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	December 31, 2008	June 30, 2009
<i>2007 Credit Agreement:</i>		
Term Debt - payable to lenders at LIBOR plus applicable margin (1.9% as of June 30, 2009), matures July 31, 2012	\$ 240.0	\$ 240.0
Revolving Credit Facility payable to lenders, interest at LIBOR plus applicable margin, matures July 31, 2012		
Total debt	\$ 240.0	\$ 240.0

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 5 CREDIT AGREEMENT (Continued)**

Maturities of the Corporation's long-term debt are as follows for the years indicated (dollars in millions):

Year Ending December 31,	
2009	\$
2010	
2011	
2012	240.0
Total	\$ 240.0

The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of June 30, 2009, was \$2.7 million. After giving effect to the letters of credit, total availability under the revolving credit facility was \$147.3 million as of June 30, 2009.

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

The obligations of the Corporation under and related to the Credit Agreement are secured by substantially all of its assets. Those obligations are guaranteed by many of the Corporation's wholly owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of our direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries. The Credit Agreement also contains financial and non-financial affirmative and negative covenants, representations, warranties, and events of default that are customary to facilities of this nature.

Covenants

The Credit Agreement requires the Corporation to satisfy a fixed charge coverage ratio and a leverage ratio. The fixed charge coverage ratio, which is tested quarterly on a trailing four quarter basis, can be no less than: 2.25:1.00 during the period January 1, 2009 through December 31, 2009; and 2.50:1.00 thereafter. The leverage ratio, which also is tested quarterly, cannot exceed 3.50:1.00 during the period January 1, 2009 through December 31, 2009; and 3.00:1.00 thereafter. The leverage ratio is not tested when at any time it is less than 2.00:1.00, or both S&P and Moody's shall have in effect corporate credit ratings for the Corporation that are investment grade. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 3.0% of revenues.

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

Fixed Charge Coverage Ratio	Leverage Ratio	Capital Expenditure
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Requirement	> = 2.00 to 1.00	< = 4.50 to 1.00	< = 3.00%
December 31, 2008	3.67	1.99	1.13%
Requirement	> = 2.25 to 1.00	< = 3.50 to 1.00	< = 3.00%
June 30, 2009	4.08	2.00	**

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

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 5 CREDIT AGREEMENT (Continued)**

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

Interest Rate Swap

On the Closing Date, the Corporation entered into an interest rate swap agreement with JPMorgan as the counterparty. The interest rate swap agreement was effective as of the Closing Date and matured on July 31, 2009. The Corporation entered into the interest rate swap agreement to mitigate the floating interest rate risk on \$200.0 million of its outstanding variable rate borrowings. The interest rate swap agreement required the Corporation to make quarterly fixed rate payments to JPMorgan calculated on a notional amount set at an annual fixed rate of 5.123%, plus applicable margin (1.0%). JPMorgan was obligated to make quarterly floating payments to the Corporation based upon the three-month LIBO rate, plus applicable margin (1.0%) on the same referenced notional amount. The Corporation does not presently intend to replace the expired swap agreement.

Notwithstanding the terms of the interest rate swap transaction, the Corporation is ultimately obligated for all amounts due and payable under the Credit Agreement. The notional value of the swap is \$200.0 million as of June 30, 2009.

The Corporation assesses the effectiveness of its cash flow hedge instrument on a quarterly basis. The Corporation completed an assessment of the cash flow hedge instrument at June 30, 2009, and determined the hedge to be highly effective. The interest rate swap agreement exposes the Corporation to credit risk in the event of non-performance by JPMorgan and other participating financial institutions, however, the Corporation does not anticipate non-performance by the parties to the agreement. The Corporation does not hold or issue derivative financial instruments for trading purposes.

The fair value of the interest rate swap agreement is based on estimates of the amount at which it could be settled. The Corporation has designated the interest rate swap as a cash flow hedge instrument, which is recorded in the Corporation's accompanying condensed consolidated balance sheets at its fair value. The fair value of the Corporation's interest rate swap is recorded as follows:

Balance Sheet Location	Asset Derivative		Liability Derivative	
	December 31, 2008	June 30, 2009	December 31, 2008	June 30, 2009
Derivative financial instrument (interest rate swap)	\$	\$	\$ (4.9)	\$ (0.7)

The following table presents the impact of derivative instruments and their location within the unaudited condensed consolidated financial statements:

	Amount of (Gain) Loss Recognized in AOCI on Derivative (Effective Portion)		Amount of (Gain) Loss Recognized in income on Derivative (Ineffective Portion)	
	Three Months Ended June 30,		Three Months Ended June 30,	
	2008	2009	2008	2009
Derivative financial instrument (interest rate swap)	\$ (2.0)	\$ (1.2)	\$	\$

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	Amount of (Gain) Loss Recognized in AOCI on Derivative (Effective Portion) Six Months Ended June 30,		Amount of (Gain) Loss Recognized in income on Derivative (Ineffective Portion) Six Months Ended June 30,	
	2008	2009	2008	2009
	Derivative financial instrument (interest rate swap)	\$ 0.3	\$ (2.4)	\$

Deferred Financing Fees

The Corporation capitalized a total of \$2.0 million in deferred financing fees associated with the Credit Agreement and recorded them as other assets in the accompanying condensed consolidated balance sheet. The Corporation amortizes the financing fees under the straight-line method over the term of the Credit Agreement. As of June 30, 2009, the Corporation had \$1.3 million of unamortized deferred financing fees.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

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

Effective October 1, 2007, CMS promulgated new rules under the Deficit Reduction Act of 2005 DRA (DRA) changing the federal upper payment limit for Medicaid reimbursement from 150% of the lowest published price for a drug (which is usually the average wholesale price) to 250% of the lowest average manufacturer price or AMP. Although the use of an AMP benchmark would have reduced Medicaid reimbursement rates for certain generic pharmaceuticals, it did not take effect due to a December 19, 2007 federal district court injunction against CMS prohibiting the agency from implementing the rule. The outcome of the AMP litigation is uncertain, and there can be no assurance that changes in reimbursement formula under the DRA or future legislation or regulation will not have an adverse impact on our business and results of operations.

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

In June 2008, First DataBank, Inc. reported that it filed amendments with the Court to a previously proposed settlement. On March 30, 2009, the Court gave final approval to First DataBank's amended and restated settlement agreement. According to the terms of the settlement agreement, First DataBank will: (i) adjust its reporting of Blue Book AWP for those prescription drugs (approximately 1,400 NDCs in number) identified in the plaintiffs' previously filed complaint by reducing the mark-up factor utilized in connection with the calculation of the Blue Book AWP data field to 1.20 times the Wholesale Acquisition Cost, or WAC, or direct price for those prescription drugs that are on a mark-up basis; and (ii) establish a centralized data repository to facilitate reasonable access to discoverable material from First DataBank concerning its drug price reporting practices. The price adjustment will occur September 26, 2009. Appeals of this settlement by several organizations, including the National Association of Chain Drug Stores, The National Community Pharmacists Association, and the Long-Term Care Pharmacy Alliance, are pending.

Independent of the settlement and on the same schedule as the Blue Book AWP adjustment noted above, First DataBank intends to apply the same 1.20 markup factor to all other National Drug Codes, or NDCs, whose Blue Book AWP is set based upon a markup to WAC or direct price in excess of 1.20. First DataBank will also independently discontinue publishing the Blue Book AWP data field for all drugs no later than two years following the date that the Blue Book AWP adjustments noted above are implemented.

Currently, we are unable to fully evaluate the potential impact of this settlement. There can be no assurance that changes in the calculation of AWP will not have an adverse impact on our business and results of operation.

Acquisitions

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

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)**

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

Prime Vendor Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the *Prime Vendor Agreement*), with AmerisourceBergen Drug Corporation (*ABDC*), a wholly owned subsidiary of AmerisourceBergen, the Corporation's former 50% stockholder and former parent of PharMerica LTC. Pursuant to this agreement, the Corporation has agreed to purchase at least 95% of the Corporation's prescription pharmaceutical drugs from ABDC and to participate in its generic formulary purchase program for a period of five years following the Closing Date. In addition, ABDC will support the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provide inventory management support and packaging services. Unless either party provides certain notice of termination, the agreement will continue on a month-to-month basis upon expiration of the initial five year term. The agreement may be terminated by either party for cause during the initial five year term, and by either party with or without cause thereafter upon 90 days notice. The Corporation is in compliance with the Prime Vendor Agreement as of June 30, 2009.

Information Technology Services Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (*KHOI*), a wholly owned subsidiary of Kindred, the Corporation's former 50% stockholder (the *IT Services Agreement*). Pursuant to this agreement, KHOI will be the Corporation's exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years, ending on July 31, 2012. The services provided by KHOI will include business services necessary to operate, manage, and support certain financial applications the Corporation uses, including enabling and/or supporting technology infrastructure and technology procurement services to support certain business functions. Such services will include, among other matters, functions for financial management, systems, and payroll. The Corporation will support internally all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records management, human resources, internal and external customer call center support, and general business systems.

Except for certain services which will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The initial term of the agreement is five years. The agreement shall automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior notice of termination as provided for in the agreement. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation's competitors. Following termination of the agreement, KHOI must provide termination and expiration assistance for up to 180 days. The Corporation has incurred \$5.0 million and \$2.8 million for the three months ended June 30, 2008 and 2009, respectively, under the IT Services Agreement. The Corporation has incurred \$9.4 million and \$5.7 million for the six months ended June 30, 2008 and 2009, respectively, under the IT Services Agreement. As of June 30, 2009, the Corporation has approximately \$1.9 million in accounts payable related to the IT Services Agreement.

Employment Agreements

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

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)**

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

Leases

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Pharmacy locations and administrative offices lease expense	\$ 4.2	\$ 3.4	\$ 8.6	\$ 7.0
Office equipment lease expense	1.8	0.7	3.4	1.3
Total lease expense	\$ 6.0	\$ 4.1	\$ 12.0	\$ 8.3

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

Ending December 31,	Operating Leases	Capital Lease Obligations	Total
2009	\$ 14.7	\$ 0.5	\$ 15.2
2010	11.9	0.6	12.5
2011	7.9	0.6	8.5
2012	5.6	0.2	5.8
2013	4.5		4.5
Thereafter	9.6		9.6
Total	\$ 54.2	\$ 1.9	\$ 56.1
Less: interest portion		(0.1)	
Long-term obligations under capital lease		\$ 1.8	

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 7 REVENUES**

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

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

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

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

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

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2008		2009		2008		2009	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Medicare Part D	\$ 217.2	44.7%	\$ 209.4	45.5%	\$ 446.1	45.5%	\$ 424.5	45.7%
Institutional healthcare providers	146.4	30.1	138.8	30.1	292.7	29.8	279.8	30.1
Medicaid	44.9	9.2	42.2	9.2	92.4	9.4	85.6	9.2
Private and other	34.0	7.0	31.4	6.8	64.9	6.6	60.3	6.5
Insured	26.2	5.4	22.7	4.9	50.1	5.1	46.0	5.0
Medicare	2.6	0.5	2.0	0.4	5.3	0.5	3.7	0.4
Hospital management fees	15.0	3.1	14.1	3.1	29.9	3.1	28.9	3.1
Total	\$ 486.3	100.0%	\$ 460.6	100.0%	\$ 981.4	100.0%	\$ 928.8	100.0%

Co-payments for the Corporation's services can be applicable under Medicare Part D, the state Medicaid programs, and certain third party payers and are typically not collected at the time products are delivered or services are provided. Co-payments under the Medicaid programs and third

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party plans are generally billed to the responsible party as part of the Corporation's normal billing procedures and are subject to the Corporation's normal collection procedures.

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

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

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 8 INTEGRATION, MERGER AND ACQUISITION RELATED COSTS AND OTHER CHARGES**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Integration costs and other charges:				
Professional and advisory fees	\$ 0.9	\$	\$ 1.1	\$
General and administrative	1.0	0.1	2.1	0.3
Employee costs	2.4	0.2	4.0	1.0
Severance costs	1.4	0.2	1.7	0.6
Facility costs	0.9		1.8	0.6
	6.6	0.5	10.7	2.5
Acquisition costs:				
Professional and advisory fees		0.1		0.1
Other costs				
		0.1		0.1
Total integration, merger, and acquisition related costs and other charges	\$ 6.6	\$ 0.6	\$ 10.7	\$ 2.6
Negative effect on diluted earnings per share	\$ (0.12)	\$ (0.01)	\$ (0.20)	\$ (0.05)

The Corporation incurred integration, merger, and acquisition related costs and other charges through June 30, 2009, related to the consolidation of pharmacies within a similar location and costs to convert data and integrate systems. All pharmacy consolidations were completed as of February 28, 2009. In fiscal year 2009, we began the integration of our pharmacy system platforms. The Corporation currently expects to incur costs related to the integration of its pharmacy system platforms during fiscal years ended December 31, 2009 and 2010.

The Corporation accounts for integration, merger and acquisition related costs and other charges in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. During the six months ended June 30, 2009, there was one pharmacy location impacted by consolidation.

The Corporation accounts for acquisition costs in accordance with SFAS 141(R). During the three and six months ended June 30, 2009, there were \$0.1 million of costs incurred related to pending acquisitions.

NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS*Common Stock*

Holders of the Corporation's common stock are entitled to one vote for each share held of record on all matters on which stockholders may vote. There are no preemptive, conversion, redemption, or sinking fund provisions applicable to our common stock. In the event of liquidation,

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dissolution, or winding up, holders of common stock are entitled to share ratably in the assets available for distribution, subject to any prior rights of any holders of preferred stock then outstanding. Delaware law prohibits the Corporation from paying any dividends unless it has capital surplus or net profits available for this purpose. In addition, the Corporation's Credit Agreement imposes restrictions on its ability to pay dividends.

Preferred Stock

The certificate of incorporation authorizes the issuance of an aggregate of 1.0 million shares of preferred stock. As of June 30, 2009, there were no shares of preferred stock outstanding.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)**

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

Amended and Restated 2007 Omnibus Incentive Plan

On July 12, 2007, the Corporation adopted the PharMerica Corporation 2007 Omnibus Incentive Plan, as amended in fiscal year 2008, (Omnibus Plan) under which the Corporation is authorized to grant equity-based and other awards to its employees, officers, directors, and consultants. The Corporation has reserved 3,800,000 shares of its common stock for awards to be granted under the Omnibus Plan plus 534,642 shares reserved for substitute equity awards for employees of KPS and PharMerica LTC whose awards were cancelled or forfeited upon the consummation of the Pharmacy Transaction. The Corporation's Compensation Committee administers the Omnibus Plan and has the authority to determine the recipient of the awards, the types of awards, the number of shares covered, and the terms and conditions of the awards. The Omnibus Plan allows for grants of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock and restricted stock units, deferred shares, performance awards, including cash bonus awards, and other stock-based awards. The Compensation Committee establishes long-term and short-term incentive programs under the Omnibus Plan. On July 24, 2008, the Corporation's stockholders approved an amendment to the Omnibus Plan to provide the Compensation Committee with increased flexibility to use non-GAAP measures to measure performance, including the ability to exclude from the performance measures certain items or charges related to an event or occurrence that the Compensation Committee determines should be excluded in accordance with the performance criteria of performance awards granted pursuant to the Omnibus Plan. In connection with the Corporation's 2009 Annual Meeting of Stockholders, the stockholders of the Corporation approved and adopted the amended and restated Omnibus Plan to preserve preferential tax treatment as qualified performance-based compensation under Section 162(m) of the Code.

The stock options granted under the Omnibus Plan to replace options granted by Kindred or AmerisourceBergen that were cancelled or forfeited upon the consummation of the Pharmacy Transaction have the same basic terms, conditions, and vesting schedule of the awards granted to them by Kindred and AmerisourceBergen. In addition, unvested restricted shares of Kindred and AmerisourceBergen common stock held by our named executive officers who were formerly KPS or PharMerica LTC employees were replaced with restricted shares of the Corporation's common stock, which have the same basic terms, conditions, and vesting schedule as applied to the forfeited Kindred or AmerisourceBergen restricted shares.

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

As of June 30, 2009, total shares available for grants of stock based awards pursuant to the Omnibus Plan were 1,543,318 shares.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)***Stock-Based Compensation Expense*

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Stock option compensation expense	\$ 0.6	\$ 0.6	\$ 0.9	\$ 0.9
Nonvested stock compensation expense	0.5	0.7	1.2	1.0
Total Stock Compensation Expense	\$ 1.1	\$ 1.3	\$ 2.1	\$ 1.9
Negative effect on diluted earnings per share	\$ (0.02)	\$ (0.03)	\$ (0.04)	\$ (0.04)

As of June 30, 2009, there was \$12.0 million of total unrecognized compensation cost related to the Corporation's stock-based compensation arrangements. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. The Corporation expects to recognize that cost over weighted average periods ranging from fewer than 1.0-2.22 years depending on the type of awards granted.

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

Year Ending December 31,	
2009	\$ 5.0
2010	5.2
2011	2.7
2012	0.9
2013	0.1
Thereafter	
Total	\$ 13.9

The following weighted average assumptions were used to estimate the fair value of options granted during 2008 and the six months ended June 30, 2009, using the Black-Scholes Merton option-pricing model:

	2008	2009
Expected volatility (range)	33.3 - 41.7%	36.36 - 41.07%
Risk free interest rate (range)	1.53 - 2.45%	0.93 - 2.09%
Expected dividends		

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Average expected term (years)	2.0 - 5.0	2.0 - 5.0
Fair value per share of stock options granted based on the Black-Sholes-Merton model	\$ 4.67	\$ 4.42

Expected Volatility

Volatility is a measure of the tendency of investment returns to vary around a long-term average rate. Historical volatility is an appropriate starting point for setting this assumption. Companies should also consider how future experience may differ from the past. This may require using other factors to adjust historical volatility, such as implied volatility, peer-group volatility and the range and mean-reversion of volatility estimates over various historical periods. The peer-group utilized consisted of twelve and fourteen companies in 2008 and 2009, respectively, in the same or similar industries as the Corporation. In addition, if a best estimate cannot be made, management should use the mid-point in the range of reasonable estimates for volatility. The Corporation estimates the volatility of its common stock in conjunction with the Corporation's annual grant and volatility is calculated utilizing the historical volatility of the Corporation's and its peer-group. To the extent material grants are made subsequent to the Corporation's annual grant, the volatility calculation is updated through the most recent grant date of the awards.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 9 COMMON STOCK, PREFERRED STOCK, STOCK BASED COMPENSATION AND OTHER BENEFITS (Continued)***Risk-Free Interest Rate*

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

Expected Dividends

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

Expected Term

The Corporation calculated an expected term using management's estimate and expectation of option exercises. The majority of the Corporation's stock options are on a graded-vesting schedule. The Corporation is permitted to estimate the value of awards with graded vesting by treating each vesting tranche as a separate award. Alternatively, the award may be valued as a single award. Management has determined to value each tranche of the awards separately utilizing a multiple fair value method.

Stock Option Activity

During the six months ended June 30, 2009, the Compensation Committee granted 538,363 stock options under the Omnibus Plan with grant prices ranging from \$14.89 to \$18.25. The weighted average fair value based on the Black-Scholes option pricing model for stock options granted for the six months ended June 30, 2008 and 2009 was \$4.29 and \$4.42 per share, respectively. The fair value of stock options exercised for the six months ended June 30, 2008 and 2009, was less than \$0.1 million and \$0.2 million, respectively. The total fair value of options vested was \$1.2 million and \$0.9 million for the six months ended June 30, 2008 and 2009, respectively. Cash received from stock option exercises for the six months ended June 30, 2009, was \$0.3 million.

During 2008, the Compensation Committee granted 324,507 stock options under the Omnibus Plan with grant prices ranging from \$15.10 to \$23.79. The weighted average fair value based on the Black-Scholes option pricing model for stock options granted during 2008 was \$4.67 per share.

The following table summarizes option activity for the periods presented:

	Number of Shares	Weighted- Average Exercise Price Per Share	Weighted- Average Remaining Term	Aggregate Intrinsic Value (in millions)
Outstanding at December 31, 2007	1,270,383	\$ 15.23	6.8 years	
Granted	324,507	15.65		
Exercised	(67,878)	13.28		
Canceled	(194,363)	14.88		
Outstanding at December 31, 2008	1,332,649	\$ 15.47	5.7 years	\$ 0.9

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Granted	538,363		15.19		
Exercised	(25,785)		12.33		
Canceled	(26,085)		14.25		
Outstanding at June 30, 2009	1,819,142	\$	15.47	5.6 years	\$ 7.6
Exercisable at June 30, 2009	543,823	\$	14.83	5.0 years	\$ 2.6

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During the six months ended June 30, 2009, the Compensation Committee granted 32,534 shares of restricted stock and 152,580 performance share units under the Omnibus Plan. The total fair value of shares vested for the six months ended June 30, 2008 and 2009, was \$0.9 million and \$0.1 million, respectively. During 2008, the Compensation Committee granted 72,548 shares of restricted stock and 68,275 performance share units under the Omnibus Plan.

Based upon the achievement of the performance criteria at the end of the performance cycle for the performance share units issued to date, the Corporation may issue no shares or a maximum of 429,909 shares.

	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding shares at December 31, 2007	360,904	\$ 15.13
Granted	140,823	16.83
Forfeited	(33,578)	12.84
Vested	(125,558)	16.23
Outstanding at December 31, 2008	342,591	\$ 15.93
Granted	185,114	15.70
Forfeited	(3,848)	13.27
Vested	(16,358)	4.38
Outstanding at June 30, 2009	507,499	\$ 16.25

401K Plan

The Corporation sponsors a defined contribution retirement plan for all eligible employees, as defined in the plan document. The plan is qualified under Section 401(k) of the Internal Revenue Code. Contributions to the plan are based upon employee contributions and the Corporation's matching contributions. The Corporation's matching contributions to the plan were \$1.5 million and \$1.3 million for the three months ended June 30, 2008 and 2009, respectively, and \$3.1 million and \$2.7 million for the six months ended June 30, 2008 and 2009, respectively.

Deferred Compensation Plans

The Corporation maintains a deferred compensation plan for certain management and highly compensated employees. Under the plan, a participant may elect to defer up to 50% of such participant's annual base salary and up to 100% of such participant's annual short-term incentive program cash bonus into the plan during each plan year. In addition, the Corporation may, in its sole discretion, make discretionary contributions to a participant's account.

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The Corporation also maintains a deferred compensation plan for the directors of the Corporation. The directors of the Corporation may elect to defer up to 100% of their cash fees and their stock fees in any one year. If a director elects to defer his/her restricted stock grant, the stock will be deferred as it vests.

As of December 31, 2008 and June 30, 2009, the Corporation had \$1.4 million and \$2.4 million, respectively, recognized as a liability related to the deferred compensation plans in the accompanying condensed consolidated balance sheets.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 10 INCOME TAXES**

The provision for income taxes is based upon the Corporation's estimate of annual taxable income or loss for each respective accounting period. The following table summarizes our provision for income taxes for the periods presented (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Tax provision	\$ 2.2	\$ 6.6	\$ 4.7	\$ 11.9
Total provision as a percentage of income	43.3%	41.9 %	43.4%	40.6 %

The decrease in our provision for income taxes as a percentage of taxable income for the six months ended June 30, 2009, compared to the comparable 2008 period, was primarily the result of a fourth quarter 2008 favorable tax ruling on specific permanent items, partially offset by a permanent rate item related to an indemnified claim payment. The effective tax rates in 2009 and 2008 are higher than the federal statutory rate largely as a result of the combined impact of state and local income taxes and various non-deductible expenses.

The Corporation derives a current federal and state income tax benefit from the impact of deductions associated with the amortization of tax-deductible goodwill acquired in the 2007 Pharmacy Transaction. At the transaction date, the tax basis of this goodwill was \$126.3 million, amortizable over a remaining life for tax purposes of approximately six years. The tax basis of this goodwill was approximately \$80.8 million and \$64.8 million at December 31, 2008 and June 30, 2009, respectively. The future tax benefits of the tax-deductible goodwill are included in the Corporation's deferred tax assets.

The Corporation recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Corporation also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards. As of June 30, 2009, the Corporation has tax benefits from federal net operating loss carryforwards of \$14.3 million. A valuation allowance is provided for the Corporation's deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized. The Corporation recognized deferred tax assets totaling \$84.3 million at December 31, 2008 and \$69.4 million at June 30, 2009, net of valuation allowances of \$10.3 million and \$6.4 million, respectively.

NOTE 11 EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share (in millions, except share and per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Numerator:				
Numerator for basic and diluted earnings per share - net income	\$ 2.9	\$ 9.2	\$ 6.2	\$ 17.4
Denominator:				
	30,074,443	30,231,797	30,069,686	30,221,804

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Denominator for basic earnings per share - weighted average shares

Effective of dilutive securities:

Employee stock options	45,763	61,041	21,141	50,838
Employee restricted shares	56,386	73,802	34,841	58,350

Denominator for diluted earnings per share - adjusted weighted average shares

30,176,592	30,366,640	30,125,668	30,330,992
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Basic earnings per share	\$ 0.10	\$ 0.30	\$ 0.21	\$ 0.58
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Diluted earnings per share	\$ 0.10	\$ 0.30	\$ 0.21	\$ 0.57
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Stock options and restricted stock shares granted by the Corporation are treated as potential common shares outstanding in computing diluted earnings per share.

Table of Contents**PHARMERICA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)****(Unaudited)****NOTE 12 BUSINESS SEGMENT DATA**

The Corporation operates in two business segments: institutional pharmacies and hospital pharmacy management. Institutional pharmacies provide pharmacy services to nursing centers and other healthcare providers and the hospital pharmacy management business provides management services to substantially all of Kindred's hospitals. For business segment reporting purposes, the Corporation defines segment operating income as earnings before interest, income taxes, depreciation, amortization, and rent. Segment operating income reported for each of the Corporation's business segments excludes the allocation of corporate overhead.

The Corporation identifies its segments in accordance with the aggregation provisions. This information is consistent with information used by the Corporation in managing its businesses.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2009	2008	2009
Revenues:				
Institutional pharmacies	\$ 471.3	\$ 446.5	\$ 951.5	\$ 899.9
Hospital pharmacy management	15.0	14.1	29.9	28.9
	\$ 486.3	\$ 460.6	\$ 981.4	\$ 928.8
Net income:				
Segment operating income:				
Institutional pharmacies	\$ 25.9	\$ 28.5	\$ 50.7	\$ 55.7
Hospital pharmacy management	2.5	1.4	4.8	3.6
Segment operating income	28.4	29.9	55.5	59.3
Rent	(6.0)	(4.1)	(12.0)	(8.3)
Depreciation and amortization	(7.2)	(6.1)	(14.7)	(12.6)
Integration, merger and acquisition related costs and other charges	(6.6)	(0.6)	(10.7)	(2.6)
Interest expense, net	(3.5)	(3.3)	(7.2)	(6.5)
Income before income taxes	5.1	15.8	10.9	29.3
Provision for income taxes	2.2	6.6	4.7	11.9
Net income	\$ 2.9	\$ 9.2	\$ 6.2	\$ 17.4
Rent:				
Institutional pharmacies	\$ 6.0	\$ 4.1	\$ 12.0	\$ 8.3
Hospital pharmacy management	\$ 6.0	\$ 4.1	\$ 12.0	\$ 8.3
Depreciation and amortization:				
Institutional pharmacies	\$ 7.2	\$ 6.1	\$ 14.7	\$ 12.6
Hospital pharmacy management	\$ 7.2	\$ 6.1	\$ 14.7	\$ 12.6

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	\$ 7.2	\$ 6.1	\$ 14.7	\$ 12.6
Capital expenditures, excluding acquisitions:				
Institutional pharmacies	\$ 3.6	\$ 3.3	\$ 11.8	\$ 8.3
Hospital pharmacy management				
	\$ 3.6	\$ 3.3	\$ 11.8	\$ 8.3
	December 31,	June 30,		
	2008	2009		
Assets:				
Institutional pharmacies	\$ 671.4	\$ 676.0		
Hospital pharmacy management	7.8	8.2		
	\$ 679.2	\$ 684.2		
Goodwill:				
Institutional pharmacies	\$ 113.7	\$ 115.6		
Hospital pharmacy management				
	\$ 113.7	\$ 115.6		

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Report on Form 10-Q contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which reflect the Corporation's current estimates, expectations and projections about the Corporation's future results, performance, prospects and opportunities. Forward-looking statements include, among other things, the information concerning the Corporation's possible future results of operations including revenue, costs of goods sold, and gross margin, business and growth strategies, financing plans, the Corporation's competitive position and the effects of competition, the projected growth of the industries in which we operate, and the Corporation's ability to consummate strategic acquisitions. Forward-looking statements include statements that are not historical facts and can be identified by forward-looking words such as anticipate, believe, could, estimate, expect, intend, plan, may, should, will, would, project, and similar expressions. These forward-looking statements are based upon information currently available to the Corporation and are subject to a number of risks, uncertainties, and other factors that could cause the Corporation's actual results, performance, prospects, or opportunities to differ materially from those expressed in, or implied by, these forward-looking statements. Important factors that could cause the Corporation's actual results to differ materially from the results referred to in the forward-looking statements the Corporation makes in this report include:

the Corporation's access to capital, credit ratings, indebtedness, and ability to raise additional financings and operate under the terms of the Corporation's debt obligations;

certain restrictions resulting from continuing relationships with the Corporation's former parent companies;

the effects of intense competition in the markets in which we operate;

the effects of retaining existing customers and service contracts and the Corporation's ability to attract new customers for growth of the Corporation's business;

the effects of renegotiating contract pricing relating to significant customers, supplier, including the hospital pharmacy segment which is substantially related to service provided to one customer;

the effects of the loss or bankruptcy of or default by any significant customer, supplier, or other entity relevant to the Corporation's operations;

the Corporation's ability to successfully pursue the Corporation's development activities and successfully integrate new operations and systems, including the realization of anticipated revenues, economies of scale, cost savings, and productivity gains associated with such operations;

the impact of the First Data Bank settlement agreement on the reimbursement the Corporation receives for its products and services and the ability to successfully implement the conversion of AWP pricing;

the Corporation's ability to control costs, particularly labor and employee benefit costs, rising pharmaceutical costs, and regulatory compliance costs;

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the effects of healthcare reform and government regulations, including proposals being contemplated by the current administration, interpretation of regulations, and changes in the nature and enforcement of regulations governing the healthcare and institutional pharmacy services industries;

changes in the reimbursement rates or methods of payment from Medicare and Medicaid and other third party payers, or the implementation of other measures to reduce the reimbursement for the Corporation's products and services or the services of the Corporation's customers;

the potential impact of state government budget shortfalls and their ability to pay the Corporation and its customers for services provided;

the Corporation's ability, and the ability of the Corporation's customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;

the ability to obtain financing for acquisitions from the various lenders in the senior secured credit facility;

the effects of changes in the interest rate on the Corporation's outstanding floating rate debt instrument and the increases or decreases in interest expense;

further consolidation of managed care organizations and other third party payers;

political and economic conditions nationally, regionally, and in the markets in which we operate;

natural disasters, war, civil unrest, terrorism, fire, floods, tornadoes, earthquakes, hurricanes, or other matters beyond the Corporation's control;

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increases in energy costs, including state and federal taxes, and the impact on the costs of delivery expenses and utility expenses;

elimination of, changes in, or the Corporation's failure to satisfy pharmaceutical manufacturers' rebate programs;

the Corporation's ability to attract and retain key executives, pharmacists, and other healthcare personnel;

the Corporation's ability to comply with the terms of its Corporate Integrity Agreement entered into between the Office of Inspector General of the Department of Health and Human Services and PharMerica LTC on March 29, 2005;

the Corporation's risk of loss not covered by insurance;

the outcome of litigation to which the Corporation is a party from time to time, including adverse results in material litigation or governmental inquiries;

changes in accounting rules and standards, audits, compliance with the Sarbanes-Oxley Act, and regulatory investigations;

the effects on the Corporation's results of operations related to the accounting for the costs of acquisitions as a result of new accounting rules;

changes in market conditions that would result in the impairment of goodwill or other assets of the Corporation;

changes in market conditions in which we operate that would influence the value of the Corporation's stock;

changes in volatility of the Corporation's stock price and the risk of litigation following a decline in the price of the Corporation's stock price;

the Corporation's ability to anticipate a shift in demand for generic drug equivalents;

the effects of changes to critical accounting estimates; and

other factors, risks, and uncertainties referenced in the Corporation's filings with the Commission, including the Risk Factors set forth in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2008.

YOU ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON ANY FORWARD-LOOKING STATEMENTS, ALL OF WHICH SPEAK ONLY AS OF THE DATE OF THIS QUARTERLY REPORT. EXCEPT AS REQUIRED BY LAW, WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR RELEASE ANY REVISIONS TO THESE FORWARD-LOOKING STATEMENTS TO REFLECT ANY EVENTS OR CIRCUMSTANCES AFTER THE DATE OF THIS QUARTERLY REPORT OR TO REFLECT THE OCCURRENCE OF UNANTICIPATED EVENTS. ALL SUBSEQUENT WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS ATTRIBUTABLE TO US OR ANY PERSON ACTING ON THE CORPORATION'S BEHALF ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THE CAUTIONARY STATEMENTS CONTAINED OR REFERRED TO IN THIS SECTION AND IN OUR RISK FACTORS SET FORTH IN PART I, ITEM 1A OF THE CORPORATION'S

ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2008, AND IN OTHER REPORTS FILED WITH THE SEC BY THE CORPORATION.

General

The Corporation was formed on October 23, 2006, by Kindred Healthcare, Inc. (Kindred or Former Parent) and AmerisourceBergen Corporation (AmerisourceBergen) for the purpose of consummating the transactions contemplated by the Master Transaction Agreement dated October 25, 2006, as amended (the Master Agreement). Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through a series of transactions (collectively, the Pharmacy Transaction), spun-off and combined their respective institutional pharmacy businesses, Kindred Pharmacy Services (KPS) and PharMerica Long-Term Care (PharMerica LTC), into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007 (the Closing Date).

The condensed consolidated financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this quarterly report on Form 10-Q as of and for the three months and six months ended June 30, 2009 reflect the financial position, results of operations, and cash flows of the Corporation.

Unless the context otherwise requires, all references to we, us, our, and Corporation refer to PharMerica Corporation and its subsidiaries.

Table of Contents**The Corporation's Business and Industry Trends*****Institutional Pharmacy Business***

The Corporation is the second largest institutional pharmacy services company in the United States based on revenues. We service healthcare facilities and provide management pharmacy services to hospitals. The Corporation operates 95 institutional pharmacies in 40 states. The Corporation's customers are typically institutional healthcare providers, such as skilled nursing facilities, assisted living facilities, hospitals, and other long-term alternative care settings. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 85 hospitals in the United States.

Our core business provides pharmacy products and services to residents and patients in skilled nursing facilities, assisted living facilities, hospitals, and other long-term alternative care settings. We purchase, repackage, and dispense prescription and non-prescription pharmaceuticals in accordance with physician orders and deliver such medication to healthcare facilities for administration to individual patients and residents. Depending on the specific location, we service healthcare facilities typically within a radius of 120 miles or less of our pharmacy locations at least once each day. Each pharmacy provides 24-hour, seven-day per week on-call pharmacist services for emergency dispensing, delivery, and/or consultation with the facility's staff or the resident's attending physician. We also provide various supplemental healthcare services that complement our institutional pharmacy services.

We offer prescription and non-prescription pharmaceuticals to our customers through unit dose or modified unit dose packaging, dispensing, and delivery systems, typically in a 15 - 30-day supply. Unit dosed medications are packaged for dispensing in individual doses as compared to bulk packaging used by most retail pharmacies. The customers we serve prefer the unit dose delivery system over the bulk delivery system employed by retail pharmacies because it improves control over the storage and ordering of drugs and reduces errors in drug administration in healthcare facilities. Nursing staff in our customers' facilities administer the pharmaceuticals to individual patients and residents.

Our computerized dispensing and delivery systems are designed to improve efficiency and control over distribution of medications to patients and residents. We provide computerized physician orders and medication administration records for each patient or resident on a monthly basis as requested. Data from these records are formulated into monthly management reports on patient or resident care and quality assurance. This system improves efficiencies and nursing time, reduces drug waste, and lowers adverse drug reactions.

Consultant Pharmacist Services

Federal and state regulations mandate that long-term care facilities, in addition to providing a source of pharmaceuticals, retain consultant pharmacist services to monitor and report on prescription drug therapy in order to maintain and improve the quality of resident care. The Omnibus Budget Reconciliation Act of 1987 (OBRA of 1987) implemented in 1990 sought to further upgrade and standardize care by setting forth more stringent standards relating to planning, monitoring, and reporting on the progress of prescription drug therapy, as well as overall drug usage. In addition, the Centers for Medicare & Medicaid Services (CMS) issued revised guidelines to surveyors of long-term care facilities which, effective December 18, 2006, expanded the scope and detail in which surveyors are assessing pharmacy services at facilities, including consultant pharmacy services. In addition, on September 30, 2008, the United States Department of Health and Human Services (HHS) Office of Inspector General published *OIG Supplemental Compliance Program Guidance for Nursing Facilities*. With quality of care the first risk area identified, the supplemental guidance is part of a series of recent government efforts focused on improving quality of care at skilled nursing and long-term care facilities. The guidance contains new compliance recommendations and an expanded discussion of risk areas. The guidance stressed that facilities must provide pharmaceutical services to meet the needs of each resident and should be mindful of potential quality of care problems when implementing policies and procedures on proper medication management. It further stated that facilities can reduce risk by educating staff on medication management and improper pharmacy kickbacks for consultant pharmacists and that facilities should review the total compensation paid to consultant pharmacists to ensure it is not structured in a way that reflects the volume or value of particular drugs prescribed or administered to residents.

We provide consultant pharmacist services that help our customers comply with the federal and state regulations applicable to nursing homes. The services offered by our consultant pharmacists include:

Monthly reviews of each resident's drug regimen to assess the appropriateness and efficacy of drug therapies, including the review of medical records, monitoring drug interactions with other drugs or food, monitoring laboratory test results, and recommending alternative therapies;

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Participation on quality assurance and other committees of our customers, as required or requested by such customers;

Monitoring and reporting on facility-wide drug utilization;

Development and maintenance of pharmaceutical policy and procedure manuals; and

Assistance with federal and state regulatory compliance pertaining to resident care.

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These services, while costly, may be replicated by local providers.

Ancillary Services

The Corporation provides intravenous drug therapy products and services to its customers. We provide intravenous (IV) (or infusion therapy) products and services for these client facilities as well as hospice and home care patients. Infusion therapy consists of the product (a nutrient, antibiotic, chemotherapy, or other drugs in solution) and the intravenous administration of the product.

We prepare the product to be administered using proper equipment in an aseptic environment and then deliver the product to the nursing home for administration by the nursing staff. Proper administration of IV drug therapy requires a highly trained nursing staff. Upon request, our nurse consultants provide an education and certification program on IV therapy to assure proper staff training and compliance with regulatory requirements in client facilities offering an IV therapy program.

Hospital Pharmacy Management Services

We also provide hospital pharmacy management services. These services generally entail the overall management of the hospital pharmacy operations, including the ordering, receipt, storage, and dispensing of pharmaceuticals to the hospital's patients pursuant to the clinical guidelines established by the hospital. We offer the hospitals a wide range of regulatory and financial management services, including inventory control, budgetary analysis, staffing optimization, and assistance with obtaining and maintaining applicable regulatory licenses, certifications, and accreditations. We work with the hospitals to develop and implement pharmacy policies and procedures, including drug formulary development and utilization management. We also offer clinical pharmacy programs that encompass a wide range of drug therapy and disease management protocols, including protocols for anemia treatment, infectious diseases, wound care, nutritional support, renal dosing, and therapeutic substitution. The hospital pharmacy management services segment is comprised of a few customers, of which, our largest service is to substantially all of Kindred's hospitals.

Additional business segment information is set forth in Part I, Item 1 *Financial Statements* and Note 12 *Business Segment Data* to the condensed consolidated financial statements of this quarterly report on Form 10-Q as of June 30, 2009.

Customers

Institutional Care Settings. Our customers are typically institutional healthcare providers, such as skilled nursing facilities, nursing centers, assisted living facilities, hospitals, and other long-term alternative care settings. We are generally the primary source of supply of pharmaceuticals for our customers.

Our customers depend on institutional pharmacies like us to provide the necessary pharmacy products and services and to play an integral role in monitoring patient medication regimens and safety. We dispense pharmaceuticals in patient specific packaging in accordance with physician instructions.

At June 30, 2009, we had contracts to provide pharmacy services to 317,358 licensed beds for patients in healthcare facilities in 40 states. We also have significant customer concentrations with facilities operated by Kindred. For the three months and six months ended June 30, 2009, Kindred institutional pharmacy contracts represented approximately 10.0% of the Corporation's total revenues.

Hospital Pharmacy Management Services. At June 30, 2009, the Corporation had provided hospital management services to Kindred and other customers for Hospital Pharmacy Services at 85 locations. For the three months and six months ended June 30, 2009, revenues under the Kindred hospital pharmacy management service contracts represented approximately 3.0% of the Corporation's total revenues.

Suppliers/Inventory

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the *Prime Vendor Agreement*), with AmerisourceBergen Drug Corporation (*ABDC*), a wholly owned subsidiary of AmerisourceBergen, the Corporation's former 50% stockholder. Pursuant to this agreement, the Corporation agreed to purchase at least 95% of the Corporation's prescription pharmaceutical drugs from ABDC and to participate in ABDC's generic formulary purchase program for a period of five years, ending on July 31, 2012. In addition, ABDC supports the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provides inventory management support and packaging services.

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We also obtain pharmaceutical and other products from contracts negotiated directly with pharmaceutical manufacturers. We are a member of industry buying groups, which contract with pharmaceutical manufacturers for discounted prices. While the loss of a supplier could adversely affect our business if alternate sources of supply are generally unavailable, numerous sources of supply are available to us and we have not experienced any difficulty in obtaining pharmaceuticals or other products and supplies to conduct our business.

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We seek to maintain an on-site inventory of pharmaceuticals and supplies to ensure prompt delivery to our customers. ABDC maintains local warehousing facilities in most major geographic markets in which we operate.

Brand versus Generic

The pharmaceutical industry has been experiencing a higher level of brand to generic drug conversions. As we move through 2009, we expect an increase in the demand for generic drugs as the result of a large number of patent expirations.

The following table summarizes the historical generic drug dispensing rate:

	2008	2009
March 31	69.0%	73.5%
June 30	69.9	74.2
September 30	71.3	N/A
December 31	72.5	N/A

The following table summarizes the material anticipated brand to generic conversions from 2009 to 2012:

2009	2010	2011	2012
Zerit	* Cozaar	* Actos	* Geodon
Depakote Sprinkles	Hyzaar	* Xalatan	* Lexapro
Depakote ER	* Flomax	Caduet	Viagra
Ambien CR	Starlix	Femara	Avapro
Topamax	Arimidex	* Zyprexa	* Seroquel
Adderall XR	Epivir	TriCor	Avandia
Cardizem	* Advair Diskus	Xeloda	Lunesta
Casodex	* Effexor XR	* Plavix	* Lovenox
Cellcept	* Aricept		* Singulair
Primaxin	* Lipitor		* Diovan
Glyset	* Levaquin		* Diovan HCT
Alphagan P			* Detrol
* Prevacid			Crestor
Valtrex			
Prandin			
Acular			
Prograf			
Allegra D			
Avelox			
Clarinet			

* Denotes top 50 drug spend for the Corporation during the six months ended June 30, 2009

Historically, when a branded drug shifts to a generic, initial pricing of the generic drug in the market will vary depending on the number of manufacturers launching their generic version of the drug. It is believed that a shift from brand to generic will decrease our revenue but at the same time may improve our gross margin from sales of these classes of drugs during the initial time period a brand drug has a generic alternative. The amount of improvement in gross margin is also dependent on the particular brand not being granted an exclusivity period and actual contracted terms with customers.

Supplier and Manufacturer Rebates

We currently receive rebates from certain manufacturers and distributors of pharmaceutical products for achieving targets of market share or purchase volumes. Rebates are designed to prefer, protect, or maintain a manufacturer's products that are dispensed by the pharmacy under its formulary. Rebates for brand name products are generally based upon achieving a defined market share tier within a therapeutic class. Rebates

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for generic products are more likely to be based on achieving volume requirements. Rebates included in our income statements were \$13.9 million and \$11.6 million for the three months ended June 30, 2008 and 2009, respectively, and \$26.6 million and \$22.1 million for the six months ended June 30, 2008 and 2009, respectively.

For more information regarding rebates, see [Overview of Reimbursement](#).

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Information Technology

Computerized medical records and documentation are an integral part of our distribution system. We primarily utilize a proprietary information technology infrastructure that automates order entry of medications, dispensing of medications, invoicing, and payment processing. These systems provide medical records, consulting drug review, electronic medication management, and regulatory compliance information to help ensure patient safety. These systems also support eligibility verification and electronic billing capabilities for the Corporation's pharmacies. They also provide order taking, shipment, and collection of service fees for medications and specialty services, as well as billing and reimbursement for other services rendered.

Based upon our electronic records, we are able to provide reports to our customers and management on patient care and quality assurance. These reports help to improve efficiency in patient care, reduce drug waste, and lower adverse drug reactions. We expect to continue to invest in technologies that help improve data integrity, critical information access, and system availability.

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

Except for certain services that are provided at cost, KHOI provides such services to the Corporation at its cost plus 10%, which are the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation's competitors. Following termination of the IT Services Agreement, KHOI must provide termination and expiration assistance for up to 180 days. The Corporation has incurred costs of \$5.0 million and \$2.8 million for the three months ended June 30, 2008 and 2009, respectively, and \$9.4 million and \$5.7 million for the six months ended June 30, 2008 and 2009, respectively, under the IT Services Agreement. As of June 30, 2009, the Corporation has approximately \$1.9 million in accounts payables related to the IT Services Agreement.

Sources of Pharmacy Revenues

We receive payment for our services from third party payers, including Medicare Part D Plans, government reimbursement programs under Medicare and Medicaid, and non-government sources such as institutional healthcare provider customers, commercial insurance companies, health maintenance organizations, preferred provider organizations, and contracted providers. The sources and amounts of our revenues will be determined by a number of factors, including the mix of our customers' patients and the rates of reimbursement among payers. Changes in our customers' censuses, the case mix of the patients, and the payer mix among private pay, Medicare Part D and Medicaid, will affect our profitability.

In December 2003, Congress enacted the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA) which includes a major expansion of the Medicare program through the introduction of a prescription drug benefit (titled Medicare Part D) which is administered by commercial market insurers contracted with CMS. Under Medicare Part D, Medicare beneficiaries who are also entitled to benefits under a state Medicaid program (so called dual eligibles) now have their outpatient prescription drug costs covered by Medicare Part D, subject to certain limitations. Since January 1, 2006, most of the nursing center residents we serve whose drug costs were previously covered by state Medicaid programs are dual eligibles who qualify for Medicare Part D. Accordingly, Medicaid is no longer a primary payer for the pharmacy services provided to these residents. See Overview of Reimbursement.

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

Three Months Ended		Six Months Ended	
June 30,		June 30,	
2008	2009	2008	2009