

LANNETT CO INC
Form 10-Q/A
September 12, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q/A

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005.**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .**

Commission File No. 0-9036

LANNETT COMPANY, INC.

(Exact Name of Registrant as Specified in its Charter)

State of Delaware
(State of Incorporation)

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

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

(Address of principal executive offices and telephone number)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Yes No

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

As of October 31, 2005, there were 24,125,884 shares of the issuer's common stock, \$.001 par value, outstanding.

EXPLANATORY NOTE

This amendment on Form 10-Q/A (the Amendment) amends Lannett Company Inc. s quarterly report on Form 10-Q for the quarter ended September 30, 2005, as initially filed with the Securities and Exchange Commission on November 8, 2005 (the Form 10-Q).

The Company has expanded and enhanced the disclosure in the text and tables located in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations, (MD&A) relating to chargebacks, rebates and returns. Similarly, tables in the Notes to the Financial Statements have also been expanded to reflect enhanced disclosure.

The Company has added disclosure of its methods of tracking Days Sales Outstanding in the section titled Accounts Receivable within the MD&A. This has been undertaken to provide enhanced disclosure relating to the Company s ability to manage receivables.

The Company has provided enhanced disclosure relating to the changes in sales year over year in the section titled Results of Operations within the MD&A.

The filing of this Amendment shall not be deemed an admission that the original Form 10-Q, when filed, included any untrue statement of material fact or omitted to state a material fact necessary to make a statement not misleading.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	(UNAUDITED)	
	9/30/2005	6/30/2005
<u>ASSETS</u>		
<i>Current Assets</i>		
Cash	\$ 2,981,086	\$ 4,165,601
Trade accounts receivable (net of allowance)	14,785,501	10,735,529
Inventories	10,792,031	9,988,769
Prepaid taxes	2,900,352	3,957,993
Deferred tax assets - current portion	3,123,953	3,123,953
Other current assets	1,871,005	1,966,270
Total current assets	36,453,928	33,938,115
Property, plant, & equipment	24,652,227	23,746,161
Less accumulated depreciation	(7,629,447)	(7,121,313)
	17,022,780	16,624,848
Construction in progress	1,788,721	2,079,650
Investments - available for sale	6,519,359	7,888,708
Note receivable	2,000,000	
Intangible asset, net of accumulated amortization	15,169,669	15,615,835
Deferred tax asset - less current portion	18,637,874	18,610,159
Other assets	154,280	159,745
Total Assets	\$ 97,746,611	\$ 94,917,060
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
<i>Current Liabilities</i>		
Accounts payable	967,834	1,208,148
Accrued expense	3,265,806	1,667,638
Unearned grant funds	500,000	500,000
Current portion of long term debt	2,269,776	2,269,776
Rebates and chargebacks	10,865,000	10,750,000
Total current liabilities	17,868,416	16,395,562
Long term debt, less current portion	6,698,656	7,262,672
Deferred tax liabilities	2,009,582	2,009,582
Total Liabilities	26,576,654	25,667,816
<i>Shareholders' Equity</i>		
Common stock - authorized 50,000,000 shares, par value \$0.001; issued and outstanding, 24,118,674 and 24,111,140, respectively	24,118	24,111
Additional paid-in capital	70,518,733	70,157,431
Retained earnings (deficit)	1,088,441	(512,535)
Accumulative other comprehensive loss, net	(66,765)	(25,193)
	71,564,527	69,643,814
Treasury stock at cost - 50,900 shares	394,570	394,570
Total shareholders' equity	71,169,957	69,249,244
Total Liabilities and Shareholders' Equity	\$ 97,746,611	\$ 94,917,060

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

LANNETT COMPANY, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	For the three months ended:	
	9/30/2005	9/30/2004
Net sales	\$ 13,641,532	\$ 15,011,496
Cost of sales (excluding amortization of intangible asset)	6,862,785	7,620,834
Gross profit	6,778,747	7,390,662
Research and development	1,141,101	1,348,217
Selling, general, & administrative	2,577,135	2,110,889
Amortization of intangible assets	446,166	1,690,084
Operating income	2,614,345	2,241,472
Other income (expense):		
Interest expense	(108,003)	(61,053)
Interest income	148,049	14,878
	40,046	(46,175)
Income before income tax expense	2,654,391	2,195,297
Income tax expense	1,053,415	878,156
Net income	\$ 1,600,976	\$ 1,317,141
Basic earnings per share	\$ 0.07	\$ 0.05
Diluted earnings per share	\$ 0.07	\$ 0.05
Basic weighted average number of shares	24,110,790	24,082,401
Diluted weighted average number of shares	24,117,149	24,199,904

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

LANNETT COMPANY, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock Shares	Amount	Additional Paid-in Capital	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Loss, net	Total Shareholders Equity
Balance at June 30, 2005	24,111,140	\$ 24,111	\$ 70,157,431	\$ (512,535))\$ (394,570))\$ (25,193))\$ 69,249,244
Shares issued in connection with employee stock purchase plan	7,534	7	33,413				33,420
Amortization expense in connection with employee stock options			327,889				327,889
Unrealized net losses on investment securities, net of reclassification adjustments and income taxes						(41,572)	(41,572)
Net Income				1,600,976			1,600,976
Balance at September 30, 2005	24,118,674	\$ 24,118	\$ 70,518,733	\$ 1,088,441	\$ (394,570))\$ (66,765))\$ 71,169,957

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

LANNETT COMPANY, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the three months ended	
	9/30/2005	9/30/2004
OPERATING ACTIVITIES:		
Net income	\$ 1,600,976	\$ 1,317,141
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	954,300	2,081,056
Deferred tax (benefit) expense	(27,715)	
Stock compensation expense	327,889	
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(3,934,972)	7,314,319
Inventories	(803,262)	(5,394,745)
Prepaid taxes	1,057,641	778,156
Prepaid expenses and other assets	100,730	267,982
Accounts payable	(240,314)	(3,094,961)
Accrued expenses	1,598,168	(1,039,744)
Net cash provided by operating activities	633,441	2,229,204
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment(including construction in progress)	(615,137)	(1,182,253)
Sales (purchases) of investment securities - available for sale	1,327,777	(2,669,440)
Purchase of note receivable	(2,000,000)	
Net cash used in investing activities	(1,287,360)	(3,851,693)
FINANCING ACTIVITIES:		
Repayments of debt	(564,016)	(470,968)
Proceeds from grant funding		500,000
Proceeds from debt, net of restricted cash released		1,602,610
Proceeds from issuance of stock	33,420	67,849
Net cash (used in)provided by financing activities	(530,596)	1,699,491
NET (DECREASE)/INCREASE IN CASH	(1,184,515)	77,002
CASH, BEGINNING OF PERIOD	4,165,601	8,966,954
CASH, END OF PERIOD	\$ 2,981,086	\$ 9,043,956
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -		
Interest paid	\$ 108,003	\$ 61,053
Income taxes paid	\$	\$ 100,000

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

LANNETT COMPANY, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for presentation of interim financial statements. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations, and cash flows for the periods presented. In our opinion, however, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. You should not base your estimate of our results of operations for fiscal year-end 2006 solely on our results of operations for the three months ended September 30, 2005. You should read these unaudited financial statements in combination with the other Notes in this section; Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Financial Statements, including the Notes to the Financial Statements, included in our Annual Report on Form 10-K for the year ended June 30, 2005.

Note 2. Summary of Significant Accounting Policies

Lannett Company, Inc. and subsidiaries (the Company), a Delaware corporation, develop, manufacture, package, market, and distribute pharmaceutical products sold under generic chemical names.

The Company is engaged in an industry which is subject to considerable government regulation related to the development, manufacturing and marketing of pharmaceutical products. In the normal course of business, the Company periodically responds to inquiries or engages in administrative and judicial proceedings involving regulatory authorities, particularly the Food and Drug Administration (FDA) and the Drug Enforcement Agency (DEA).

Principles of Consolidation The consolidated financial statements include the accounts of the operating parent company, Lannett Company, Inc., and its wholly owned subsidiary, Lannett Holdings, Inc.

Reclassifications Certain reclassifications have been made to the prior period's financial information to conform to the September 30, 2005 presentation.

Revenue Recognition The Company recognizes revenue when its products are shipped. At this point, title and risk of loss have transferred to the customer and provisions for estimates, including rebates, promotional adjustments, price adjustments, returns, chargebacks, and other potential adjustments are reasonably determinable. Accruals for these provisions are presented in the consolidated financial statements as rebates and chargebacks payable and reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional and other credits are estimated based on historical payment experience, estimated customer inventory levels, and contract terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks require management to make subjective judgments. Unlike branded innovator companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS Health and NDC Health, in estimating future returns

and other credits. Lannett's methodology for estimating reserves has been consistent with previous periods. It is based on historical experience, and re-evaluated on a quarterly basis.

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

Rebates Rebates are offered to the Company's key customers to promote customer loyalty and encourage greater product sales. These rebate programs provide customers with rebate credits upon attainment of pre-established volumes or attainment of net sales milestones for a specified period. Other promotional programs are incentive programs offered to the customers. At the time of shipment, the Company estimates reserves for rebates and other promotional credit programs based on the specific terms in each agreement. The reserve for rebates increases as sales to certain wholesale and retail customers increase. However, these rebate programs are tailored to the customers' individual programs. Hence, the reserve will depend on the mix of customers that comprise such rebate programs.

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

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

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The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the three months ended September 30, 2005 and 2004:

For the three months ended September 30, 2005

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve balance as of June 30, 2005	\$ 7,999,700	\$ 1,028,800	\$ 1,692,000	\$ 29,500	\$ 10,750,000
Actual credits issued related to sales recorded in prior fiscal years	(5,277,200)	(712,000)	(164,000)	(20,500)	(6,173,700)
Reserves or (reversals) charged during Fiscal 2006 related to sales recorded in prior fiscal years					
Reserves charged to net sales during fiscal 2006 related to sales recorded in fiscal 2006	5,147,100	1,500,200	12,100	413,300	7,072,700
Actual credits issued related to sales recorded in Fiscal 2006	(576,400)	(207,600)			(784,000)
Reserve balance as of September 30, 2005	\$ 7,293,200	\$ 1,609,400	\$ 1,540,100	\$ 422,300	\$ 10,865,000

For the three months ended September 30, 2004

Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve balance as of June 30, 2004	\$ 6,484,500	\$ 1,864,200	\$ 448,000	\$ 88,300	\$ 8,885,000
Actual credits issued related to sales recorded in prior fiscal years	(3,236,300)	(1,936,500)	(408,400)	(87,000)	(5,668,200)
Reserves or (reversals) charged during Fiscal 2005 related to sales recorded in prior fiscal years					
Reserves charged to net sales during fiscal 2005 related to sales recorded in fiscal 2005	4,828,900	2,609,400	284,000	300	7,722,600
Actual credits issued related to sales recorded in Fiscal 2005	(662,800)	(396,600)			(1,059,400)
Reserve balance as of September 30, 2004	\$ 7,414,300	\$ 2,140,500	\$ 323,600	\$ 1,600	\$ 9,880,000

The Company ships its products to the warehouses of its wholesale and retail chain customers. When the Company and a customer come to an agreement for the supply of a product, the customer will generally continue to purchase the product, stock its warehouse(s), and resell the product to its own customers. The Company's customer will continually reorder the product as its warehouse is depleted. The Company generally has no minimum size orders for its customers. Additionally, most warehousing customers prefer not to stock excess inventory levels due to the additional carrying costs and inefficiencies created by holding excess inventory. As such, the Company's customers continually reorder the Company's products. It is common for the Company's customers to order the same products on a monthly basis. For generic pharmaceutical manufacturers, it is critical to ensure that customers' warehouses are adequately stocked with its products. This is important due to the fact that several generic competitors compete for the consumer demand for a given product. Availability of inventory ensures that a manufacturer's product is considered. Otherwise, retail prescriptions would be filled with

competitors' products. For this reason, the Company periodically offers incentives to its customers to purchase its products. These incentives are generally up-front discounts off its standard prices at the beginning of a generic campaign launch for a newly-approved or newly-introduced product, or when a customer purchases a Lannett product for the first time. Customers generally inform the Company that such purchases represent an estimate of expected resales for a period of time. This period of time is generally up to three months. The Company records this revenue, net of any discounts offered and accepted by its customers at the time of shipment. The Company's products have from 18 months to 36 months of shelf-life at the time of manufacture. The Company monitors its customers' purchasing trends to attempt to identify any significant lapses in purchasing activity. If the Company observes a lack of recent activity, inquiries will be made to such customer regarding the success of the customer's resale efforts. The Company attempts to minimize any potential return (or shelf life issues) by maintaining an active dialogue with the customers.

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

Accounts Receivable The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history and the customer's current credit worthiness, as determined by a review of current credit information. The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses based upon historical experience and any specific customer collection issues that have been identified. While such credit losses have historically been within both the Company's expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

Inventories The Company values its inventory at the lower of cost (determined by the first-in, first-out method) or market, regularly reviews inventory quantities on hand, and records a provision for excess and obsolete inventory based primarily on estimated forecasts of product demand and production requirements. The Company's estimates of future product demand may prove to be inaccurate, in which case it may have understated or overstated the provision required for excess and obsolete inventory. In the future, if the Company's inventory is determined to be overvalued, the Company would be required to recognize such costs in cost of goods sold at the time of such determination. Likewise, if inventory is determined to be undervalued, the Company may have recognized excess cost of goods sold in previous periods and would be required to recognize such additional operating income at the time of sale.

Property, Plant and Equipment Property, plant and equipment are stated at cost. Depreciation is provided for by the straight-line and accelerated methods over estimated useful lives of the assets. Depreciation expense for the three months ended September 30, 2005 and 2004 was approximately \$508,000 and \$384,500, respectively.

Investment Securities The Company's investment securities consist of marketable debt securities, primarily in U.S. government and agency obligations, and a \$500,000 equity investment in an API provider. All of the Company's marketable debt securities are classified as available-for-sale and recorded at fair value, based on

quoted market prices. The Company accounts for its investment in the API provider at cost. Unrealized holding gains and losses are recorded, net of any tax effect, as a separate component of accumulated other comprehensive income. No gains or losses on marketable debt securities are realized until they are sold or a decline in fair value is determined to be other-than-temporary. If a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established. There were no securities determined by management to be other-than-temporarily impaired for the three month period ended September 30, 2005.

Deferred Debt Acquisition Costs Costs incurred in connection with obtaining financing are amortized by the straight-line method over the term of the loan arrangements. Amortization expense for debt acquisition costs for the three months ended September 30, 2005 and 2004 was approximately \$5,500 and \$6,500, respectively.

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

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

Advertising Costs The Company charges advertising costs to operations as incurred. Advertising expense for the three months ended September 30, 2005 and 2004 was approximately \$40,500 and \$74,200, respectively.

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

Segment Information The Company reports segment information in accordance with Statement of Financial Accounting Standard No. 131 (FAS 131), *Disclosures about Segments of an Enterprise and Related Information*. The Company operates one business segment-generic pharmaceuticals; accordingly the Company has one reporting segment. In accordance with FAS 131, the Company aggregates its financial information for all products and reports on one operating segment. The Company's products contain various active pharmaceutical ingredients aimed at treating a diverse range of medical indications. The following table identifies the Company's approximate net product sales by medical indication for the three months ended September 30, 2005 and 2004:

Medical Indication	For the Three Months Ended	
	9/30/05	9/30/04
Migraine Headache	\$ 3,173,000	\$ 3,294,000
Epilepsy	3,360,000	4,314,000
Heart Failure	1,748,000	1,445,000
Thyroid Deficiency		