LANNETT CO INC
Form 10-Q
May 10, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED March 31, 2006.**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ TO _____.**

Commission File No. 001-31298
LANNETT COMPANY, INC.
(Exact Name of Registrant as Specified in its Charter)

State of Delaware	**23-0787699**
(State of Incorporation)	**(I.R.S. Employer I.D. No.)**

9000 State Road
Philadelphia, PA 19136
(215) 333-9000
(Address of principal executive offices and telephone number)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and larger accelerated filer in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer o Accelerated filer **þ** Non-accelerated filer o

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

As of April 28, 2006, there were 24,141,325 shares of the issuer s common stock, $.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	(UNAUDITED) 3/31/2006	6/30/2005
ASSETS		
Current Assets		
Cash	$ 1,729,926	$ 4,165,601
Trade accounts receivable (net of allowance; 70,000 and 70,000)	23,664,023	10,735,529
Inventories	11,699,262	9,988,769
Prepaid taxes	1,201,432	3,957,993
Deferred tax assets current portion	3,182,281	3,123,953
Other current assets	2,106,974	1,966,270
Total current assets	43,583,898	33,938,115
Property, plant, & equipment	27,382,105	23,746,161
Less accumulated depreciation	(8,701,345)	(7,121,313)
	18,680,760	16,624,848
Construction in progress	2,477,558	2,079,650
Investments available for sale	5,584,657	7,888,708
Note receivable	2,000,000	
Intangible asset, net of accumulated amortization	14,277,335	15,615,835
Deferred tax asset less current portion	18,593,364	18,610,159
Other assets	207,127	159,745
Total Assets	$ 105,404,699	$ 94,917,060
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 1,313,609	$ 1,208,148
Accrued expense	3,867,139	1,667,638
Unearned grant funds	500,000	500,000
Current portion of long term debt	1,130,706	2,269,776
Rebates and chargebacks	14,698,211	10,750,000
Total current liabilities	21,509,665	16,395,562
Long term debt, less current portion	7,385,431	7,262,672
Deferred tax liabilities	2,009,582	2,009,582

Total Liabilities	30,904,678	25,667,816
Commitments and Contingencies		
Shareholders Equity		
Common stock authorized 50,000,000 shares, par value $0.001; issued and outstanding, 24,136,625 and 24,111,140, respectively	24,137	24,111
Additional paid-in capital	71,344,203	70,157,431
Retained earnings (deficit)	3,610,744	(512,535)
Accumulated other comprehensive loss, net	(84,493)	(25,193)
	74,894,591	69,643,814
Treasury stock at cost 50,900 shares	(394,570)	(394,570)
Total shareholders equity	74,500,021	69,249,244
Total Liabilities and Shareholders Equity	$ 105,404,699	$ 94,917,060

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

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LANNETT COMPANY, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Three months ended: (UNAUDITED)		Nine months ended: (UNAUDITED)	
	3/31/2006	3/31/2005	3/31/2006	3/31/2005
Net sales	$ 15,737,180	$ 7,603,189	$ 44,607,481	$ 35,533,206
Cost of sales (excluding amortization of intangible assets)	9,404,156	4,266,839	24,330,916	18,973,152
Gross profit	6,333,024	3,336,350	20,276,565	16,560,054
Research and development	1,252,108	1,172,853	4,814,186	3,521,507
Selling, general, & administrative	2,554,595	2,930,801	7,332,135	6,817,487
Amortization of intangible assets	446,166	1,690,083	1,338,499	5,070,251
Impairment loss on intangible assets		46,093,236		46,093,236
Operating income (loss)	2,080,155	(48,550,623)	6,791,745	(44,942,427)
Other income (expense):				
Realized loss on sale of investments	(10,800)	(871)	(2,818)	(1,466)
Interest expense	(54,646)	(96,373)	(246,853)	(245,056)
Interest income	96,352	50,584	333,540	99,361
	30,906	(46,660)	83,869	(147,161)
Income (loss) before income taxes	2,111,061	(48,597,283)	6,875,614	(45,089,588)
Income taxes	856,402	(19,438,913)	2,752,335	(18,035,836)
Net income (loss)	$ 1,254,659	$ (29,158,370)	$ 4,123,279	$ (27,053,752)
Basic earnings (loss) per share	$ 0.05	$ (1.21)	$ 0.17	$ (1.12)
Diluted earnings (loss) per share	$ 0.05	$ (1.21)	$ 0.17	$ (1.12)
Basic weighted average number of shares	24,135,723	24,103,256	24,126,588	24,092,958
Diluted weighted average number of shares	24,201,162	24,103,256	24,174,198	24,092,958

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

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

	Common Stock Shares	Common Stock 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	25,485	26	114,701				114,727
Amortization expense in connection with employee stock options			1,072,071				1,072,071
Unrealized net losses on investment securities, net of reclassification adjustments and income taxes						(59,300)	(59,300)
Net income				4,123,279			4,123,279
Balance at March 31, 2006	24,136,625	$ 24,137	$ 71,344,203	$ 3,610,744	$ (394,570)	$ (84,493)	$ 74,500,021

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

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

	For the nine months ended	
	3/31/2006	**3/31/2005**
OPERATING ACTIVITIES:		
Net income (loss)	$ 4,123,279	$ (27,053,752)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	2,918,531	6,377,820
Impairment loss on intangible asset		46,093,236
Stock compensation expense	1,072,071	
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	(8,980,283)	16,767,510
Inventories	(1,710,493)	(5,110,706)
Prepaid taxes	2,756,561	(1,298,542)
Prepaid expenses and other assets	(229,619)	(18,605,932)
Accounts payable	105,461	(4,938,378)
Accrued expenses	2,199,501	(1,824,429)
Net cash provided by operating activities	2,255,009	10,406,827
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment (including construction in progress)	(4,033,852)	(2,878,657)
Sales (purchases) of investment securities available for sale	2,244,751	(5,987,228)
Purchase of note receivable	(2,000,000)	
Net cash used in investing activities	(3,789,101)	(8,865,885)
FINANCING ACTIVITIES:		
Repayments of debt	(7,266,310)	(1,599,000)
Proceeds from grant funding		500,000
Proceeds from debt, net of restricted cash released	6,250,000	1,602,608
Purchase of treasury stock		(394,570)
Proceeds from issuance of stock	114,727	169,929
Net cash (used in) provided by financing activities	(901,583)	278,967
NET (DECREASE)/INCREASE IN CASH	(2,435,675)	1,819,909
CASH, BEGINNING OF PERIOD	4,165,601	8,966,954

CASH, END OF PERIOD	$ 1,729,926	$ 10,786,863
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -		
Interest paid	$ 231,853	$ 245,055
Income taxes paid	$	$ 1,700,000

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

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

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for presentation of interim financial statements. 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 nine months ended March 31, 2006. 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 subsidiary (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).

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

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position and the results of operations and cash flows. The results of operations for the nine months ended March 31, 2006 and 2005 are not necessarily indicative of results for the full year. While management believes that the disclosures presented are adequate to make the information not misleading, it is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and the notes included in the Company s Annual Report on Form 10-K for the year ended June 30, 2005.

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.

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Reclassifications Certain reclassifications have been made to the prior period s financial information to conform to the March 31, 2006 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.

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. Estimated reserves are based upon historical experience, and may change from time to time. Management re-evaluates these reserves quarterly.

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

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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.

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the nine months ended March 31, 2006 and 2005:

For the nine months ended March 31, 2006

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 Fiscal 2005	(7,720,000)	(1,450,900)	(1,264,800)	(27,200)	(10,462,900)
Actual Credits Issued-Related To Sales Recorded in Fiscal 2006	(8,612,100)	(2,313,400)	(273,400)	(892,800)	(12,091,700)
Additional Reserves Charged to Net Sales During Fiscal 2006	21,207,000	4,085,800	297,300	912,700	26,502,800
Reserve Balance as of March 31, 2006	$ 12,874,600	$ 1,350,300	$ 451,100	$ 22,200	$ 14,698,200

For the nine months ended March 31, 2005

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 Fiscal 2004	(4,966,500)	(1,936,500)	(408,400)	(87,000)	(7,398,400)

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Actual Credits Issued-Related To Sales Recorded in Fiscal 2005	(8,494,900)	(4,455,300)	(736,500)	(425,800)	(14,112,500)
Additional Reserves Charged to Net Sales During Fiscal 2005	14,559,400	6,696,800	971,900	472,800	22,700,900
Reserve Balance as of March 31 2005	$ 7,582,500	$ 2,169,200	$ 275,000	$ 48,300	$ 10,075,000

The chargeback reserve increased to $12,874,600 at March 31, 2006 due to an increased level of chargebacks, as a percentage of sales, required by the wholesale distributor market. In many cases, the increasingly competitive generic pharmaceutical market has resulted in decreased prices to Lannett customers. This competitive environment resulted in increased chargeback reserves. The increase in the rebate reserve to $1,350,300 at March 31, 2006 from $1,028,800 at June 30, 2005 is related to the increase in sales for the quarter then ended.

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 returns (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,

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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 March 31, 2006 and 2005 was approximately $541,000 and $473,000, respectively. Depreciation expense for the nine months ended March 31, 2006 and 2005 was approximately $1,580,000 and $1,308,000, 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 nine month period ended March 31, 2006.

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 March 31, 2006 and 2005 was approximately $9,000 and $5,500, respectively. Amortization expense for debt acquisition costs for the nine months ended March 31, 2006 and 2005 was approximately $51,000 and $16,000, 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.

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Advertising Costs The Company charges advertising costs to operations as incurred. Advertising expense for the three months ended March 31, 2006 and 2005 was approximately $7,000 and $16,000, respectively. Advertising expense for the nine months ended March 31, 2006 and 2005 was $148,000 and $123,000, 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 and nine months ended March 31, 2006 and 2005:

	For the Three Months Ended		For the Nine Months Ended	
Medical Indication	**03/31/06**	**03/31/05**	**03/31/06**	**03/31/05**
Migraine Headache	$ 2,137,000	$ 2,721,000	$ 8,656,000	$ 9,191,000
Epilepsy	3,240,000	2,026,000	9,929,000	10,900,000
Heart Failure	1,620,000	702,000	4,886,000	3,910,000
Thyroid Deficiency	4,787,000	1,607,000	12,067,000	9,708,000
Other	3,953,000	547,000	9,069,000	1,824,000
Total	$ 15,737,000	$ 7,603,000	$ 44,607,000	$ 35,533,000

Concentration of Market and Credit Risk Five of the Company s products, defined as generics containing the same active ingredient or combination of ingredients, accounted for approximately 21%, 30%, 5%, 8%, and 10%, respectively, of net sales for the three months ended March 31, 2006. The same five products accounted for 27%, 21%, 15%, 20%, and 10%, respectively, of net sales for the three months ended March 31, 2005; 23%, 27%, 7%, 12%, 11% of net sales for the nine months ended March 31, 2006; 31%, 28%, 10%, 16%, and 11%, respectively, of net sales for the nine months ended March 31, 2005.

Credit terms are offered to customers based on evaluations of the customers financial condition. Generally, collateral is not required from customers. Accounts receivable payment terms vary and are stated in the financial statements at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company s previous loss history, the customer s current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

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Stock Options In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (R), *Share-Based Payment* (SFAS 123(R)). This standard is a revision of SFAS 123, *Accounting for Stock-Based Compensation* and supercedes Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*. SFAS 123(R) addresses the accounting for share-based compensation in which we receive employee services in exchange for our equity instruments. Under the standard, we are required to recognize compensation cost for share-based compensation issued to or purchased by employees, net of estimated forfeitures, under share-based compensation plans using a fair value method.

At March 31, 2006, the Company had two stock-based employee compensation plans. Prior to July 1, 2005, the Company accounted for those plans under the recognition and measurement provisions of APB 25, and related Interpretations, as permitted by SFAS 123. No stock-based employee compensation cost was recognized in the Statement of Operations for the year ended June 30, 2005, nor in the three month or nine month period ended March 31, 2005, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant. Effective July 1, 2005, the Company adopted the fair value recognition provisions of SFAS 123(R), using the modified-prospective-transition method.

The Company adopted an Incentive Stock Option Plan in 2003 (the 2003 plan) that authorized 1,125,000 shares to be reserved. The options generally vest over a three-year period and expire no later than 10 years from the date of grant. Accordingly, prior periods have not been restated. Under this method, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding as of the beginning of the period of adoption. We measured share-based compensation cost using the Black-Scholes option pricing model. The following ranges of assumptions were used to compute share-based compensation:

Risk-free interest rate	2.92%	4.5%
Expected volatility		59.46%
Expected dividend yield		0.0%
Expected life (in years)		5.00
Forfeiture rate		3.0%
Weighted average fair value at date of grant	$ 2.36	$9.54

Expected volatility is based on the historical volatility of the price of our common shares since the date we commenced trading on the AMEX, April 2002. We use historical information to estimate expected life and forfeitures within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using a straight-line method over the vesting or service period and is net of estimated forfeitures.

The forfeiture rate assumption is the estimated annual rate at which unvested awards will be forfeited during the next year. This assumption is based on our historical forfeiture rate. Periodically, management will assess whether it is necessary to adjust the forfeiture rate to reflect its expectations. For example, adjustments may be needed if, historically, forfeitures were affected mainly by turnover that resulted from a business restructuring that is not expected to recur.

The following table presents all share-based compensation costs recognized in our statements of income. All share based compensation expenses are included in S.G.& A:

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	Nine months ended March 31,	
	2006	2005
	Fair Value	Intrinsic
Method used to account for share-based compensation		
Share-based compensation under SFAS 123(R)	$ 1,072,071	$
Tax benefit at effective rate	$ 238,050	$

The following table illustrates the pro forma effect on net income and earnings per share if we had recorded compensation expense based on the fair value method for all share-based compensation awards:

	Nine months ended March 31,	
	2006	2005
Net income (loss) as reported	$ 4,123,279	$ (27,053,752)
Deduct: total share-based compensation, determined under fair value based method		(2,407,795)
Add: tax benefit at effective rate		963,118
Net income (loss) pro forma	$ 4,123,279	$ (28,498,429)
Basic earnings (loss) per share as reported	$ 0.17	$ (1.12)
Basic earnings (loss) per share pro forma	$ 0.17	$ (1.18)
Diluted earnings (loss) per share as reported	$ 0.17	$ (1.12)
Diluted earnings (loss) per share pro forma	$ 0.17	$ (1.18)

A summary of award activity under the Plans as of March 31, 2006, and changes during the nine months then ended, is presented below:

	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Contractual Life
Outstanding at July 1, 2005	857,108	$13.72		
Granted	108,500	6.07		
Exercised	1,000	4.63		
Forfeited or expired				
Outstanding at March 31, 2006	964,608	$11.25	$	7.6
Outstanding at March 31, 2006 and not yet vested	388,721	$11.40	$	8.0
Exercisable at March 31, 2006	575,887	$11.14	$	7.4

As of March 31, 2006, there was approximately $1,568,000 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the Plans. That cost is expected to be recognized over a weighted average period of 1.4 years.

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

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Note 3. New Accounting Standards

In March 2005, the FASB issued FIN 47 Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143. This Interpretation clarifies that a conditional retirement obligation refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The liability should be recognized when incurred, generally upon acquisition, construction or development of the asset. FIN 47 is effective no later than the end of the fiscal years ending after December 15, 2005. Our current assessment is that adoption of FIN 47 will have no impact on our financial statements.

In November 2004, the FASB issued FASB Statement No. 151, Inventory Costs an amendment of ARB No. 43, Chapter 4 (SFAS No. 151), which is the result of its efforts to converge U.S. accounting standards for inventories with International Accounting Standards. SFAS No. 151 requires abnormal amounts of idle facility expense, freight, handling costs and wasted material or spoilage to be recognized as current-period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 was effective for inventory costs incurred beginning January 1, 2006. The adoption of this standard did not have any impact on the Company in the current quarter.

In May 2005, the FASB issued FASB Statement No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154). Previously, APB Opinion No. 20, Accounting Changes and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements required the inclusion of the cumulative effect of changes in accounting principle in net income of the period of the change. SFAS No. 154 requires companies to recognize a change in accounting principle, including a change required by a new accounting pronouncement when the pronouncement does not include specific transition provisions, retrospectively to prior period financial statements. SFAS No. 154 was effective as of January 1, 2006 and the adoption of this standard did not have any impact on the Company in the current quarter.

In September 2005, the FASB ratified Emerging Issues Task Force (EITF) Issue No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty (EITF 04-13). EITF 04-13 provides guidance on whether two or more inventory purchase and sales transactions with the same counterparty should be viewed as a single exchange transaction within the scope of APB No. 29, Accounting for Nonmonetary Transactions. In addition, EITF 04-13 indicates whether nonmonetary exchanges of inventory within the same line of business should be recognized at cost or fair value. EITF 04-13 will be effective as of April 1, 2006 for the Company. The provisions of EITF 04-13 are applied prospectively. The impact on the Company in periods subsequent to the effective date is dependent on transactions that could occur in future periods, and therefore cannot be determined until the transaction occurs.

In April 2006, the FASB issued FASB Staff Position No. FIN 46(R)-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R) (FSP No. 46(R)-6). This pronouncement provides guidance on how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, which could impact the assessment of whether certain variable interest entities are consolidated. FSP No. 46(R)-6 will be effective for the Company on July 1, 2006. The provisions of FSP No. 46(R)-6 are applied prospectively. The impact on the

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Company in periods subsequent to the effective date is dependent on transactions that could occur in future periods, and therefore cannot be determined until the transaction occurs.

Note 4. Inventories

Inventories consist of the following:

	March 31, 2006 (unaudited)	June 30, 2005
Raw materials	$ 4,879,880	$ 5,091,883
Work-in-process	1,871,207	1,351,112
Finished goods	4,536,306	3,303,478
Packaging supplies	411,869	242,296
	$ 11,699,262	$ 9,988,769

The preceding amounts are net of inventory reserves of $4,125,000 and $5,300,000 at March 31, 2006 and June 30, 2005, respectively.

Note 5. Property, Plant and Equipment

Property, plant and equipment consist of the following:

	Useful Lives	Mar. 31 2006 (unaudited)	June 30, 2005
Land		$ 233,414	$ 233,414
Building and improvements	10 39 years	10,366,435	9,339,706
Machinery and equipment	5 10 years	15,955,553	13,347,416
Furniture and fixtures	5 7 years	826,703	825,625
		$ 27,382,105	$ 23,746,161

Note 6. Investment Securities Available-for-Sale

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

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	March 31, 2006 Available-for-Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Other Investments	$ 500,000	$	$	$ 500,000
U.S. Government Agency	4,500,720	100	(112,369)	4,388,451
Mortgage-Backed Securities	333,713		(22,195)	311,518
Asset-Backed Securities	393,045		(8,357)	384,688
	$ 5,727,478	$ 100	$ (142,921)	$ 5,584,657

	June 30, 2005 Available-for-Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government Agency	$ 6,582,022	$ 8,970	$ (35,794)	$ 6,555,198
Mortgage-Backed Securities	363,429		(10,105)	353,324
Asset-Backed Securities	985,246	5,361	(10,421)	980,186
	$ 7,930,697	$ 14,331	$ (56,320)	$ 7,888,708

The amortized cost and fair value of the Company s current available-for-sale securities by contractual maturity at March 31, 2006 are summarized as follows:

	Available for Sale	
	Amortized Cost	Fair Value
Due in one year or less	$ 410,898	$ 399,000
Due after one year through five years	3,389,166	3,315,632
Due after five years through ten years	361,030	353,192
Due after ten years	1,566,384	1,516,833
	$ 5,727,478	$ 5,584,657

The Company uses the specific identification method to determine the cost of securities sold. There were no securities held from a single issuer that represented more than 15% of shareholders equity.

The table below indicates the length of time individual securities have been in a continuous unrealized loss position as of March 31, 2006:

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		As of March 31, 2006					
		Less than 12 months		12 months or longer		Total	
Description of Securities	Number of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Government Agency	27	4,203,554	(108,269)	122,462	(4,100)	4,326,016	(112,369)
Mortgage-Backed Securities	3	311,519	(22,195)			311,519	(22,195)
Asset-Backed Securities	4	384,688	(8,357)			384,688	(8,357)
Total temporarily impaired investment securities	34	$ 4,899,761	$ (138,821)	$ 122,462	$ (4,100)	$ 5,022,223	$ (142,921)

The investment securities shown above currently have fair values less than amortized cost and therefore contain unrealized losses. The Company has evaluated these securities and has determined that the decline in value is not related to any company or industry specific event. At March 31, 2006, there were approximately 34 out of 35 investment securities with unrealized losses. The Company anticipates full recovery of amortized costs with respect to these securities at maturity or sooner in the event of a more favorable market interest rate environment.

Note 7. Note Receivable

A loan agreement with an API provider (the Borrower) was entered into in July 2005. In the agreement, the Company loaned the Borrower $2,000,000 to finance general business activities. The note receivable is secured by a promissory note and a security interest in substantially all the Borrower s assets. Interest on the principal balance will be earned at 10% per annum for the first three years, and then at variable rates based on the Prime Rate plus 500 basis points. Borrower shall pay all interest that has accrued and is due and owing on the Loan on the first, second and third anniversary date of this Agreement. The Borrower shall pay the principal balance on the loan, plus accrued interest, in twenty four equal consecutive monthly installments beginning July 2008.

Note 8. Bank Line of Credit

The Company has a $3,000,000 line of credit from Wachovia Bank, N.A. that bears interest at the prime interest rate less 0.25% (7.50% at March 31, 2006). The line of credit was renewed and extended to November 30, 2006. At March 31, 2006 and 2005, the Company had $0 outstanding and $3,000,000 available under the line of credit. The line of credit is collateralized by substantially all of the Company s assets. The Company currently has no plans to borrow under this line of credit

Note 9. Unearned Grant Funds

In July 2005, the Company received $500,000 of grant funding from the Commonwealth of Pennsylvania, acting through the Department of Community and Economic Development. The grant funding program requires the Company to use the funds for machinery and equipment located at their Pennsylvania locations, hire an additional 100 full-time employees by June 30, 2006, operate its Pennsylvania locations a minimum of five years and meet certain matching investment requirements. If the Company fails to comply with any of the requirements above, the Company would be liable to repay the full amount of the grant funding ($500,000). The Company records the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program. On a quarterly basis, the Company will monitor its progress in fulfilling the requirements of the grant funding program and will determine the status of the liability. As of March 31, 2006, the Company has recognized the grant funding as a short term liability under the caption of Unearned Grant Funds.

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Note 10. Long-Term Debt

Long-term debt consists of the following:

	March 31, 2006	June 30, 2005
PIDC regional center, LP III loan	$ 4,500,000	$
Pennsylvania Industrial Development Authority loan	1,238,750	
Pennsylvania Department of Community & Economic Development loan	500,000	
Tax-exempt bond loan (PAID)	1,154,471	1,645,720
Mortgage loan		2,700,000
Equipment loan	1,122,916	4,486,729
Construction loan		699,999
Total debt	8,516,137	9,532,448
Less current portion	1,130,706	2,269,776
Long term debt	$ 7,385,431	$ 7,262,672

On December 13, 2005 the Company refinanced $5,750,000 of its debt through the Philadelphia Industrial Development Corporation (PIDC) and the Pennsylvania Industrial Development Authority (PIDA). With the proceeds from the refinancing, the Company paid off its Mortgage and Construction Loan, as well as a portion of the Equipment loan. These loans were with Wachovia Bank. $4,500,000 was financed through the Immigrant Investor Program (PIDC Regional Center, LP III). The Company will pay a bi-annual interest payment at a rate equal to two and one-half percent per annum. The outstanding principal balance shall be due and payable 5 years (60 months) from January 1, 2006. The remaining $1,250,000 is financed through the PIDA Loan. The Company is required to make equal payments each month for 180 months starting February 1, 2006 with interest of two and three-quarter percent per annum. The PIDA Loan has $1,238,750 outstanding and as of March 31, 2006, and $68,588 is currently due; none of the PIDC Loan is currently due.

An additional $500,000 was financed through the Pennsylvania Department of Community and Economic Development Machinery and Equipment Loan Fund. The Company is required to make equal payments for 60 months starting May 1, 2006 with interest of two and three quarter percent per annum. As of March 31, 2006, $86,602 is currently due.

In April 1999, the Company entered into a loan agreement (the Agreement) with a governmental authority, the Philadelphia Authority for Industrial Development (the Authority or PAID), to finance future construction and growth projects of the Company. The Authority issued $3,700,000 in tax-exempt variable rate demand and fixed rate revenue bonds to provide the funds to finance such growth projects pursuant to a trust indenture (the Trust Indenture). A portion of the Company s proceeds from the bonds was used to pay for bond issuance costs of approximately $170,000. The Trust Indenture requires that the Company repay the Authority loan through installment payments beginning in May 2003 and continuing through May 2014, the year the bonds mature. The bonds bear interest at the floating variable rate determined by the organization responsible for selling the bonds (the remarketing agent). The interest rate fluctuates on a weekly basis. The effective interest rate at March 31, 2006 was 3.32%. At March 31, 2006, the Company has $1,154,471 outstanding on the Authority loan, of which $654,996 is classified as currently due. The remainder is classified as a long-term liability. In April 1999, an irrevocable letter of credit of $3,770,000 was issued by Wachovia Bank, National Association (Wachovia) to

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secure payment of the Authority Loan and a portion of the related accrued interest. At March 31, 2006, no portion of the letter of credit has been utilized.

The Equipment Loan consists of a term loan with a maturity date of five years. The Company as part of the 2003 Loan Financing agreement with Wachovia is required to make equal payments of principal and interest. As of March 31, 2006, the Company has outstanding $1,122,916 under the Equipment Loan, of which $320,520 is classified as currently due.

The financing facilities under the 2003 Loan Financing, which only the Equipment Loan is left, bear interest at a variable rate equal to the LIBOR rate plus 150 basis points. The LIBOR rate is the rate per annum, based on a 30-day interest period, quoted two business days prior to the first day of such interest period for the offering by leading banks in the London interbank market of dollar deposits. As of March 31, 2006, the interest rate for the 2003 Loan Financing (of which only the Equipment loan remains) was 6.38%.

The Company has executed Security Agreements with Wachovia, PIDA and PIDC in which the Company has agreed to use substantially all of its assets to collateralize the amounts due.

The terms of the line of credit (see note 8), the PIDC and PIDA financing, the related letter of credit, and the Equipment loan require that the Company meet certain financial covenants and reporting standards, including the attainment of standard financial liquidity and net worth ratios. As of March 31, 2006, the Company has complied with such terms, and successfully met its financial covenants.

Note 11. Income Taxes

The provision (credit) for federal, state and local income taxes for the three month period ended March 31, 2006 and 2005 was $856,402 and $(19,438,913), respectively, with effective tax rates of 40.0% and 40.0%, respectively. The provision (credit) for federal, state, and local income taxes for the nine month period ended March 31, 2006 and 2005 was $2,752,335 and $(18,035,836), respectively, with effective tax rates of 40.0% and 40.0% respectively.

Note 12. Earnings Per Share

Statement of Financial Accounting Standards No. 128 (FAS 128), *Earnings Per Share,* requires the presentation of basic and diluted earnings per share on the face of the Company s consolidated statement of operations and a reconciliation of the computation of basic earnings per share to diluted earnings per share. Basic earnings per share excludes the dilutive impact of common stock equivalents and is computed by dividing net income by the weighted-average number of shares of common stock outstanding for the period. Diluted earnings per share include the effect of potential dilution from the exercise of outstanding common stock equivalents into common stock using the treasury stock method. Earnings per share amounts for all periods presented have been calculated in accordance with the requirements of FAS 128. A reconciliation of the Company s basic and diluted earnings (loss) per share follows:

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	Three months ended March 31,			
	2006		2005	
	Net Income (Numerator)	Shares (Denominator)	Net Income (loss) (Numerator)	Shares (Denominator)
Basic earnings (loss) per share factors	$ 1,254,659	24,135,723	$ (29,158,370)	24,103,256
Effect of dilutive stock options		65,439		
Diluted earnings (loss) per share factors	$ 1,254,659	24,201,162	$ (29,158,370)	24,103,256
Basic earnings (loss) per share	$ 0.05		$ (1.21)	
Diluted earnings (loss) per share	$ 0.05		$ (1.21)	

	Nine months ended March 31,			
	2006		2005	
	Net Income (Numerator)	Shares (Denominator)	Net Income (loss) (Numerator)	Shares (Denominator)
Basic earnings (loss) per share factors	$ 4,123,279	24,126,588	$ (27,053,752)	24,092,958
Effect of dilutive stock options		47,610		
Diluted earnings (loss) per share factors	$ 4,123,279	24,174,198	$ (27,053,752)	24,092,958
Basic earnings (loss) per share	$ 0.17		$ (1.12)	
Diluted earnings (loss) per share	$ 0.17		$ (1.12)	

The number of anti-dilutive weighted average shares that have been excluded in the computation of diluted earnings per share for the three months ended March 31, 2006 and 2005 were 760,358 and 0, respectively. The number of anti-dilutive weighted average shares that have been excluded in the computation of diluted earnings per share for the nine months ended March 31, 2006 and 2005 were 760,358 and 0, respectively. Because the period prior was in a net loss, none of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

Note 13. Comprehensive Income (Loss)

The Company s other comprehensive loss is comprised of unrealized losses on investment securities classified as available-for-sale. The components of comprehensive income and related taxes consisted of the following as of March 31, 2006 and 2005:

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COMPREHENSIVE INCOME (LOSS)	For the three months ended 3/31/2006	3/31/2005	For the nine months ended 3/31/2006	3/31/2005
Other Comprehensive Loss:				
Unrealized holding loss on securities	$ (19,244)	$ (66,421)	$ (100,933)	$ (71,918)
Add: Tax savings at effective rate	7,698	26,568	41,533	28,767
Total unrealized loss on securities, net	(11,546)	(39,853)	(59,300)	(43,151)
Total other comprehensive loss	(11,546)	(39,853)	(59,300)	(43,151)
Net income (loss)	1,254,659	(29,158,370)	4,123,279	(27,053,752)
Total comprehensive income (loss)	$ 1,243,113	$ (29,198,223)	$ 4,063,979	$ (27,096,903)

Note 14. Related Party Transactions

The Company had gross sales of approximately $900,000 and $394,000 during the nine months ended March 31, 2006 and 2005, respectively, to a distributor (the related party) owned by Jeffrey Farber, the son of the Chairman of the Board of Directors and principal shareholder of the Company, William Farber. Accounts receivable includes amounts due from the related party of approximately $171,000 and $109,000 at March 31, 2006 and 2005, respectively. In management s opinion, the terms of these transactions were not more favorable to the related party than they would have been to a non-related party.

Stuart Novick, the son of Marvin Novick, a Director on the Company s Board of Directors through January 13, 2005, was employed by two insurance brokerage companies (the Insurance Brokers) that provide insurance agency services to the Company. The Company paid approximately $125,000 and $495,000 during the nine months ended March 31, 2006 and 2005 to the Insurance Brokers for various insurance policies. In management s opinion, the terms of these transactions were not more favorable to the related party than they would have been to a non-related party.

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased for $100,000 and future royalty payments the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. owns the ANDA. This agreement is subject to the Company s ability to obtain FDA approval to use the proprietary rights. In the event that an approval can not be obtained, Pharmeral, Inc. must repay the $100,000 to the Company. Accordingly, the Company has treated this payment as a prepaid asset. Arthur Bedrosian, President and Chief Executive Officer of the Company, was formerly the President and Chief Executive Officer and currently owns 100% of Pharmeral, Inc. This transaction was approved by the Board of Directors of the Company and in their opinion the terms were not more favorable to the related party than they would have been to a non-related party.

Note 15. Material Contract with Suppliers

The Company s primary finished product inventory supplier is Jerome Stevens Pharmaceuticals, Inc. (JSP), in Bohemia, New York. On March 23, 2004, the Company entered into an agreement with JSP for the exclusive distribution rights in the United States to the current line of JSP products, in exchange for four million (4,000,000) shares of the Company s common stock. The JSP products covered under the agreement included Butalbital, Aspirin, Caffeine with Codeine Phosphate capsule; Digoxin tablets; and Levothyroxine Sodium tablets, sold generically and under the brand name Unithroid®. The term of the agreement is ten years ending on March 22, 2014. Both Lannett and JSP have the right to terminate the contract if one of the parties does not cure a material breach of the contract within sixty (60) days of notice from the non-breaching party.

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During the term of the agreement, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP s products being distributed by the Company. The minimum quantity to be purchased in the first year of the agreement was $15 million. Thereafter, the minimum quantity to be purchased increases by $1 million per year up to $24 million for the last year of the ten-year contract. The Company met the minimum purchase requirement for the first year of the contract, but there is no guarantee that the Company will be able to continue to do so in the future. If the Company does not meet the minimum purchase requirements, JSP s sole remedy is to terminate the agreement.

Under the agreement, JSP is entitled to nominate one person to serve on the Company s Board of Directors (the Board) provided, however, that the Board shall have the right to reasonably approve any such nominee in order to fulfill its fiduciary duty by ascertaining that such person is suitable for membership on the board of a publicly traded corporation. Suitability is determined by, but not limited to, the requirements of the Securities and Exchange Commission, the American Stock Exchange, and other applicable laws, including the Sarbanes-Oxley Act of 2002. As of March 31, 2006, JSP has not exercised the nomination provision of the agreement. The agreement was included as an Exhibit in the Current Report on Form 8-K filed by the Company on May 5, 2005, as subsequently amended.

The following table identifies the purchase commitments with JSP:

	Commitments with JSP
Less than 1 year	$ 17,000,000
1 3 years	37,000,000
3 5 years	41,000,000
More than 5 years	69,000,000
Total	$ 164,000,000

Management determined that the intangible product rights asset created by this agreement was impaired as of March 31, 2005.

In October 2005, the Company signed an agreement with Orion Pharma (Orion), based in Finland to purchase and distribute three drug products. Under the terms of the agreement, Orion will supply Lannett with the finished products and all laboratory documentation and Lannett will coordinate the completion of the clinical biostudies necessary to submit Abbreviated New Drug Applications (ANDAs) to the Food and Drug Administration.

In March 2006, the Company signed a multi-part agreement with AZAD Pharma AG to jointly develop and commercialize one product and entered into a supply agreement for five active pharmaceutical ingredients.

Note 16. Contingencies

The Company monitors its compliance with all environmental laws. Any compliance costs which may be incurred are contingent upon the results of future site monitoring and will be charged to operations when incurred. No monitoring costs were incurred during the three or nine months ended March 31, 2006 and 2005.

The Company is currently engaged in several civil actions as a co-defendant with many other manufacturers of Diethylstilbestrol (DES), a synthetic hormone. Prior litigation established that the Company s pro rata share of any liability is less than one-tenth of one percent. The Company was represented in many of these actions by the insurance company with which the Company maintained coverage during the time period that damages were alleged to have occurred. The insurance company denies coverage for actions alleging involvement of the

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Company filed after January 1, 1992. With respect to these actions, the Company paid nominal damages or stipulated to its pro rata share of any liability. The Company has either settled or is currently defending over 500 such claims. At this time, management is unable to estimate a range of loss, if any, related to these actions. Management believes that the outcome of these cases will not have a material adverse impact on the financial position or results of operations of the Company.

In addition to the matters reported herein, the Company is involved in litigation which arises in the normal course of business. In the opinion of management, the resolution of these lawsuits will not have a material adverse effect on the consolidated financial position or results of operations.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Introduction

The following information should be read in conjunction with the consolidated financial statements and notes in Part I, Item 1 of this Quarterly Report and with Management s Discussion and Analysis of Financial Condition and Results of Operations contained in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2005.

In addition to historical information, this Form 10-Q contains forward-looking information. The forward-looking information contained herein is subject to certain risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Important factors that might cause such a difference include, but are not limited to, those discussed in the following section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date of this Form 10-Q. The Company undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances which arise later. Readers should carefully review the risk factors described in other documents the Corporation files from time to time with the Securities and Exchange Commission, including the Annual report on Form 10-K filed by the Company in Fiscal 2005, and any Current Reports on Form 8-K filed by the Company.

In addition to the risks and uncertainties posed generally by the generic drug industry, the Company faces the following risks and uncertainties:

- § competition from other manufacturers of generic drugs;
- § potential declines in revenues and profits from individual generic pharmaceutical products due to competitors introductions of their own generic equivalents;
- § new products or treatments by other manufacturers that could render the Company s products obsolete;
- § the value of the Company s common stock has fluctuated widely in the past, which could lead to investment losses for shareholders;
- § intense regulation by government agencies may delay the Company s efforts to commercialize new drug products; and
- § dependence on third parties to supply raw materials and certain finished goods inventory any failure to obtain a sufficient supply of raw materials from these suppliers could materially and adversely affect the Company s business.

Because of the foregoing and other factors, the Company may experience fluctuations in future operating results on a quarterly or annual basis which could materially adversely affect the business, financial condition, operating results and the Company s stock price.

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Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies include those described below.

Stock Options We adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2005), *Share-Based Payment*, (123(R)) effective July 1, 2005. We applied the standard using the modified prospective-transition method with no restatement of prior periods. Prior to July 1, 2005, the Company accounted for those plans under the recognition and measurement provisions of APB 25, and related Interpretations, as permitted by SFAS 123. No stock-based employee compensation cost was recognized in the Statement of Operations for the year ended June 30, 2005, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant.

Since we applied the standard using the modified-prospective-transition-method, prior periods have not been restated. Under this method, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding as of the beginning of the period of adoption. We measured share-based compensation cost using the Black-Scholes option pricing model. Total share-based compensation expense under SFAS 123(R) was $385,000 and $1,072,000 for the three-month period and nine month period ended March 31, 2006, respectively. Total compensation cost related to non-vested awards not yet recognized is $1,568,000 and the weighted average period over which it is to be recognized is 1.4 years.

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.

Chargebacks The provision for chargebacks is the most significant and complex estimate used in the recognition of revenue. The Company sells its products directly to wholesale distributors, generic distributors, retail pharmacy chains and mail-order pharmacies. The Company also sells its products indirectly to independent pharmacies, managed care organizations, hospitals, nursing homes, and group purchasing organizations, collectively referred to as indirect customers. Lannett enters into agreements with its indirect customers to establish pricing for certain products. The indirect customers then independently select a wholesaler from which

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to actually purchase the products at these agreed-upon prices. Lannett will provide credit to the wholesaler for the difference between the agreed-upon price with the indirect customer and the wholesaler s invoice price if the price sold to the indirect customer is lower than the direct price to the wholesaler. This credit is called a chargeback. The provision for chargebacks is based on expected sell-through levels by the Company s wholesale customers to the indirect customers, and estimated wholesaler inventory levels. As sales to the large wholesale customers, such as Cardinal Health, AmerisourceBergen, and McKesson, increase, the reserve for chargebacks will also generally increase. However, the size of the increase depends on the product mix. 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. The reserve for returns has returned to historical norms after a prior year one time adjustment for the anticipation of a large return concerning Levothyroxine. The prior year return reserve was $1.25 million of which most has been returned. 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.

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the nine months ended March 31, 2006 and 2005:

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For the nine months ended March 31, 2006

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 Fiscal 2005	(7,720,000)	(1,450,900)	(1,264,800)	(27,200)	(10,462,900)
Actual Credits Issued-Related To Sales Recorded in Fiscal 2006	(8,612,100)	(2,313,400)	(273,400)	(892,800)	(12,091,700)
Additional Reserves Charged to Net Sales During Fiscal 2006	21,207,000	4,085,800	297,300	912,700	26,502,800
Reserve Balance as of March 31, 2006	$ 12,874,600	$ 1,350,300	$ 451,100	$ 22,200	$ 14,698,200

For the nine months ended March 31, 2005

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 Fiscal 2004	(4,966,500)	(1,936,500)	(408,400)	(87,000)	(7,398,400)
Actual Credits Issued-Related To Sales Recorded in Fiscal 2005	(8,494,900)	(4,455,300)	(736,500)	(425,800)	(14,112,500)
Additional Reserves Charged to Net Sales During Fiscal 2005	14,559,400	6,696,800	971,900	472,800	22,700,900
Reserve Balance as of March 31, 2005	$ 7,582,500	$ 2,169,200	$ 275,000	$ 48,300	$ 10,075,000

The chargeback reserve increased to $12,874,600 at March 31, 2006 due to an increased level of chargebacks, as a percentage of sales, required by the wholesale distributor market. In many cases, the increasingly competitive generic pharmaceutical market has resulted in decreased prices to Lannett customers. This competitive environment resulted in increased chargeback reserves. The increase in the rebate reserve to $1,350,300 at March 31, 2006 from $1,028,800 at June 30, 2005 is related to the increase in sales for the quarter then ended.

The reserved amount at June 30, 2005 compared to actual credits issued on prior sales has a remaining balance of $287,000. This is due in part to our return policy which allows customers up to 6 months past expiration to return

items as well as a small amount of customer inventory gone unsold. The difference in the reserve for rebates and the actual rebates as well as the return difference is additional rebates were offered to offset future returns.

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

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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 the both 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.

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Results of Operations Three months ended March 31, 2006 compared with three months ended March 31, 2005

Net sales increased 107% from $7,603,000 for the three months ended March 31, 2005 (Third Quarter Fiscal 2005) to $15,737,000 for the three months ended March 31, 2006 (Third Quarter Fiscal 2006). The primary result was due to decreased price pressure from a year ago and new product sales of $3,100,000. Year over year increase in existing product sales were a result of volume increases of 42% and price increases of 24%.

The table below identifies the Company s approximate net sales to each category for the three months ended March 31, 2006 and 2005:

	For the three months ended	
Customer Category	3/31/2006	3/31/2005
Wholesaler/Distributor	$ 12,256,000	$ 4,141,000
Retail Chain	1,521,000	1,712,000
Mail-Order Pharmacy	1,589,000	1,000,000
Private Label	371,000	750,000
Total	$ 15,737,000	$ 7,603,000

Cost of sales increased 120% from $4,267,000 for the Third Quarter Fiscal 2005 to $9,404,000 for the Third Quarter Fiscal 2006. The increase in cost of sales is due to an increase in direct variable costs such as raw materials and costs of finished goods as a result of increased volume. Gross profit margins for the Third Quarter Fiscal 2006 and the Third Quarter Fiscal 2005 were 40% and 44%, respectively. Cost of Sales and gross margin discussed here excludes amortization of intangible assets. The Company anticipates gross profit margins to remain stable for the foreseeable future.

Research and development (R&D) expenses increased 7% from $1,173,000 for the Third Quarter Fiscal 2005 to $1,252,000 for the Third Quarter Fiscal 2006. The increase is primarily due to an increase in the number of ongoing product development projects as well generic bioequivalence tests which are commonly required for ANDA submissions. R&D costs represent spending on products in the pipeline. Current spending is anticipated to benefit the continued growth of the Company s product mix.

Selling, general and administrative expenses decreased 13% from $2,931,000 for the Third Quarter Fiscal 2005 to $2,555,000 for the Third Quarter Fiscal 2006. The decrease is due to fewer costs associated with the first year of Sarbanes Oxley compliance and the elimination of professional fees incurred in the Third Quarter Fiscal 2005 to perform analysis on the impairment of the Company s intangible assets. The savings were somewhat offset by the adoption of SFAS 123(R) which totaled $385,000 for the quarter ending March 31, 2006.

Amortization expense for the intangible asset for the three months ended March 31, 2006 and 2005 was approximately $446,000 and $1,690,000, respectively. The amortization expense relates to the March 23, 2005 exclusive marketing and distribution rights agreement with JSP. The reduction of this expense is due entirely to the impairment of the intangible assets recorded in the Third Quarter Fiscal 2005.

In fiscal year 2005 management believed that events (as described below) occurred which indicated that the carrying value of the intangible asset was not recoverable. In accordance with Statement of Financial Accounting Standards No. 144 (FAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company engaged a third party valuation specialist to assist in the performance of an impairment test for the quarter ended

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March 31, 2005. The impairment test was performed by discounting forecasted future net cash flows for the JSP products covered under the agreement and then comparing the discounted present value of those cash flows to the carrying value of the asset (inclusive of the $1.5 million payable to JSP for the Third AB rating). As a result of the testing, the Company has determined that the intangible asset was impaired as of March 31, 2005. In accordance with FAS 144, the Company recorded a non-cash impairment loss of approximately $46,093,000 to write the asset down to its fair value of approximately $16,062,000 as of March 31, 2005. This impairment loss is shown on the statement of operations as a component of operating loss.

Management believes that several factors contributed to the impairment of this asset. In December 2005, the Levothyroxine Sodium tablet product received the AB rating to Synthroid®. The expected sales increase as a result of the AB rating did not occur in the third quarter of 2005. The delay in receiving the AB rating to Synthroid® caused the Company to be competitively disadvantaged with its Levothyroxine Sodium tablet product and to lose market share to competitors whose products had already received AB ratings to both major brand thyroid deficiency drugs. Additionally, the generic market for thyroid deficiency drugs turned out to be smaller than it was anticipated to be as a result of a lower brand-to-generic substitution rate. Increased competition in the generic drug market, both from existing competitors and new entrants, has resulted in significant pricing pressure on other products supplied by JSP. The combination of these factors has resulted in diminished forecasted future net cash flows which, when discounted, yield a lower present value than the carrying value of the asset before impairment.

For the remaining nine years of the contract, the Company will incur annual amortization expense of approximately $1,785,000.

As a result of the items discussed above, the Company s financial results increased from an operating loss of $48,551,000 in the Third Quarter Fiscal 2005 to an operating income of $2,080,000 in the Third Quarter of Fiscal 2006.

The Company s interest expense decreased slightly from approximately $96,000 in the Third Quarter Fiscal 2005 to approximately $55,000 in the Third Quarter Fiscal 2006 as a result of the refinancing. Interest income increased from approximately $51,000 in the Third Quarter Fiscal 2005 to approximately $96,000 in the Third Quarter Fiscal 2006, as a result of increasing investments of excess cash in marketable securities.

The Company s income tax benefit decreased from $19,439,000 in the Third Quarter Fiscal 2005 to a tax expense of $856,000 in the Third Quarter Fiscal 2006 as a result of the Company s increased operating income. The effective tax rate held steady at 41% in the Third Quarter Fiscal 2005 to Third Quarter of 2006.

The Company reported a net loss of $29,158,000 in the Third Quarter Fiscal 2005, or $1.21 basic and diluted loss per share, compared to net income of $1,255,000 in the Third Quarter Fiscal 2006, or $0.05 basic and diluted income per share.

Results of Operations Nine months ended March 31 ,2006 compared with nine months ended March 31, 2005

Net sales increased 26% from $35,533,000 for the nine months ended March 31, 2005 to $44,607,000 for the nine months ended March 31, 2006. The increase was primarily due to new products introduced in the second and third quarters in combination with better sales across a wider mix of drugs. Overall, new product sales contributed $7,800,000 to the sales in the current year, across a broad variety of medical indications. The year over year increase in existing product sales was a result of volume declines of 2% and price increases of 5%.

The table below identifies the Company s approximate net sales to each category for the nine months ended March 31, 2006 and 2005:

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	For the nine months ended	
Customer Category	3/31/2006	3/31/2005
Wholesaler/Distributor	$ 30,495,000	$ 22,880,000
Retail Chain	6,979,000	6,993,000
Mail-Order Pharmacy	5,094,000	3,511,000
Private Label	2,039,000	2,149,000
Total	$ 44,607,000	$ 35,533,000

Cost of sales increased 28% from $18,973,000 for the nine months ended March 31, 2005 to $24,331,000 for the nine months ended March 31, 2006. The increase is attributable to increases in sales volume. Gross profit margins for the nine months ended March 31, 2005 and the nine months ended March 31, 2006 were 47% and 45%, respectively. Cost of Sales and gross margin discussed here excludes amortization of intangible assets. The Company anticipates gross profit margins to remain stable for the foreseeable future.

Research and development (R&D) expenses increased 37% from $3,522,000 for the nine months ended March 31, 2005 to $4,814,000 for the nine months ended March 31, 2006. The increase is primarily due to the Company s effort to increase the number of product development projects. R&D costs represent spending on products in the pipeline. Current spending is anticipated to benefit the continued growth of the Company s product mix.

Selling, general and administrative expenses increased 8% from $6,817,000 for the nine months ended March 31, 2005 to $7,332,000 for the nine months ended March 31, 2006. The increase is primarily due to the adoption of SFAS 123(R) which contributed stock compensation expense of $1,072,000. Depreciation expense increased $272,000 compared to the prior year.

Amortization expense for the intangible asset for the nine months ended March 31, 2006 and 2005 was approximately $1,339,000 and $5,070,000, respectively. The amortization expense relates to the March 23, 2005 exclusive marketing and distribution rights agreement with JSP. The reduction of this expense is due entirely to the impairment of the intangible assets recorded in the Third Quarter Fiscal 2005.

In fiscal year 2005, management believed that events (as described below) occurred which indicated that the carrying value of the intangible asset was not recoverable. In accordance with Statement of Financial Accounting Standards No. 144 (FAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company engaged a third party valuation specialist to assist in the performance of an impairment test for the quarter ended March 31, 2005. The impairment test was performed by discounting forecasted future net cash flows for the JSP products covered under the agreement and then comparing the discounted present value of those cash flows to the carrying value of the asset (inclusive of the $1.5 million payable to JSP for the Third AB rating). As a result of the testing, the Company has determined that the intangible asset was impaired as of March 31, 2005. In accordance with FAS 144, the Company recorded a non-cash impairment loss of approximately $46,093,000 to write the asset down to its fair value of approximately $16,062,000 as of March 31, 2005. This impairment loss is shown on the statement of operations as a component of operating loss.

Management believes that several factors contributed to the impairment of this asset. In December 2005, the Levothyroxine Sodium tablet product received the AB rating to Synthroid®. The expected sales increase as a result of the AB rating did not occur in the third quarter of 2005. The delay in receiving the AB rating to Synthroid® caused the Company to be competitively disadvantaged with its Levothyroxine Sodium tablet product and to lose market share to competitors whose products had already received AB ratings to both major brand thyroid deficiency drugs. Additionally, the generic market for thyroid deficiency drugs turned out to be smaller than it was anticipated to be as a result of a lower brand-to-generic substitution rate. Increased

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competition in the generic drug market, both from existing competitors and new entrants, has resulted in significant pricing pressure on other products supplied by JSP. The combination of these factors has resulted in diminished forecasted future net cash flows which, when discounted, yield a lower present value than the carrying value of the asset before impairment.

For the remaining nine years of the contract, the Company will incur annual amortization expense of approximately $1,785,000.

As a result of the items discussed above, the Company s financial results increased from an operating loss of $44,942,000 in the nine months ended March 31, 2005 to an operating income of $6,792,000 in the nine months ended March 31, 2006.

The Company s interest expense increased from approximately $245,000 in the nine months ended March 31, 2005 to approximately $247,000 in the nine months ended March 31, 2006 primarily as a result of an increase in the Prime Rate and LIBOR rate which the variable rates of the Construction and Equipment loans depend offset by the refinancing in December 2005. Interest income increased from approximately $99,000 in the nine months ended March 31, 2006 to approximately $334,000 in the nine months ended March 31, 2006, as a result of increasing investments of excess cash in marketable securities.

The Company s income tax classification changed from an income tax benefit of $18,036,000 for the nine months ended March 31, 2005 to an income tax expense of $2,752,000 in the nine months ended March 31, 2006 as a result of the Company s increased operating income. The effective tax rate held steady at 40% in the nine months ended March 31, 2005 to nine months ended March 31, 2006.

The Company reported net income of $4,123,000 in the nine months ended March 31, 2006, or $0.17 basic and diluted income per share, compared to a net loss of $27,054,000 in the nine months ended March 31, 2005, or $1.12 basic and diluted loss per share.

The Company regularly monitors customer Accounts Receivable (AR) balances, as it and others in the industry may experience significant fluctuations in balances due from customers. The primary benchmark for evaluating the receivable balances is a calculation called Days Sales in Accounts Receivable. This calculation takes the Net AR and subtracts the Rebates and Chargeback reserve. This total is then divided by the average daily sales for the period. The table below shows how the Company has calculated this item for the most recent periods.

	3/31/05	**6/30/05**	**3/31/06**
Trade Accounts Receivable	8,663,377	$10,735,529	$23,664,023
Rebates and chargebacks accrual	10,075,000	10,750,000	14,698,211
Net Sales	35,533,206	44,901,645	44,607,481
Daily Sales	129,683	123,018	162,801
Days Sales in AR	-10.9	-0.1	55.1

The Company s credit terms are consistent with the industry at 60 days for payment from customers and wholesalers. As can be seen in the above table, the Days Sales calculation amounts to less than zero at March 31, 2005 and June 30, 2005. This is a result of a few significant wholesaler customers with balances near zero or with credit balances. When an active customer has a zero balance, it is due to the inability of the customer to

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resell Lannett s products within 60 days. At that point, the wholesaler is required to remit to Lannett the full balance due. Subsequent chargebacks will cause the net AR balance to decline even further, until the wholesaler sells the product and requests actual chargebacks. At March 31, 2005 and June 30, 2005, the product Levothyroxine Sodium tablets were selling at a slower pace than anticipated by the Company s wholesale customers due to a delay in the AB rating. The Company believes this was a one-time event and does not expect a similar situation in the future. A number of wholesaler customers had paid the full balances due, and had not sold the product to end-user customers, and thus did not yet claim any chargebacks until after June 30, 2005. At March 31, 2006, Days Sales calculation has returned to a number that indicates payments by wholesalers and other customers are more closely matching the sales less chargebacks for the period. Currently, no customer has a credit balance. This is due to improved sales of Levothyroxine Sodium tablets by the wholesalers for the fiscal year 2006.

Liquidity and Capital Resources

Net cash provided by operating activities of $2,255,009 for the nine months ended March 31, 2006 was attributable to net income of $4,123,279, as adjusted for the effects of non-cash items of $3,990,602 and a net increase in operating assets and liabilities of $5,858,872. Significant changes in operating assets and liabilities are comprised of:

1. An increase in trade accounts receivable of $8,980,283 due to a continued growth in gross sales in the months of February and March.

2. An increase in inventories of $1,710,493 is due to a general increase in products offered. Also, in anticipation of newer product sales, inventory is building up.

3. A decrease in prepaid taxes of $2,756,561 is attributable to estimated tax payments on net income that offsets previous tax payments that were made during Fiscal 2005 while in a net loss position.

4. An increase in accrued expenses of $2,199,501 due in part to a timing difference in the receipt of large inventory purchases. It is also attributable to a performance based bonus, payable annually.

The net cash used in investing activities of $3,789,101 for the nine months ended March 31, 2006 was attributable to the Company s purchase of a $2,000,000 note receivable and $4,033,852 in capital expenditures to expand production and R&D space. This was partially offset by the sale of a portion of the Company s investment securities, which consist primarily of U. S. government and agency marketable debt securities.

The net cash used in financing activities of $901,583 for the nine months ended March 31, 2006 was attributed to the Company s refinancing efforts to gain more favorable percentage rates as well as move more debt long term.

The following table summarizes the remaining repayments of debt, including sinking fund requirements as of March 31, 2006 for the subsequent twelve month periods:

Twelve Month Periods	Amounts Payable to Institutions
2006	$ 1,130,706
2007	987,487
2008	492,677
2009	338,309
2010	4,681,880
Thereafter	885,078
	$ 8,516,137

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The Company has no material leases, commitments, or contractual obligations other than the JSP commitment that is disclosed in Note 15, Material Contract with Suppliers.

The Company has a $3,000,000 line of credit from Wachovia Bank, N.A. that bears interest at the prime interest rate less 0.25% (7.50% at March 31, 2006). The line of credit was renewed and extended to November 30, 2006. At March 31, 2006 and 2005, the Company had $0 outstanding and $3,000,000 available under the line of credit. The line of credit is collateralized by substantially all of the Company s assets. The Company currently has no plans to borrow under this line of credit

The terms of the line of credit, the loan agreement, the related letter of credit, the 2003 Loan Financing, and the new PIDC/PIDA loan agreements require that the Company meet certain financial covenants and reporting standards, including the attainment of standard financial liquidity and net worth ratios. As of March 31, 2006, the Company has complied with such terms, and successfully met its financial covenants.

In July 2005, the Company received $500,000 of grant funding from the Commonwealth of Pennsylvania, acting through the Department of Community and Economic Development. The grant funding program requires the Company to use the funds for machinery and equipment located at their Pennsylvania locations, hire an additional 100 full-time employees by June 30, 2006, operate its Pennsylvania locations a minimum of five years and meet certain matching investment requirements. If the Company fails to comply with any of the requirements above, the Company would be liable to the full amount of the grant funding ($500,000). The Company records the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program. On a quarterly basis, the Company will monitor its progress in fulfilling the requirements of the grant funding program and will determine the status of the liability. As of March 31, 2006, the Company has recognized the grant funding as a current liability under the caption of Unearned Grant Funds.

Except as set forth in this report, the Company is not aware of any trends, events or uncertainties that have or are reasonably likely to have a material adverse impact on the Company s short-term or long-term liquidity or financial condition.

Prospects for the Future

The Company has several generic products under development. These products are all orally-administered, products designed to be generic equivalents to brand named innovator drugs. The Company s developmental drug products are intended to treat a diverse range of indications. As the oldest generic drug manufacturer in the country, formed in 1942, Lannett currently owns several ANDAs for products which it does not manufacture and market. These ANDAs are simply dormant on the Company s records. Occasionally, the Company reviews such ANDAs to determine if the market potential for any of these older drugs has recently changed, so as to make it attractive for Lannett to reconsider manufacturing and selling it. If the Company makes the determination to introduce one of these products into the consumer marketplace, it must review the ANDA and related documentation to ensure that the approved product specifications, formulation and other factors meet current FDA requirements for the marketing of that drug. Generally, in these situations, the Company must file a supplement to the FDA for the applicable ANDA, informing the FDA of any significant changes in the manufacturing process, the formulation, or the raw material supplier of the previously-approved ANDA. The Company would then redevelop the product and submit it to the FDA for supplemental approval. The FDA s approval process for ANDA supplements is similar to that of a new ANDA.

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A majority of the products in development represent either previously approved ANDAs that the Company is planning to reintroduce (ANDA supplements), or new formulations (new ANDAs). The products under development are at various stages in the development cycle formulation, scale-up, and/or clinical testing. Depending on the complexity of the active ingredient s chemical characteristics, the cost of the raw material, the FDA-mandated requirement of bioequivalence studies, the cost of such studies and other developmental factors, the cost to develop a new generic product varies. It can range from $100,000 to $1 million. Some of Lannett s developmental products will require bioequivalence studies, while others will not depending on the FDA s Orange Book classification. Since the Company has no control over the FDA review process, management is unable to anticipate whether or when it will be able to begin producing and shipping additional products.

In addition to the efforts of its internal product development group, Lannett has contracted with an outside firm for the formulation and development of several new generic drug products. These outsourced R&D products are at various stages in the development cycle formulation, analytical method development and testing and manufacturing scale-up. These products are orally-administered solid dosage products intended to treat a diverse range of medical indications. It is the Company s intention to ultimately transfer the formulation technology and manufacturing process for all of these R&D products to the Company s own commercial manufacturing sites. The Company initiated these outsourced R&D efforts to compliment the progress of its own internal R&D efforts.

Occasionally the Company will work on developing a drug product that does not require FDA approval. The FDA allows generic manufacturers to manufacture and sell products which are equivalent to innovator drugs which are grand-fathered, under FDA rules, prior to the passage of the Hatch-Waxman Act of 1984. The FDA allows generic manufacturers to produce and sell generic versions of such grand-fathered products by simply performing and internally documenting the product s stability over a period of time. Under this scenario, a generic company can forego the time required for FDA ANDA approval.

The Company has also contracted with Spectrum Pharmaceuticals Inc., based in California, to market generic products developed and manufactured by Spectrum and/or its partners. The first applicable product under this agreement is ciprofloxacin tablets, the generic version of Cipro ®, an anti-bacterial drug, marketed by Bayer Corporation, prescribed to treat infections. The Company has also initiated discussions with UniChem, of India, and Orion Pharma, of Finland, for similar new product initiatives, in which Lannett will market and distribute products manufactured by third parties. Lannett intends to use its strong customer relationships to build its market share for such products, and increase future revenues and income.

The majority of the Company s R&D projects are being developed in-house under Lannett s direct supervision and with Company personnel. Management believes the future spending on product development, including bio equivalency studies, will likely increase in future periods. Hence, the Company does not believe that its outside contracts for product development and manufacturing supply, including Spectrum Pharmaceuticals Inc., are material in nature, nor is the Company substantially dependent on the services rendered by such outside firms. Since the Company has no control over the FDA review process, management is unable to anticipate whether or when it will be able to begin producing and shipping such additional products.

The Company plans to enhance relationships with strategic business partners, including providers of product development research, raw materials, active pharmaceutical ingredients as well as finished goods. Management believes that mutually beneficial strategic relationships in such areas, including potential financing arrangements, partnerships, joint ventures or acquisitions, could allow for potential competitive advantages in the generic pharmaceutical market. For example, the Company has entered into prepayment arrangements in exchange for discounted purchase prices on certain active pharmaceutical ingredients (API) and oral dosage forms. The Company has also arranged for a loan to a certain API provider that should facilitate the availability of difficult to source material in the future. The Company plans to continue to explore such areas for potential opportunities to enhance shareholder value.

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PART I. FINANCIAL INFORMATION

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management necessarily applies its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management s control objectives.

With the participation of management, the Company s Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures at the conclusion of the nine months ended March 31, 2006. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective in ensuring that material information required to be disclosed is included in the reports that it files with the Securities and Exchange Commission.

Changes in Internal Controls

There were no significant changes in the Company s internal controls or, to the knowledge of management of the Company, in other factors that could significantly affect internal controls subsequent to the date of the Company s most recent evaluation of its disclosure controls and procedures utilized to compile information included in this filing.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Regulatory Proceedings

The Company is engaged in an industry which is subject to considerable government regulation relating to the development, manufacturing and marketing of pharmaceutical products. Accordingly, incidental to its business, the Company periodically responds to inquiries or engages in administrative and judicial proceedings involving regulatory authorities, particularly the FDA and the Drug Enforcement Agency.

PART II. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) A list of the exhibits required by Item 601 of Regulation S-K to be filed as a part of this Form 10-Q is shown on the Exhibit Index filed herewith.

SIGNATURE

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LANNETT COMPANY, INC.

Dated: May 9, 2006

By: /s/ Brian Kearns

Brian Kearns
Vice President of Finance, Treasurer and Chief Financial Officer

By: /s/ Arthur P. Bedrosian

Arthur P. Bedrosian
President and Chief Executive Officer

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