LANNETT CO INC
Form 10-Q
May 13, 2011
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2011

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 x No o

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

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

Class	**Outstanding as of May 10, 2011**
Common stock, par value $0.001 per share	28,388,444 shares

Table of Contents

Table of Contents

		Page No.
PART I. FINANCIAL INFORMATION		
ITEM 1.	**FINANCIAL STATEMENTS**	
	Consolidated Balance Sheets as of March 31, 2011 (unaudited) and June 30, 2010	1
	Consolidated Statements of Operations (unaudited) for the three and nine months ended March 31, 2011 and 2010	2
	Consolidated Statement of Changes in Shareholders Equity (unaudited) for the nine months ended March 31, 2011	3
	Consolidated Statements of Cash Flows (unaudited) for the nine months ended March 31, 2011 and 2010	4
	Notes to Consolidated Financial Statements (unaudited)	5
ITEM 2.	**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**	29
ITEM 3.	**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**	44
ITEM 4.	**CONTROLS AND PROCEDURES**	44
PART II. OTHER INFORMATION		
ITEM 1.	**LEGAL PROCEEDINGS**	45
ITEM 6.	**EXHIBITS**	45

31.1 CERTIFICATION OF PRESIDENT & CHIEF EXECUTIVE OFFICER

31.2 CERTIFICATION OF CHIEF FINANCIAL OFFICER

32 CERTIFICATION PURSUANT TO SECTION 906 OF SARBANES OXLEY ACT OF 2002

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	(Unaudited) March 31, 2011	June 30, 2010
ASSETS		
Current Assets		
Cash and cash equivalents	$ 14,449,304	$ 21,895,648
Investment securities	8,322,240	604,464
Trade accounts receivable (net of allowance of $123,573 and $123,192 respectively)	34,868,146	38,324,258
Inventories, net	24,746,159	19,056,868
Interest receivable	10,311	9,631
Prepaid taxes	2,407,350	
Deferred tax assets	4,203,287	5,337,391
Other current assets	1,134,156	2,506,114
Total Current Assets	90,140,953	87,734,374
Property, plant and equipment	53,712,234	50,160,114
Less accumulated depreciation	(23,760,894)	(21,531,845)
	29,951,340	28,628,269
Construction in progress	4,989,118	2,939,898
Investment securities		183,742
Intangible assets (product rights) - net of accumulated amortization	6,399,407	7,785,298
Deferred tax assets	10,550,788	12,544,330
Other assets	1,532,388	147,886
Total Assets	$ 143,563,994	$ 139,963,797
LIABILITIES AND SHAREHOLDERS EQUITY		
LIABILITIES		
Current Liabilities		
Accounts payable	$ 17,104,478	$ 16,280,675
Accrued expenses	995,252	3,464,181
Accrued payroll and payroll related	1,085,034	6,304,465
Income taxes payable		1,479,658
Current portion of long-term debt	281,236	4,851,278
Rebates, chargebacks and returns payable	13,836,564	15,249,412
Total Current Liabilities	33,302,564	47,629,669
Long-term debt, less current portion	2,703,696	2,868,549
Unearned grant funds	500,000	500,000
Other long-term liabilities	3,563	7,864
Total Liabilities	36,509,823	51,006,082
Commitment and Contingencies, See notes 10 and 11		

SHAREHOLDERS EQUITY				
Common stock - authorized 50,000,000 shares, par value $0.001; issued and outstanding, 28,379,466 and 24,882,123 shares, respectively		28,379		24,882
Additional paid in capital		96,595,443		79,862,940
Retained earnings		11,152,164		9,564,632
Noncontrolling interest		122,522		111,982
Accumulated other comprehensive income		27,966		44,692
		107,926,474		89,609,128
Less: Treasury stock at cost - 156,611 and 110,108 shares, respectively		(872,303)		(651,413)
TOTAL SHAREHOLDERS EQUITY		107,054,171		88,957,715
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	143,563,994	$	139,963,797

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

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three months ended March 31,		Nine months ended March 31,	
	2011	**2010**	**2011**	**2010**
Net sales	$ 25,892,483	$ 31,266,224	$ 81,327,667	$ 91,417,926
Cost of sales	20,098,084	20,190,460	60,667,878	59,095,559
Amortization of intangible assets	463,769	448,667	1,385,892	1,346,000
Product royalties	26,980	229,827	(290,380)	967,889
Gross profit	5,303,650	10,397,270	19,564,277	30,008,478
Research and development expenses	1,854,216	3,352,173	5,557,296	9,110,126
Selling, general, and administrative expenses	4,279,502	4,392,593	11,755,062	12,205,145
Gain on investments	(41,791)		(56,556)	
Loss (gain) on sale of assets	17,565	(19,394)	16,299	(19,629)
Operating (loss) income	(805,842)	2,671,898	2,292,176	8,712,836
Other income (expense):				
Foreign currency gain	1,529	2,050	5,494	2,758
Interest and dividend income	24,744	5,168	39,852	49,451
Interest expense	(28,030)	(49,528)	(174,882)	(204,032)
	(1,757)	(42,310)	(129,536)	(151,823)
(Loss) income before income tax (benefit) expense	(807,599)	2,629,588	2,162,640	8,561,013
Income tax (benefit) expense	(449,797)	527,327	554,568	3,524,973
Net (loss) income	(357,802)	2,102,261	1,608,072	5,036,040
Less net income attributable to noncontrolling interest	(4,259)	(9,407)	(20,540)	(31,224)
Net (loss) income attributable to Lannett Company, Inc.	$ (362,061)	$ 2,092,854	$ 1,587,532	$ 5,004,816
Basic (loss) earnings per common share - Lannett Company, Inc.	$ (0.01)	$ 0.08	$ 0.06	$ 0.20
Diluted (loss) earnings per common share - Lannett Company, Inc.	$ (0.01)	$ 0.08	$ 0.06	$ 0.20
Basic weighted average number of shares	28,373,436	24,849,745	26,215,510	24,697,669
Diluted weighted average number of shares	28,373,436	25,286,331	26,558,432	25,171,750

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

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

	Common Stock Shares Issued	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Noncontrolling Interest	Accum. Other Comprehensive Income	Shareholders Equity
Balance, June 30, 2010	24,882,123	$ 24,882	$ 79,862,940	$ 9,564,632	$ (651,413)	$ 111,982	$ 44,692	$ 88,957,715
Exercise of stock options	59,200	59	229,567					229,626
Shares issued in connection with employee stock purchase plan	44,090	44	167,836					167,880
Share based compensation								
Restricted stock			618,951					618,951
Stock options			770,534					770,534
Employee stock purchase plan			48,584					48,584
Shares issued in connection with public stock offering	3,250,000	3,250	14,947,092					14,950,342
Shares issued in connection with restricted stock grant	144,053	144	(144)					
Tax shortfall on stock options exercised			(49,917)					(49,917)
Purchase of treasury stock					(220,890)			(220,890)
Distribution to noncontrolling interests						(10,000)		(10,000)
Other comprehensive loss, net of income tax							(16,726)	(16,726)
Net income				1,587,532		20,540		1,608,072
Balance, March 31, 2011	28,379,466	$ 28,379	$ 96,595,443	$ 11,152,164	$ (872,303)	$ 122,522	$ 27,966	$ 107,054,171

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

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the nine months ended March 31,	
	2011	**2010**
OPERATING ACTIVITIES:		
Net income	$ 1,608,072	$ 5,036,040
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	3,652,356	3,485,136
Deferred tax expense	3,133,015	1,312,062
Stock compensation expense	1,438,069	1,533,611
Other noncash expenses (income)	16,697	(11,054)
Gain on sale of assets	(40,257)	(19,629)
Changes in assets and liabilities which provided (used) cash:		
Trade accounts receivable	3,456,112	(6,817,060)
Inventories	(5,689,291)	(3,028,844)
Prepaid and income taxes payable	(3,887,008)	(1,488,327)
Prepaid expenses and other assets	(34,222)	(1,728,213)
Accounts payable	823,803	939,251
Accrued expenses	(2,468,929)	821,791
Rebates, chargebacks and returns payable	(1,412,848)	2,165,591
Accrued payroll and payroll related	(5,219,431)	(413,288)
Net cash (used in) provided by operating activities	(4,623,862)	1,787,067
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment (including construction in progress)	(5,663,361)	(8,788,906)
Proceeds from sale of property, plant and equipment	8,306	29,550
Purchase of intangible asset (product rights)		(500,000)
Purchases of investment securities	(11,925,702)	
Proceeds from sale of investment securities	4,434,800	
Net cash used in investing activities	(13,145,957)	(9,259,356)
FINANCING ACTIVITIES:		
Proceeds from public stock offering	14,950,342	
Proceeds from issuance of stock	397,506	696,714
Tax (shortfall) benefit on stock options exercised	(49,917)	63,751
Purchase of treasury stock	(220,890)	(122,922)
Repayments of debt	(4,734,895)	(251,250)
Distribution to noncontrolling interests	(10,000)	
Net cash provided by financing activities	10,332,146	386,293
Effect of foreign currency rates on cash and cash equivalents	(8,671)	(22,340)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(7,446,344)	(7,108,336)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	21,895,648	25,832,456
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 14,449,304	$ 18,724,120

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION -				
Interest paid	$	235,000	$	136,802
Income taxes paid	$	1,363,186	$	3,637,565
Lannett stock issued - Fiscal 2009 accrued incentive compensation	$		$	758,712

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

Table of Contents

LANNETT COMPANY, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for presentation of interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations, and cash flows for the periods presented. In the opinion of management, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. Operating results for the three and nine months ended March 31, 2011 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2011. You should read these unaudited financial statements in combination with the other Notes in this section; Management s Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Financial Statements, including the Notes to the Financial Statements, included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

Note 2. Summary of Significant Accounting Policies

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

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

Principles of Consolidation - The consolidated financial statements include the accounts of the operating parent company, Lannett Company, Inc., and its wholly owned subsidiaries, as well as the consolidation of Cody LCI Realty, LLC, a variable interest entity. See Note 17 regarding the consolidation of this variable interest entity. All intercompany accounts and transactions have been eliminated.

Foreign Currency Translation - The local currency is the functional currency of its foreign subsidiary. Assets and liabilities of the foreign subsidiary are translated into U.S. dollars at the period-end currency exchange rate and revenues and expenses are translated at an average currency exchange rate for the period. The resulting translation adjustment is recorded in a separate component of shareholders equity and changes to such are included in comprehensive income. Exchange adjustments resulting from transactions denominated in foreign currencies are recognized in the consolidated statements of operations.

Reclassifications - Certain prior year amounts have been reclassified to conform to the current year financial statement presentation.

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

Table of Contents

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, chargebacks and returns payable and reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS and Wolters Kluwer, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations.

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

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

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

Table of Contents

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

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for the nine months ended March 31, 2011 and 2010:

For the nine months ended March 31, 2011	**Chargebacks**	**Rebates**	**Returns**	**Other**	**Total**
Reserve Category					
Reserve Balance as of June 30, 2010	$ 6,282,127	$ 3,566,031	$ 5,401,254	$	$ 15,249,412
Actual credits issued related to sales recorded in prior fiscal years	(6,258,862)	(3,946,924)	(3,290,619)		(13,496,405)
Reserves or (reversals) charged during Fiscal 2011 related to sales in prior fiscal years		380,893			380,893
Reserves charged to net sales during Fiscal 2011 related to sales recorded in Fiscal 2011	40,105,340	12,276,977	5,602,225	2,739,301	60,723,843
Actual credits issued related to sales recorded in Fiscal 2011	(34,059,033)	(10,144,801)	(2,078,044)	(2,739,301)	(49,021,179)
Reserve Balance as of March 31, 2011	$ 6,069,572	$ 2,132,176	$ 5,634,816	$	$ 13,836,564

For the nine months ended March 31, 2010	**Chargebacks**	**Rebates**	**Returns**	**Other**	**Total**
Reserve Category					
Reserve Balance as of June 30, 2009	$ 6,089,802	$ 2,537,746	$ 5,106,992	$	$ 13,734,540
Actual credits issued related to sales recorded in prior fiscal years	(5,218,835)	(2,537,746)	(3,112,587)		(10,869,168)
Reserves or (reversals) charged during Fiscal 2010 related to sales in prior fiscal years					
Reserves charged to net sales during Fiscal 2010 related to sales recorded in Fiscal 2010	35,900,162	12,529,499	3,803,056	880,860	53,113,577
Actual credits issued related to sales recorded in Fiscal 2010	(30,081,997)	(9,527,547)		(880,860)	(40,490,404)
Reserve Balance as of March 31, 2010	$ 6,689,132	$ 3,001,952	$ 5,797,461	$	$ 15,488,545

The total reserve for chargebacks, rebates, returns and other adjustments decreased from $15,249,412 at June 30, 2010 to $13,836,564 at March 31, 2011. The decrease in total reserves was mainly due to a decrease in the

Table of Contents

rebates reserve as a result of a timing of credits taken by customers, and a decrease in chargeback reserves due primarily to a decrease in inventory levels at wholesaler distribution centers. The activity in the Other category for the nine months ended March 31, 2011 includes shelf-stock adjustments totaling $2,250,404 primarily related to products for the treatment of thyroid deficiency and heart failure.

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

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

Cash and cash equivalents The Company considers all highly liquid securities purchased with original maturities of 90 days or less to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value, and consist of certificates of deposit that are readily convertible to cash. The Company maintains cash and cash equivalents with several major financial institutions. Such amounts frequently exceed Federal Deposit Insurance Corporation (FDIC) limits.

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

Table of Contents

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.

Fair Value of Financial Instruments - The Company s financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and debt obligations. The carrying values of these assets and liabilities approximate fair value based upon the short-term nature of these instruments. The Company has estimated that the fair value of long-term debt associated with the 20 year mortgage on its land and building in Cody, Wyoming approximates the discounted amount of future payments to the mortgage-holder.

Investment Securities - The Company s investment securities consist of equity securities and marketable debt securities, primarily U.S. government and agency obligations. All of the Company s equity securities are classified as trading and all of its marketable debt securities are classified as available-for-sale. Investment securities are recorded at fair value based on quoted market prices. For trading investments, unrealized holding gains and losses are recorded in gain of investments on the consolidated statements of operations. For available-for-sale investments, 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 investment securities are realized until they are sold or a decline in fair value is determined to be other-than-temporary. The Company reviews its investment securities and determines whether the investments are other-than-temporarily impaired. If the investments are deemed to be other-than-temporarily impaired, the investments are written down to their then current fair market value with a new cost basis being established. There were no securities determined by management to be other-than-temporarily impaired during the nine months ended March 31, 2011 or the fiscal year ended June 30, 2010.

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

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

Intangible Assets In March 2004, the Company entered into an agreement with Jerome Stevens Pharmaceuticals, Inc. (JSP) for the exclusive marketing and distribution rights in the United States to the current line of JSP products in exchange for four million (4,000,000) shares of the Company s common stock. As a result of the JSP agreement, the Company recorded an intangible asset for the exclusive marketing and distribution rights obtained from JSP. The Company will incur annual amortization expense of approximately $1,785,000 for the JSP intangible asset over the remaining term of the agreement.

On April 10, 2007, the Company entered into a Stock Purchase Agreement to acquire Cody by purchasing all of the remaining shares of common stock of Cody. The consideration for the April 10, 2007 acquisition was approximately $4,438,000, which represented the fair value of the tangible net assets acquired. The agreement also required Lannett to issue to the sellers up to 120,000 shares of unregistered common stock of the Company contingent upon the receipt of a license from a regulatory agency. This license was subsequently received in July 2008 and triggered the payment of 105,000 shares (87.5% of the 120,000 shares to be issued as the Company already owned 12.5% of Cody) of Lannett stock to the former owners of Cody Labs, which was completed in October 2008. Therefore, the Company recorded an intangible asset related to the acquisition of a drug import license in the original amount of $581,175 and recorded a corresponding deferred tax liability of approximately $150,700 due to the non-deductibility of the amortization for tax purposes. The Company has assigned a 15 year life to this intangible asset based on average life cycles of Lannett products.

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased for $100,000 and future royalty payments the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. owned the ANDA. In May 2008, the Company and Pharmeral waived their rights to any royalty payments on the sales of the drug by Lannett under Lannett s current ownership structure. Should Lannett undergo a change in control transaction with a third party, this royalty will be reinstated. In Fiscal 2008, the Company obtained FDA approval to

Table of Contents

use these proprietary rights. Accordingly, the Company originally capitalized these purchased product rights as an indefinite lived intangible asset and tested this asset for impairment at least on an annual basis. During the fourth quarter of Fiscal 2009, it was determined that this intangible asset no longer had an indefinite life. No impairment existed because the estimated fair value exceeded the carrying amount on that date. Accordingly, the $100,000 carrying amount of this intangible asset is being amortized on a straight line basis prospectively over its 10 year remaining estimated useful life.

In August 2009, the Company acquired eight new ANDAs covering three separate product lines from another generic drug manufacturer for a purchase price of $500,000. The Company began shipping one of these product lines in October 2010. Accordingly, the Company allocated $325,000 of the purchase price to this product line, based on the relative fair market values of the acquired ANDAs, which is being amortized on a straight line basis over its 15 year estimated product life. It is expected that the Company will be able to produce the other two product lines by the first half of Fiscal 2012. Amortization will begin on the remaining $175,000 when the Company starts shipping these products.

An intangible asset that is not subject to amortization shall be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. An impairment loss is measured as the excess of the asset s carrying value over its fair value, calculated using a discounted future cash flow method. Our discounted cash flow models are highly reliant on various assumptions which are considered level 3 inputs, including estimates of future cash flow (including long-term growth rates), discount rate, and expectations about variations in the amount and timing of cash flows and the probability of achieving the estimated cash flows. As of March 31, 2011 and June 30, 2010, no impairment existed with respect to these non-amortized assets.

For the three months ended March 31, 2011 and 2010, the Company incurred amortization expense of approximately $464,000 and $458,000, respectively. For the nine months ended March 31, 2011 and 2010, the Company incurred amortization expense of approximately $1,386,000 and $1,375,000, respectively. As of March 31, 2011 and June 30, 2010, accumulated amortization totaled approximately $10,844,000 and $9,458,000, respectively.

Future annual amortization expense consists of the following as of March 31, 2011:

Fiscal Year Ending June 30,		Annual Amortization Expense
2011	$	463,770
2012		1,855,079
2013		1,855,079
2014		1,408,912
2015		70,412
Thereafter		571,155
	$	6,224,407

The amounts above do not include two of the product lines covered by the ANDAs purchased in August 2009 for $175,000 as amortization will begin when the Company starts shipping these products.

Other Assets - As of July 24, 2010, Lannett has stopped manufacturing and distributing Morphine Sulfate Oral Solution. Lannett filed a 505(b)(2) New Drug Application (MS NDA) in February 2010 and currently awaits FDA approval on the submission. The filing fee related to

this application totaled $1,405,500 and was initially recorded within other current assets on the consolidated balance sheets because part or all of this fee was thought

Table of Contents

to be refundable. Lannett met with the FDA in January 2011 to review the status of the application. At that time, the FDA stated that it will need to inspect Lannett s facilities as part of a Pre-Approval Inspection before it could give final approval on the MS NDA. Additionally, the Company corresponded with the FDA regarding the refundability of the filing fee in March 2011. The FDA s current position is that all of the filing fee is not refundable, but the Company believes the FDA continues to review this position. The Company continued conversations with the FDA in March 2011 and still believes that part of the fee is refundable.

The Company s position is that the value related to the part of the fee that is not refunded is the cost of getting regulatory approval for its MS product and that this value should be properly recorded as an intangible asset at time of approval and amortized over the product s estimated useful life. The revenues and gross profit margins attained by the Company when it was previously selling its MS product currently substantiate its value as an intangible asset.

As a result of the new information the Company received at the meeting related to what was now required for the MS NDA approval and the filing fee discussions and correspondence, the Company has reclassified this amount to other long-term assets as of March 31, 2011. Once the FDA determines how much of the fee will be refunded, the nonrefundable amount will be reclassified to intangible assets upon FDA approval of the MS NDA. Amortization will begin when the Company starts shipping these products. If this application is not approved, the Company has the right to re-file multiple applications for this specific product with no additional fees due.

Advertising Costs - The Company charges advertising costs to operations as incurred. Advertising expense for the nine months ended March 31, 2011 and 2010 was approximately $23,000 and $20,000, respectively.

Income Taxes - The Company uses the liability method to account 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. The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative standards issued by the FASB also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

Segment Information - The Company operates one business segment - generic pharmaceuticals; accordingly the Company has one reporting segment. The Company aggregates its financial information for all products and reports as one operating segment. The following table identifies the Company s approximate net product sales by medical indication for the three and nine months ended March 31, 2011 and 2010:

Table of Contents

Medical Indication	For the Three Months Ended March 31, 2011	2010	For the Nine Months Ended March 31, 2011	2010
Migraine Headache	$ 1,949,000	$ 2,135,000	$ 6,985,000	$ 7,275,000
Epilepsy	457,000	357,000	1,338,000	1,396,000
Prescription Vitamin		1,446,000	1,821,000	4,502,000
Heart Failure	2,990,000	5,070,000	9,738,000	15,212,000
Thyroid Deficiency	12,331,000	12,798,000	34,898,000	38,906,000
Antibiotic	1,664,000	1,709,000	4,502,000	4,928,000
Pain Management	2,726,000	3,818,000	11,128,000	8,782,000
Other	3,775,000	3,933,000	10,918,000	10,417,000
Total	$ 25,892,000	$ 31,266,000	$ 81,328,000	$ 91,418,000

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 43%, 12%, 9%, 5% and 5%, respectively of net sales for the nine months ended March 31, 2011. Those same products accounted for 43%, 17%, 8%, 2% and 1% respectively, of net sales for the nine months ended March 31, 2010. For the three months ended March 31, 2011 and 2010, the same five products accounted for 48%, 12%, 8%, 7% and 6%, and 41%, 16%, 7%, 2% and 5%, respectively, of net sales.

Four of the Company s customers accounted for 22%, 13%, 11%, and 9%, respectively, of net sales for the nine months ended March 31, 2011, and 26%, 11%, 9%, and 8%, respectively, of net sales for the nine months ended March 31, 2010. For the three months ended March 31, 2011 and 2010, four customers accounted for 22%, 12%, 12%, and 9%, and 27%, 11%, 11%, and 8%, respectively, of net sales. At March 31, 2011, four customers accounted for 71% of the Company s accounts receivable balances. At June 30, 2010, four customers accounted for 69% of the Company s accounts receivable balances.

Share-based Compensation - The Company recognizes 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, 2011, the Company had four stock-based employee compensation plans (the Old Plan, the 2003 Plan, the 2006 Long-term Incentive Plan, or 2006 LTIP and the 2011 Long-Term Incentive Plan or 2011 LTIP).

At March 31, 2011, there were 1,962,366 options outstanding. Of those, 965,360 were options issued under the 2006 LTIP, 791,773 were issued under the 2003 Plan, and 205,233 under the Old Plan. There are no further shares authorized to be issued under the Old Plan. 1,125,000 shares were authorized to be issued under the 2003 Plan, with 52,365 shares under options having already been exercised under that plan since its inception, leaving a balance of 280,862 shares in that plan for future issuances. 2,500,000 shares were authorized to be issued under the 2006 LTIP, with 150,925 shares under options having already been exercised under that plan since its inception. At March 31, 2011, there were 155,011 nonvested restricted shares outstanding which were issued under the 2006 LTIP, with 484,344 shares having already vested under that plan since its inception. At March 31, 2011, a balance of 744,360 shares is available in the 2006 LTIP for future issuances.

Table of Contents

In January 2011, the shareholders of the Company approved a new stock option and restricted stock award plan, the 2011 LTIP, which authorized 1,500,000 new shares of common stock for future issuances under this plan. As of March 31, 2011, no shares have been issued under this plan.

During the fiscal year ended June 30, 2010, the Company awarded 237,500 shares of restricted stock to management employees under the 2006 LTIP which vest in equal portions on October 29, 2010, 2011 and 2012. Stock compensation expense of $126,593 and $130,129 was recognized during the three months ended March 31, 2011 and 2010, respectively, related to these shares of restricted stock. Stock compensation expense of $406,808 and $220,217 was recognized during the nine months ended March 31, 2011 and 2010, respectively, related to these shares of restricted stock.

During the fiscal year ended June 30, 2008, the Company awarded 209,264 shares of restricted stock to management employees under the 2006 LTIP, of which 74,464 of these shares vested 100% on January 1, 2008, and the remainder vested in equal portions on September 18, 2008, 2009 and 2010. Stock compensation expense of $43,007 was recognized during the three months ended March 31, 2010 related to these shares of restricted stock. Stock compensation expense of $29,968 and $129,021 was recognized during the nine months ended March 31, 2011 and 2010, respectively, related to these shares of restricted stock.

During the three months ended March 31, 2011, the Company awarded 32,500 shares of restricted stock under the 2006 LTIP which vested immediately. Stock compensation expense of $182,175 was recognized during the three months ended March 31, 2011 related to the vesting of these shares of restricted stock.

During the three months ended March 31, 2010, the Company awarded 45,000 shares of restricted stock under the 2006 LTIP which vested immediately. Stock compensation expense of $290,250 was recognized during the three months ended March 31, 2010 related to the vesting of these shares of restricted stock.

The Company measures the fair value of share-based compensation cost for options using the Black-Scholes option pricing model. The following table presents the weighted average assumptions used to estimate fair values of the stock options granted and the estimated forfeiture rates during the nine months ended March 31:

	Incentive Stock Options FY 2011	Non-qualified Stock Options FY 2011	Incentive Stock Options FY 2010	Non-qualified Stock Options FY 2010
Risk-free interest rate	%	%	2.4%	2.4%
Expected volatility	%	%	66.4%	66.8%
Expected dividend yield	%	%	%	%
Forfeiture rate	%	%	5.0%	5.0%
Expected term	n/a	n/a	5.0 years	5.0 years
Weighted average fair value at date of grant	$	$	$ 3.99	$ 4.00

Expected volatility is based on the historical volatility of the price of our common shares since the date we commenced trading on the NYSE-Amex, April 2002, or a historical period equal to the expected term of the option, whichever is shorter. We use historical information to

estimate expected term within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using the straight-line method over the vesting or service period and is net of estimated forfeitures.

Table of Contents

The forfeiture rate assumption is the estimated annual rate at which unvested awards are expected to be forfeited during the vesting period. This assumption is based on our historical forfeiture rate. Periodically, management will assess whether it is necessary to adjust the estimated rate to reflect changes in actual forfeitures or changes in expectations. For example, adjustments may be needed if forfeitures were affected by turnover that resulted from a business restructuring that is not expected to recur. The Company will incur additional expense if the actual forfeiture rate is lower than originally estimated. A recovery of prior expense will be recorded if the actual rate is higher than originally estimated.

The following table presents all share-based compensation costs recognized in our statements of operations, substantially all of which is reflected in the selling, general and administrative expense line:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
Stock based compensation				
Stock options	$ 212,916	$ 320,013	$ 770,534	$ 850,607
Employee stock purchase plan	24,292	10,440	48,584	43,516
Restriced stock	308,768	463,386	618,951	639,488
Tax benefit at statutory rate	16,895	22,934	70,003	56,677

Options outstanding that have vested and are expected to vest as of March 31, 2011 are as follows:

	Awards	Weighted - Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Options vested	1,457,607	$ 7.92	$ 820,377	5.1
Options expected to vest	468,089	$ 6.43	$ 137,768	8.4
Total vested and expected to vest	1,925,696	$ 7.56	$ 958,145	5.9

A summary of nonvested restricted stock award activity as of March 31, 2011 and changes during the nine months then ended, is presented below:

	Awards	Weighted Average Grant Date Fair Value
Nonvested at July 1, 2010	269,898	$ 1,778,814
Granted	32,500	182,175
Vested	(144,053)	(862,075)
Forfeited	(3,334)	(23,138)
Nonvested at March 31, 2011	155,011	$ 1,075,776

Table of Contents

A summary of award activity under the Plans as of March 31, 2011 and 2010, and changes during the nine months then ended, is presented below:

	Incentive Stock Options				Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Outstanding at July 1, 2010	1,309,254	$ 6.11			749,597	$ 9.77		
Granted		$				$		
Exercised	(59,200)	$ 3.88				$		
Forfeited, expired or repurchased	(37,285)	$ 7.92				$		
Outstanding at March 31, 2011	1,212,769	$ 6.17	$ 737,617	6.8	749,597	$ 9.77	$ 225,865	4.7
Outstanding at March 31, 2011 and not yet vested	428,677	$ 6.36	$ 143,105	8.4	76,082	$ 6.99	$	8.6
Exercisable at March 31, 2011	784,092	$ 6.07	$ 594,512	5.9	673,515	$ 10.08	$ 225,865	4.3

	Incentive Stock Options				Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life
Outstanding at July 1, 2009	958,909	$ 5.60			626,772	$ 10.52		
Granted	502,642	$ 6.98			152,658	$ 6.99		
Exercised	(108,546)	$ 4.47			(13,804)	$ 4.97		
Forfeited, expired or repurchased	(15,650)	$ 5.17				$		
Outstanding at March 31, 2010	1,337,355	$ 6.21	$ 214,484	7.7	765,626	$ 9.91	58,121	5.7
Outstanding at March 31, 2010 and not yet vested	769,982	$ 5.98	129,399	9.1	196,218	$ 6.20	35,275	9.2
Exercisable at March 31, 2010	567,373	$ 6.52	$ 85,085	5.8	569,408	$ 11.19	22,846	4.5

Options with a fair value of $1,192,300 vested during the nine months ended March 31, 2011. As of March 31, 2011, there was $2,054,934 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 1.6 years. The Company issues new shares when stock options are exercised.

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.

Table of Contents

(Loss) Earnings per Common Share A dual presentation of basic and diluted (loss) earnings per share is required on the face of the Company s consolidated statement of operations as well as a reconciliation of the computation of basic (loss) earnings per share to diluted (loss) earnings per share. Basic (loss) 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 includes the effect of potential dilution from the exercise of outstanding common stock equivalents into common stock using the treasury stock method. Dilutive shares have been excluded in the weighted average shares used for the calculation of earnings per share in periods of net loss because the effect of such securities would be anti-dilutive. A reconciliation of the Company s basic and diluted (loss) earnings per share follows:

	Three Months Ended March 31,				Nine Months Ended March 31,			
	2011		2010		2011		2010	
	Net Loss Attirbutable to Lannett (Numerator)	Shares (Denominator)	Net Income Attirbutable to Lannett (Numerator)	Shares (Denominator)	Net Income Attirbutable to Lannett (Numerator)	Shares (Denominator)	Net Income Attirbutable to Lannett (Numerator)	Shares (Denominator)
Basic (loss) earnings per share factors	$ (362,061)	28,373,436	$ 2,092,854	24,849,745	$ 1,587,532	26,215,510	$ 5,004,816	24,697,669
Effect of potentially dilutive option and restricted stock plans				436,586		342,922		474,081
Diluted (loss) earnings per share factors	$ (362,061)	28,373,436	$ 2,092,854	25,286,331	$ 1,587,532	26,558,432	$ 5,004,816	25,171,750
Basic (loss) earnings per share	$ (0.01)		$ 0.08		$ 0.06		$ 0.20	
Diluted (loss) earnings per share	$ (0.01)		$ 0.08		$ 0.06		$ 0.20	

The number of anti-dilutive shares that have been excluded in the computation of diluted (loss) earnings per share for the three months ended March 31, 2011 and 2010 were 2,117,377 and 1,406,344, respectively. The number of anti-dilutive shares that have been excluded in the computation of diluted (loss) earnings per share for the nine months ended March 31, 2011 and 2010 were 1,405,879 and 1,315,984, respectively.

Note 3. New Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued authoritative guidance for determining whether an entity is a variable interest entity and modifies the methods allowed for determining the primary beneficiary of a variable interest entity. This guidance requires an enterprise to perform an analysis to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity. It also requires ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. The authoritative guidance is effective for the annual reporting period that begins after November 15, 2009. We adopted this authoritative guidance effective in our first quarter of Fiscal 2011 and it had no significant impact on our consolidated financial statements.

In January 2010, the FASB issued authoritative guidance which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair- value measurements. The FASB s Accounting Standards Update (ASU) 2010-6 is effective for annual reporting periods beginning after December 15, 2009, except for

Table of Contents

Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. We do not anticipate that this update will have a material impact on our consolidated financial statements.

Note 4. Inventories

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

Inventories consist of the following:

	March 31, 2011	June 30, 2010
Raw materials	$ 9,955,949	$ 5,183,735
Work-in-process	3,626,382	2,375,396
Finished goods	10,486,939	10,527,630
Packaging supplies	676,889	970,106
	$ 24,746,159	$ 19,056,868

The preceding amounts are net of excess and obsolete inventory reserves of $3,756,294 and $2,481,810 at March 31, 2011 and June 30, 2010, respectively.

Recently, the FDA has increased its efforts to force companies to file and seek FDA approval for GRASE or Grandfathered products. GRASE products are those old drugs that do not require prior approval from FDA in order to be marketed because they are generally recognized as safe and effective based on published scientific literature. Similarly, Grandfathered products are those which entered the market before the passage of the 1906 act, the 1938 act or the 1962 amendments to the act. Efforts have included granting market exclusivity to approved GRASE or Grandfathered products and issuing notices to discontinue marketing certain products to companies currently producing these products. Lannett currently manufactures and markets several products that are considered GRASE or Grandfathered products, including Morphine Sulfate Oral Solution. The Company is currently litigating the issue of Grandfathered drugs with the FDA. The FDA is currently undertaking activities to force all companies who manufacture Morphine Sulfate Oral Solution to file applications and seek approval for this product or remove their product from the market.

As of July 24, 2010, Lannett has stopped manufacturing and distributing Morphine Sulfate Oral Solution. Lannett filed a 505(b)(2) New Drug Application (MS NDA) in February 2010 and currently awaits FDA approval on the submission. Lannett met with the FDA in January 2011 to review the status of the application. At that time, the FDA stated that it will need to inspect Lannett s facilities as part of a Pre-Approval Inspection (PAI) before it could give final approval on the MS NDA. As a result of the new information the Company received at this meeting related to what was now required for the MS NDA approval, the Company has revised its date estimate for MS NDA approval and re-launch of its Morphine Sulfate Oral Solution product and recorded additional inventory reserves of $49,000 and $1,546,000, respectively, for the three and

nine months ended March 31, 2011 based on the relevant expiration dates of the material. Therefore, as of March 31, 2011, the Company has approximately $214,000 of Morphine Sulfate Oral Solution net finished goods inventory value. If

Table of Contents

the Company is rejected on its current application, if the current application takes significantly longer than anticipated to be approved, or if the FDA were to prevail on the current lawsuit filed by Lannett which seeks determination that Morphine Sulfate Oral Solution is a Grandfathered product, the Company is at risk of losing the remaining value of its Morphine Sulfate Oral Solution net inventory as of March 31, 2011. Lannett also has approximately $317,000 of net inventory value at March 31, 2011 of other Grandfathered products which would also be at risk if the FDA were to pursue enforcement actions on these products similar to their actions on Morphine Sulfate Oral Solution.

Note 5. Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is provided for by the straight-line method for financial reporting purposes over the estimated useful lives of the assets. Depreciation expense for the three months ended March 31, 2011 and 2010 was approximately $822,000 and $714,000, respectively. Depreciation expense for the nine months ended March 31, 2011 and 2010 was approximately $2,266,000 and $2,110,000, respectively.

Property, plant and equipment consist of the following:

	Useful Lives	March 31, 2011	June 30, 2010
Land		$ 1,350,499	$ 1,375,103
Building and improvements	10 - 39 years	25,029,000	23,101,751
Machinery and equipment	5 - 10 years	26,198,436	24,638,754
Furniture and fixtures	5 - 7 years	1,134,299	1,044,506
		$ 53,712,234	$ 50,160,114
Accumulated depreciation		(23,760,894)	(21,531,845)
		$ 29,951,340	$ 28,628,269

Note 6. Investment Securities

On July 1, 2008, the Company adopted the authoritative guidance which clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The authoritative guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Three levels of inputs were established that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities. The fair value of the Company s trading securities in the table below are derived solely from Level 1 inputs.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices for identical or similar instruments in markets that are not active; or model-derived valuations whose inputs are observable or whose significant value drivers are observable. The Company s Level 2 assets and liabilities primarily include debt securities with quoted prices that are traded less frequently than exchange-traded instruments, corporate bonds, U.S. government and agency securities and certain mortgage-backed and asset-backed securities whose values are determined using pricing models with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. The fair value of the Company s available-for-sale securities in the table below are derived solely from Level 2 inputs.

Table of Contents

Level 3 Unobservable inputs that are supported by little or no market activity and that are financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant judgment or estimation. The Company does not have any Level 3 investment securities as of March 31, 2011 or June 30, 2010.

If the inputs used to measure the financial assets and liabilities fall within more than one level described above, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

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

March 31, 2011

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale				
U.S. Government Agency	$ 208,671	$ 1,484	$	$ 210,155
Corporate Bonds	179,507	3,040		182,547
	$ 388,178	$ 4,524	$	$ 392,702
Trading				
Equity securities	7,947,436		(17,898)	7,929,538
Total	$ 8,335,614	$ 4,524	$ (17,898)	$ 8,322,240

June 30, 2010

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale				
U.S. Government Agency	$ 590,751	$ 13,713	$	$ 604,464
Corporate Bonds	179,507	4,235		183,742
	$ 770,258	$ 17,948	$	$ 788,206

Table of Contents

The amortized cost and fair value of the Company s investment securities by contractual maturity at March 31, 2011 and June 30, 2010 are summarized as follows:

	March 31, 2011		June 30, 2010	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 8,335,614	$ 8,322,240	$ 590,751	$ 604,464
Due after one year through five years			179,507	183,742
Due after five years through ten years				
Due after ten years				
Total investment securities	8,335,614	8,322,240	770,258	788,206
Less current portion	8,335,614	8,322,240	590,751	604,464
Long term investment securites	$	$	$ 179,507	$ 183,742

The Company uses the specific identification method to determine the cost of securities sold. For the nine months ended March 31, 2011, the Company had gains on investments of $56,556, of which $74,454 was realized gains and $17,898 was unrealized losses. For the nine months ended March 31, 2010, the Company had no realized gains or losses on investment securities.

As of March 31, 2011 and June 30, 2010, there were no securities held from a single issuer that represented more than 10% of shareholders equity. As of March 31, 2011, there were no individual securities in a continuous unrealized loss position.

Note 7. Bank Line of Credit

The Company had a $3,000,000 line of credit from Wells Fargo, N. A., formerly Wachovia Bank, N.A. (Wells Fargo) that bears interest at the prime interest rate less 0.25% (3.0% at March 31, 2011 and June 30, 2010, respectively). Availability under the line of credit is reduced by outstanding letters of credit. As of March 31, 2011 and June 30, 2010, the Company had $2,995,000 and $3,000,000, respectively, of availability under this line of credit. The line of credit was collateralized by substantially all of the Company s assets. The agreement contained covenants with respect to working capital, net worth and certain ratios, as well as other covenants.

Effective as of March 31, 2011, the Company renegotiated this line of credit as part of establishing a mortgage on its new Townsend Road property (see Note 9 Long-Term Debt). As part of this renegotiation, the line which expires on March 31, 2012, is now only collateralized by the working capital assets of the Company. As of March 31, 2011, the Company was in compliance with the new financial covenants under the agreement. The availability fee on the unused balance of the line of credit is 0.375%. Under the previous agreement with Wells Fargo, the existing line of credit would have expired on November 30, 2011.

Table of Contents

Note 8. Unearned Grant Funds

In July 2004, 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 has recorded the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program. As of March 31, 2011, the Company has had preliminary discussions with the Commonwealth of Pennsylvania to determine whether it will be required to repay any of the funds provided under the grant funding program. Based on information available at March 31, 2011, the Company has recorded the grant funding as a long-term liability under the caption of Unearned Grant Funds.

Note 9. Long-Term Debt

Long-term debt consists of the following:

	March 31, 2011	June 30, 2010
PIDC Regional Center, LP III loan	$	4,500,000
Pennsylvania Industrial Development Authority loan	876,019	933,820
Pennsylvania Department of Community & Economic Development loan	8,898	88,141
Tax-exempt bond loan (PAID)	555,000	555,000
First National Bank of Cody mortgage	1,545,015	1,642,866
Total debt	2,984,932	7,719,827
Less current portion	281,236	4,851,278
Long term debt	$ 2,703,696	$ 2,868,549

Current Portion of Long Term Debt

	March 31, 2011	June 30, 2010
PIDC Regional Center, LP III loan	$	$ 4,500,000
Pennsylvania Industrial Development Authority loan	78,686	77,091
Pennsylvania Department of Community & Economic Development loan	8,898	88,141
Tax-exempt bond loan (PAID)	130,000	130,000
First National Bank of Cody mortgage	63,652	56,046
Total current portion of long term debt	$ 281,236	$ 4,851,278

In December 2005, the Company financed $4,500,000 through the Philadelphia Industrial Development Corporation (PIDC) as part of the Company s expansion of its Torresdale Avenue facility. The outstanding principal balance, which was due and payable on December 13, 2010, was repaid on that date. The Company paid a bi-annual interest payment at a rate equal to two and one-half percent per annum.

Table of Contents

The Company financed $1,250,000 through the Pennsylvania Industrial Development Authority (PIDA). 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.

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.

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, 2011 and June 30, 2010 was 0.46% and 0.52%, respectively.

The Company has recently negotiated a set of mortgages on its new Townsend Road facility with both Wells Fargo N.A. and the PIDA. The Wells Fargo portion of the loan is for $3.1 million, bears a floating interest rate of the One Month LIBOR rate plus 2.95%, amortizes the loan over a 15 year term and has an eight year maturity date. The PIDA portion of the loan is for $2.0 million, is expected to bear a 3.75% interest rate and mature in 15 years. Both loans are expected to close shortly.

The Company has executed Security Agreements with Wells Fargo, PIDA and PIDC in which the Company has agreed to pledge its working capital, some equipment and its Townsend Road property to collateralize the amounts due.

The Company is the primary beneficiary to a variable interest entity (VIE) called Cody LCI Realty, LLC. See Note 17, Consolidation of Variable Interest Entity for additional description. The VIE owns land and a building which is being leased to Cody. A mortgage loan with First National Bank of Cody has been consolidated in the Company s financial statements, along with the related land and building. Principal and interest payments of $14,782, at a fixed interest rate of 7.5%, are being made on a monthly basis through June 2026. The mortgage loan is collateralized by the land and building.

Long-term debt amounts due, for the twelve month periods ending March 31 are as follows:

Twelve Month Periods		**Amounts Payable to Institutions**
2011	$	281,236
2012		284,471
2013		297,157
2014		315,062

2015		173,672
Thereafter		1,633,334
	$	2,984,932

Table of Contents

Note 10. Contingencies

In January 2010, the Company initiated an arbitration proceeding against Olive Healthcare (Olive) for damages arising out of Olive s delivery of defective soft-gel prenatal vitamin capsules. The Company seeks damages in excess of $3.5 million. Olive has denied liability and filed a counterclaim in February 2010 for breach of contract. The arbitration proceeding is still in its initial stages. A mediation was scheduled to take place in mid-December 2010, but Olive did not appear. The Company is now moving forward with the arbitration proceeding. Olive also filed a lawsuit against the Company in December 2010 in Daman, India seeking to enjoin the United States arbitration and claiming damages in excess of $4.0 million arising out of a contract for the soft-gel capsules. The Company has engaged Indian counsel and is actively defending that suit.

In June 2008, the Company filed a declaratory judgment suit in the Federal District Court of Delaware (Civil Action No. 08-338 (JJF)) against KV Pharmaceuticals, DrugTech Corp. and Ther-Rx Corp (collectively, KV). The complaint sought declaratory judgment for non-infringement and invalidity of certain patents owned by KV. The complaint further sought declaratory judgment of anti-trust violations and federal and state unfair competition violations for actions taken by KV in securing and enforcing these patents. KV also countered with claims of infringement by the Company of KV s patents seeking the Company s profits for sales of MMCs or other monetary relief, preliminary and permanent injunctive relief, attorney s fees and a finding of willful infringement. In March 2009, the Company and KV settled the litigation. In May 2010, the Company filed an action for declaratory relief in the Delaware Superior Court against KV seeking a declaration that KV breached its obligations under a settlement agreement entered into with the Company (the Binding Agreement). In June 2010, KV filed a counterclaim to the complaint and asserted claims for breach of contract, declaratory judgment, negligent misrepresentation and fraud in connection with the Binding Agreement, alleging among other things that the Company has improperly withheld royalties from KV arising out of its sales of a pre-natal vitamin product. On December 15, 2010, the Company executed a settlement agreement with KV in which the Company paid KV $850,000 to satisfy all royalties earned through December 31, 2010. In addition, effective January 1, 2011, the license granted to Lannett in the Binding Agreement was terminated, and the Company and its affiliates were required to cease making, using or offering to sell products covered by the licensed patents.

Note 11. Commitments

Leases

In June 2006, Lannett signed a lease agreement on a 66,000 square foot facility located on approximately seven acres in Philadelphia. The Company purchased this building in October 2009 for approximately $3.8 million plus the cost of fit out of approximately $2.0 million. A significant portion of the purchase price and fit out costs are expected to be financed through a series of loans with Wells Fargo N.A. bank and a Pennsylvania state run development agency. These loans could not be put in place until all construction had been completed and a proper certificate of occupancy had been obtained, due to a requirement by the state run development agency. Construction was substantially complete by June 30, 2010. A certificate of occupancy was obtained by September 2010. The financing is expected to be completed and funded by the end of May 2011 see Note 9 Long-Term Debt. This new facility is being used for certain administrative functions, warehouse space, shipping and possibly additional manufacturing space in the future.

Lannett s subsidiary, Cody leases a 73,000 square foot facility in Cody, Wyoming. This location houses Cody s manufacturing and production facilities. Cody leases the facility from Cody LCI Realty, LLC, a Wyoming limited liability company which is 50% owned by Lannett. See Note 17.

23

Table of Contents

Rental and lease expense for the three months ended March 31, 2011 and 2010 was approximately $22,000 and $30,000, respectively. Rental and lease expense for the nine months ended March 31, 2011 and 2010 was approximately $68,000 and $134,000, respectively.

Employment Agreements

The Company has entered into employment agreements with Arthur P. Bedrosian, President and Chief Executive Officer, Keith R. Ruck, Vice President of Finance and Chief Financial Officer, Kevin Smith, Vice President of Sales and Marketing, William Schreck, Chief Operating Officer, and Ernest Sabo, Vice President of Regulatory Affairs and Chief Compliance Officer. Each of the agreements provide for an annual base salary and eligibility to receive a bonus. The bonus amounts of these executives are determined by the Board of Directors. Additionally, these executives are eligible to receive stock options and restricted stock awards, which are granted at the discretion of the Board of Directors, and in accordance with the Company s policies regarding stock option and restricted stock grants. Under the agreements, these executive employees may be terminated at any time with or without cause, or by reason of death or disability. In certain termination situations, the Company is liable to pay severance compensation to these executives of between 18 months and three years.

Fiscal 2010 Bonus

The Company accrued approximately $4,812,000 of incentive compensation costs at June 30, 2010, of which approximately $3,421,000 was paid in cash during the first quarter of Fiscal 2011. The remaining $1,391,000 was expected to be paid in unrestricted shares of Company stock, and which shares were expected to vest immediately upon grant. These shares were only to be granted upon the timely approval by the FDA of Lannett s 505(b)(2) New Drug Application to manufacture and distribute its Morphine Sulfate Oral Solution product. The determination of the actual payment of this portion of the bonus was at the discretion of the CEO, dependent on the timing of the approval and the financial results of the Company dictated by the events surrounding the approval. At the January 2011 meeting with the FDA regarding the status of the MS NDA, the FDA stated that it will need to inspect Lannett s facilities as part of a PAI before it could give final approval on the MS NDA. Due to the amount of time the Company believes it will take to complete this inspection and receive approval on the MS NDA and the resulting impact to the value of the Morphine Sulfate inventory and the related expiration dates, the CEO has determined that the adverse financial results surrounding the MS NDA approval necessitates cancellation of the remaining Fiscal 2010 bonus. Therefore, the Company reversed the entire $1,391,000 remaining bonus accrual during the quarter ended December 31, 2010.

Note 12. Common Stock Offering

The Company completed a secondary offering of its common stock in December 2010. The initial offering of 2,500,000 shares was completed on December 17, 2010 and an over-allotment of 750,000 shares was exercised and closed on December 28, 2010. Net proceeds of the combined offerings were approximately $14,950,000 after deducting underwriting, legal and accounting fees.

Table of Contents

Note 13. Comprehensive Income

The Company s other comprehensive (loss) income is comprised of unrealized losses on investment securities classified as available-for-sale as well as foreign currency translation adjustments. There is no other comprehensive income (loss) attributable to the noncontrolling interest.

The components of comprehensive (loss) income and related taxes consisted of the following:

	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
	2011	2010	2011	2010
Net (loss) income	$ (357,802)	$ 2,102,261	$ 1,608,072	$ 5,036,040
Foreign currency translation adjustments	(16,120)	(33,239)	(8,671)	(22,340)
Unrealized holding loss on securities	(1,690)	(5,552)	(13,424)	(16,639)
Tax effect	676	2,221	5,369	6,656
Total Other Comprehensive Loss	(17,134)	(36,570)	(16,726)	(32,323)
Total Comprehensive (Loss) Income	$ (374,936)	$ 2,065,691	$ 1,591,346	$ 5,003,717

Note 14. Employee Benefit Plan

The Company has a defined contribution 401k plan (the Plan) covering substantially all employees. Pursuant to the Plan provisions, the Company is required to make matching contributions equal to 50% of each employee s contribution, but not to exceed 4% of the employee s compensation for the Plan year. Contributions to the Plan during the three months ended March 31, 2011 and 2010 were $79,000 and $88,000, respectively. For the nine months ended March 31, 2011 and 2010, contributions to the Plan were $302,000 and $303,000, respectively.

Note 15. Employee Stock Purchase Plan

In February 2003, the Company s shareholders approved an Employee Stock Purchase Plan (ESPP). Employees eligible to participate in the ESPP may purchase shares of the Company s stock at 85% of the lower of the fair market value of the common stock on the first day of the calendar quarter, or the last day of the calendar quarter. Under the ESPP, employees can authorize the Company to withhold up to 10% of their compensation during any quarterly offering period, subject to certain limitations. The ESPP was implemented on April 1, 2003 and is qualified under Section 423 of the Internal Revenue Code. The Board of Directors authorized an aggregate total of 1,125,000 shares of the Company s common stock for issuance under the ESPP. As of March 31, 2011, 261,283 shares have been issued under the ESPP. Compensation expense of $24,292 and $10,440 relating to the ESPP was recognized for the three months ended March 31, 2011 and 2010, respectively. Compensation expense of $48,584 and $43,516 relating to the ESPP was recognized for the nine months ended March 31, 2011 and 2010, respectively.

25

Table of Contents

Note 16. Income Taxes

The Company uses the liability method to account 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.

The provision for federal, state and local income taxes for the three months ended March 31, 2011 and 2010 was tax (benefit) expense of approximately ($450,000) and $527,000, respectively, with effective tax rates of 56% and 20%, respectively. The provision for federal, state and local income taxes for the nine months ended March 31, 2011 and 2010 was tax expense of approximately $555,000 and $3,525,000, respectively, with effective tax rates of 26% and 41%, respectively. The effective tax rate for the three and nine months ended March 31, 2011 includes the impact of income tax credits and the reversal of a portion of our liability for unrecognized tax benefits totaling $263,793 related to a settlement with the IRS. These decreases were partially offset by the effect of nondeductible incentive stock option compensation expenses relative to the expected pretax income for Fiscal 2011. The effective tax rate for the three months ended March 31, 2010 was lower compared to the three months ended March 31, 2011 due primarily to the settlement reached with the IRS related to its review of the federal income tax return for Fiscal 2008. As a result of that settlement, the Company recorded a refund receivable totaling approximately $418,000. The Company also reduced its liability for unrecognized tax benefits by approximately $216,000 as a result of the IRS settlement. The effective tax rate for the nine months ended March 31, 2010 includes the impact of a change in Pennsylvania tax law which lowered the Company s apportionment factor within this state. The impact of this change caused the Company to reduce its deferred tax assets by approximately $650,000, and therefore increased the effective tax rate by approximately 8% for the nine months ended March 31, 2010. The increase in effective tax rate related to this change in Pennsylvania tax law was essentially offset by the impact of the IRS settlement agreement described above. The Company expects its overall effective tax rate will be approximately 27% to 29% for the full year ended June 30, 2011 primarily as a result of the reversal of the liability for unrecognized tax benefits totaling $263,793 related to a settlement with the IRS.

The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative standards issued by the FASB also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

As of March 31, 2011 and June 30, 2010, the Company reported total unrecognized tax benefits of $217,633 and $399,034, respectively. As a result of the positions taken during the period, the Company has not recorded any interest and penalties for the period ended March 31, 2011 in the statement of operations and no cumulative interest and penalties have been recorded either in the Company s statement of financial position as of March 31, 2011 and June 30, 2010. The Company will recognize interest accrued on unrecognized tax benefits in interest expense and any related penalties in operating expenses. The Company does not believe that the total unrecognized tax benefits will significantly increase or decrease in the next twelve months.

The Company files income tax returns in the United States federal jurisdiction, Pennsylvania, New Jersey and California. The Company s tax returns for Fiscal 2007 and prior generally are no longer subject to review as such years generally are closed. The Company believes that an unfavorable resolution for open tax years would not be material to the financial position of the Company.

Table of Contents

Note 17. Consolidation of Variable Interest Entity

Lannett consolidates any Variable Interest Entity (VIE) of which it is the primary beneficiary. The liabilities recognized as a result of consolidating a VIE do not represent additional claims on our general assets; rather, they represent claims against the specific assets of the consolidated VIE. Conversely, assets recognized as a result of consolidating a VIE do not represent additional assets that could be used to satisfy claims against our general assets. Reflected in the March 31, 2011 and June 30, 2010 balance sheets are consolidated VIE assets of approximately $1.8 million and $1.9 million, which are comprised mainly of land and building. VIE liabilities consist of a mortgage on that property in the amount of approximately $1.5 million and $1.6 million at March 31, 2011 and June 30, 2010, respectively.

Cody LCI Realty LLC (Realty) is the only VIE that is consolidated. Realty had been consolidated by Cody prior to its acquisition by Lannett. Realty is a 50/50 joint venture with a former shareholder of Cody. Its purpose was to acquire the facility used by Cody. Until the acquisition of Cody in April 2007, Lannett had not consolidated the VIE because Cody Labs had been the primary beneficiary of the VIE. The risks associated with our interests in this VIE is limited to a decline in the value of the land and building as compared to the balance of the mortgage note on that property, up to Lannett s 50% share of the venture. Realty owns the land and building, and Cody leases the building and property from Realty for $20,000 per month effective October 2009, when the lease increased from $15,000 per month. All intercompany rent expense is eliminated upon consolidation with Cody. The Company is not involved in any other VIE.

Note 18. Related Party Transactions

The Company had sales of approximately $658,000 and $625,000 during the nine months ended March 31, 2011 and 2010, respectively, to a generic distributor, Auburn Pharmaceutical Company (Auburn). Sales to Auburn for the three months ended March 31, 2011 and 2010 were $184,000 and $201,000, respectively. Jeffrey Farber (the related party), who is a current board member and the son of the Chairman of the Board of Directors and principal shareholder of the Company, is the owner of Auburn. Accounts receivable includes amounts due from the related party of approximately $195,000 and $161,000 at March 31, 2011 and June 30, 2010, respectively. In the Company s opinion, the terms of these transactions were not more favorable to the related party than 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. (Pharmeral) owned the ANDA. In Fiscal 2008, the Company obtained FDA approval to use the proprietary rights. Accordingly, the Company originally capitalized these rights as an indefinite lived intangible asset and tested this asset for impairment at least on an annual basis. During the fourth quarter of Fiscal 2009, it was determined that this intangible asset no longer has an indefinite life. No impairment existed because the estimated fair value exceeded the carrying amount on that date. Accordingly, the $100,000 carrying amount of this intangible asset is being amortized on a straight line basis prospectively over its 10 year remaining estimated useful life.

Arthur P. Bedrosian, President and Chief Executive Officer, currently owns 100% of Pharmeral. 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. In May 2008, Mr. Bedrosian and Pharmeral waived their rights to any royalty payments on the sales of the drug by Lannett under Lannett s current ownership structure. Should Lannett undergo a change in control where a third party is involved, this royalty would be reinstated. The registered trademark OB-Natal® was transferred to Lannett for one dollar from Mr. Bedrosian.

Lannett Company, Inc. paid a management consultant who is related to Mr. Bedrosian $30,660 in fees during the three months ended March 31, 2011 and $27,760 in fees and $6,090 in reimbursable expenses during the three

Table of Contents

months ended March 31, 2010. The Company paid this consultant $103,600 in fees and $8,079 in reimbursable expenses during the nine months ended March 31, 2011 and $79,620 in fees and $15,823 in reimbursable expenses during the nine months ended March 31, 2010. This consultant provided management, construction planning, laboratory set up and administrative services in regards to the Company s initial set up of its Bio-study laboratory in a foreign country. It is expected that this consultant will continue to be utilized into Fiscal 2012. In the Company s opinion, the fee rates paid to this consultant and the expenses reimbursed to him were not more favorable than what would have been paid to a non-related party.

Note 19. Material Contract with Supplier

Jerome Stevens Pharmaceuticals agreement:

The Company s primary finished product inventory supplier is Jerome Stevens Pharmaceuticals, Inc. (JSP), in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for approximately 72% and 64% of the Company s inventory purchases during the three and nine month periods ended March 31, 2011 and approximately 73% and 77% during the three and nine month periods ended March 31, 2010, respectively. 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 capsules, Digoxin tablets and Levothyroxine Sodium tablets, sold generically and under the brand name Unithroid®. The term of the agreement is ten years, beginning on March 23, 2004 and continuing through 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 thirty (30) days of notice from the non-breaching party.

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 has met the minimum purchase requirement for the first six years 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, 2011, JSP has not exercised the nomination provision of the agreement.

The Company s financial condition, as well as its liquidity resources, are very dependent on an uninterrupted supply of product from JSP. Should there be an interruption in the supply of product from JSP for any reason, this event would have a material impact to the financial condition of Lannett.

Table of Contents

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, 2010.

This Report on Form 10-Q and certain information incorporated herein by reference contain forward-looking statements which are not historical facts made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not promises or guarantees and investors are cautioned that all forward-looking statements involve risks and uncertainties, including but not limited to the impact of competitive products and pricing, product demand and market acceptance, new product development, the regulatory environment, including without limitation, reliance on key strategic alliances, availability of raw materials, fluctuations in operating results and other risks detailed from time to time in the Company s filings with the Securities and Exchange Commission. These statements are based on management s current expectations and are naturally subject to uncertainty and changes in circumstances. We caution you not to place undue reliance upon any such forward-looking statements which speak only as of the date made. Lannett is under no obligation to, and expressly disclaims any such obligation to, update or alter its forward-looking statements, whether as a result of new information, future events or otherwise.

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.

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 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, chargebacks and returns payable and as reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS and Wolters

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

Table of Contents

management using several ratios and calculated metrics. As we continue to obtain additional information about our historical experience for chargebacks, rebates and returns, we also update our estimates of the required reserves.

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

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

Returns Consistent with industry practice, the Company has a product returns policy that allows certain 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, adjusted for any changes in business practices or conditions that would cause management to believe that future product returns may differ from those returns assumed in the establishment of reserves. Generally, the reserve for returns increases as sales increase and decrease when credits are issued or payments are made for actual returns received. The reserve for returns is included in the rebates, chargebacks and returns 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 a price reduction. Decreases in selling prices are discretionary decisions made by management to reflect competitive market conditions. Amounts recorded for estimated shelf stock adjustments are based upon specified terms with direct customers, estimated declines in market prices, and estimates of inventory held by customers. The Company regularly monitors these and other factors and evaluates the reserve as additional information becomes available. Other adjustments are included in the rebates, chargebacks and returns payable account on the balance sheet. When competitors enter the market for existing products, shelf stock adjustments may be issued to maintain price competitiveness.

Table of Contents

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, 2011 and 2010:

For the nine months ended March 31, 2011	Chargebacks	Rebates	Returns	Other	Total
Reserve Category					
Reserve Balance as of June 30, 2010	$ 6,282,127	$ 3,566,031	$ 5,401,254	$	$ 15,249,412
Actual credits issued related to sales recorded in prior fiscal years	(6,258,862)	(3,946,924)	(3,290,619)		(13,496,405)
Reserves or (reversals) charged during Fiscal 2011 related to sales in prior fiscal years		380,893			380,893
Reserves charged to net sales during Fiscal 2011 related to sales recorded in Fiscal 2011	40,105,340	12,276,977	5,602,225	2,739,301	60,723,843
Actual credits issued related to sales recorded in Fiscal 2011	(34,059,033)	(10,144,801)	(2,078,044)	(2,739,301)	(49,021,179)
Reserve Balance as of March 31, 2011	$ 6,069,572	$ 2,132,176	$ 5,634,816	$	$ 13,836,564

For the nine months ended March 31, 2010	Chargebacks	Rebates	Returns	Other	Total
Reserve Category					
Reserve Balance as of June 30, 2009	$ 6,089,802	$ 2,537,746	$ 5,106,992	$	$ 13,734,540
Actual credits issued related to sales recorded in prior fiscal years	(5,218,835)	(2,537,746)	(3,112,587)		(10,869,168)
Reserves or (reversals) charged during Fiscal 2010 related to sales in prior fiscal years					
Reserves charged to net sales during Fiscal 2010 related to sales recorded in Fiscal 2010	35,900,162	12,529,499	3,803,056	880,860	53,113,577
Actual credits issued related to sales recorded in Fiscal 2010	(30,081,997)	(9,527,547)		(880,860)	(40,490,404)
Reserve Balance as of March 31, 2010	$ 6,689,132	$ 3,001,952	$ 5,797,461	$	$ 15,488,545

The total reserve for chargebacks, rebates, returns and other adjustments decreased from $15,249,412 at June 30, 2010 to $13,836,564 at March 31, 2011. The decrease in total reserves is mainly due to a decrease in the rebates reserve as a result of timing of credits taken by customers, and a decrease in chargeback reserves due primarily to a decrease in inventory levels at wholesaler distribution centers. The activity in the Other category for the nine months ended March 31, 2011 includes shelf-stock adjustments totaling $2,250,404 primarily related to products for the treatment of thyroid deficiency and heart failure.

Credits issued during the quarter that relate to prior year sales are charged against the opening balance. In aggregate, additional reserves or reversals of reserves have historically offset each other. The table above shows the effects of reversals within the rebates, returns and other categories. It is the Company s intention that all

Table of Contents

reserves be charged to sales in the period that the sale is recognized, however, due to the nature of this estimate, it is possible that the Company may sometimes need to increase or decrease the reserve based on prior period sales. If that were to occur, management would disclose that information at that time. 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.

The rates of reserves will vary, as well as the category under which the credit falls. This variability comes about when the Company is working with indirect customers to compete with the pricing of other generic companies. The Company has improved its computer systems in order to improve the accuracy of tracking and processing chargebacks and rebates and will continue to look at ways for further improvements. Improvements to automate calculation of reserves will not only reduce the potential for human error, but also will result in more in-depth analysis and improved customer interaction for resolution of open credits.

The rate of credits issued is monitored by the Company at least on a quarterly basis. The Company may change the estimate of future reserves based on the amount of credits processed, or the rate of sales made to indirect customers. The decrease of reserves to $13,836,564 at March 31, 2011 from $15,249,412 at June 30, 2010 is due to the timing of credits being processed by the customers and by the Company. Approximately $13,496,000 or 89% of the reserve balance from June 30, 2010 has been processed through the first nine months of Fiscal 2011. Management estimates reserves based on sales mix. A comparison to wholesaler inventory reports is performed quarterly, in order to justify the balance of unclaimed chargebacks and rebates. The Company has historically found a direct correlation between the calculation of the reserve based on sales mix, and the wholesaler inventory analysis.

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.

The Company also regularly monitors accounts receivable (AR) balances by reviewing both net and gross day s sales outstanding (DSO). Net DSO is calculated by dividing gross accounts receivable less the reserve for rebates and chargebacks by the average daily net sales for the period. Gross DSO shows the result of the same calculation without regard to rebates and chargebacks.

The Company monitors both net DSO and gross DSO as an overall check on collections and to assess the reasonableness of the reserves. Gross DSO provides management with an understanding of the frequency of customer payments, and the ability to process customer payments and deductions. The net DSO calculation provides management with an understanding of the relationship of the AR balance net of the reserve liability compared to net sales after charges to the reserves during the period. Standard payment terms offered to customers are consistent with industry practice at 60 days. Net DSO eliminates the effect of timing of processing, which is inherent in the gross DSO calculation.

Table of Contents

The following table shows the results of these calculations as of the relevant periods:

	3/31/11	6/30/10	3/31/10
Net DSO (in days)	93	77	78
Gross DSO (in days)	65	69	65

The level of net DSO at March 31, 2011 is higher than the Company s expectation that DSO will be in the 60 to 70 day range based on 60 day payment terms for most customers. The increase is due to lower net sales in the third quarter of Fiscal 2011 as well as the timing of cash receipts.

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.

Consolidation of Variable Interest Entity The Company consolidates any Variable Interest Entity (VIE) of which we are the primary beneficiary. The liabilities recognized as a result of consolidating a VIE do not represent additional claims on our general assets; rather, they represent claims against the specific assets of the consolidated VIE. Conversely, assets recognized as a result of consolidating a VIE do not represent additional assets that could be used to satisfy claims against our general assets. Reflected in the March 31, 2011 and June 30, 2010 balance sheets are consolidated VIE assets of approximately $1.8 million and $1.9 million, respectively, which is comprised mainly of land and a building. VIE liabilities consist of a mortgage on that property in the amount of approximately $1.5 million and $1.6 million at March 31, 2011 and June 30, 2010, respectively. This VIE was initially consolidated by Cody, as Cody has been the primary beneficiary. Cody has then been consolidated within Lannett s financial statements since its acquisition in April 2007.

Results of Operations - Three months ended March 31, 2011 compared with three months ended March 31, 2010

Net sales for the three months ended March 31, 2011 (Fiscal 2011) decreased 17% to $25,892,000 from $31,266,000 for the three months ended March 31, 2010 (Fiscal 2010). The following factors contributed to the $5,374,000 decrease in sales:

Medical indication	Sales volume change %	Sales price change %
Heart Failure	-28%	-18%
Antibiotics	1%	-2%
Prescription Vitamins	-101%	-97%
Epilepsy	33%	-4%
Thyroid Deficiency	10%	-12%
Pain Management	-50%	44%
Migraine Headache	3%	-11%

33

Table of Contents

Sales of drugs used for pain management decreased by approximately $1,092,000 for the three months ended March 31, 2011 compared to March 31, 2010. This decrease is primarily the result of the lost Fiscal 2010 third quarter revenues of Morphine Sulfate Oral Solution totaling $1,702,000 as a result of the FDA s action to force Lannett and all but one competitor to cease manufacturing and/or distributing Morphine Sulfate Oral Solution effective July 24, 2010. Partially offsetting this decrease is an increase in demand for sales of Hydromorphone which increased $848,000 for the three months ended March 31, 2011. Sales of drugs used in the treatment of thyroid deficiency decreased by approximately $467,000 primarily as a result of a competitive price reduction in order to retain one of our major customers. The overall decrease in sales was also affected by a decrease in sales of drugs for the treatment of congestive heart failure by approximately $2,080,000 for the three months ended March 31, 2011 compared to March 31, 2010 mainly due to a decrease in the volume of bottles shipped, as well as a result of a competitive price reduction in order to retain one of our major customers. Net sales of our prescription vitamins also decreased by approximately $1,446,000 due to the settlement agreement reached with KV on December 15, 2010 which requires the Company to cease selling products covered by the licensed patents (see note 10).

The Company sells its products to customers in various categories. The table below identifies the Company s approximate net sales to each category for the three months ended March 31, 2011 and 2010:

Customer Category		**2011**		**2010**
Wholesaler/ Distributor	$	14,254,000	$	14,369,000
Retail Chain		10,771,000		15,223,000
Mail-Order Pharmacy		867,000		1,674,000
Total	$	25,892,000	$	31,266,000

The sales to retail chains decreased primarily as a result of the competitive price reductions on two products in order to retain one of our major customers as discussed above. Sales to retail chains also declined as a result of the settlement agreement reached with KV which requires the Company to cease selling products covered by the licensed patents as discussed above.

Cost of sales for the third quarter decreased 1% to $20,589,000 in Fiscal 2011 from $20,869,000 in Fiscal 2010. The decrease reflected the impact of the 17% decrease in sales as well as a change in the mix of products sold.

Amortization expense primarily relates to the JSP Distribution Agreement. For the remaining term of the JSP Distribution Agreement, the Company will incur annual amortization expense of approximately $1,785,000.

Gross profit margins for the third quarter of Fiscal 2011 and Fiscal 2010 were 20% and 33%, respectively. Gross profit percentage reflects the overall decrease in sales described above as well as product mix. While the Company is continuously striving to keep product costs low, there can be no guarantee that profit margins will not fluctuate in future periods. Pricing pressure from competitors and costs of producing or purchasing new drugs may also fluctuate in the future. Changes in the future sales product mix may also occur. These changes may affect the gross profit percentage in future periods.

Research and development (R&D) expenses in the third quarter decreased 45% to $1,854,000 for Fiscal 2011 from $3,352,000 for Fiscal 2010. The decrease is primarily due to the timing of milestone achievements for costs of products in development and completed phases for several

biostudies. The Company expenses all production

Table of Contents

costs as R&D until the drug is approved by the FDA. R&D expenses may fluctuate from period to period, based on R&D plans for submission to the FDA.

Selling, general and administrative (SG&A) expenses in the third quarter decreased 3% to $4,280,000 in Fiscal 2011 from $4,393,000 in Fiscal 2010. The decrease is primarily due to incentive compensation costs incurred in Fiscal 2010, but not incurred in the Fiscal 2011 period.

While the Company is focused on controlling costs, increases in personnel costs may have an ongoing and longer lasting impact on the administrative cost structure. Other costs are being incurred to facilitate improvements in the Company s infrastructure. These costs are expected to be temporary investments in the future of the Company and may not continue at the same level.

Interest expense in the third quarter of Fiscal 2011 decreased to $28,000 compared to $50,000 in Fiscal 2010 primarily due to lower levels of long-term debt. Interest and dividend income in the third quarter increased to $25,000 in Fiscal 2011 from $5,000 in Fiscal 2010 due to dividends earned on higher investment securities balances.

The Company recorded an income tax benefit in the third quarter of 2011 of $450,000 compared to income tax expense of $527,000 in the third quarter of Fiscal 2010. The effective tax rate for the three months ended March 31, 2011 was 56%, compared to 20% for the three months ended March 31, 2010. The effective tax rate for the three months ended March 31, 2011 includes the impact of income tax credits and the reversal of a portion of our liability for unrecognized tax benefits totaling $263,793 related to a settlement with the IRS. These decreases were partially offset by the effect of nondeductible incentive stock option compensation expenses relative to the expected pretax income for Fiscal 2011. The effective tax rate for the three months ended March 31, 2010 includes the impact of the settlement reached with the IRS related to its review of the federal income tax return for Fiscal 2008. As a result of the settlement, the Company recorded a refund receivable totaling approximately $418,000 and reduced its liability for unrecognized tax benefits by approximately $216,000. The Company expects its overall effective tax rate will be approximately 27% to 29% for the full year ended June 30, 2011 primarily as a result of the reversal of the liability for unrecognized tax benefits totaling $263,793 related to a settlement with the IRS.

The Company reported a net loss attributable to Lannett of approximately $362,000 in the third quarter of Fiscal 2011, or $0.01 basic and diluted loss per share, as compared to net income attributable to Lannett of approximately $2,093,000 in the third quarter Fiscal 2010, or $0.08 basic and diluted earnings per share.

Results of Operations Nine months ended March 31, 2011 compared with nine months ended March 31, 2010

Net sales for the nine months ended March 31, 2011 (Fiscal 2011) decreased 11% to $81,328,000 from $91,418,000 for the nine months ended March 31, 2010 (Fiscal 2010). The following factors contributed to the $10,090,000 decrease in sales:

Medical indication	Sales volume change %	Sales price change %
Heart Failure	-31%	- 8%

Antibiotics	-17%	11%
Prescription Vitamins	-67%	22%
Epilepsy	33%	-28%
Thyroid Deficiency	4%	-14%
Pain Management	-9%	40%
Migraine Headache	6%	-10%

Table of Contents

Sales of drugs used in the treatment of thyroid deficiency decreased by approximately $4,008,000 primarily as a result of a competitive price reduction in order to retain one of our major customers. Included in this amount is a one-time shelf stock adjustment totaling approximately $1,271,000. The overall decrease in sales was also affected by a decrease in sales of drugs for the treatment of congestive heart failure by approximately $5,474,000 for the nine months ended March 31, 2011 compared to March 31, 2010 mainly due to a decrease in the volume of bottles shipped, as well as a result of a competitive price reduction in order to retain one of our major customers. Included in this amount is a one-time shelf stock adjustment totaling approximately $682,000. Net sales of our prescription vitamins also decreased by approximately $2,681,000 due to the settlement agreement reached with KV on December 15, 2010 which requires the Company to cease selling products covered by the licensed patents. The overall decrease in sales was partially offset by an increase in sales of drugs used for pain management which increased by approximately $2,346,000 for the nine months ended March 31, 2011 compared to March 31, 2010. This increase is primarily the result of an increase in demand for pain management products including Hydromorphone HCl and Oxycodone HCl which increased $3,156,000 and $3,308,000, respectively for the nine months ended March 31, 2011 compared to March 31, 2010. Partially offsetting this increase were Fiscal 2010 revenues of Morphine Sulfate Oral Solution totaling $5,007,000 which were not recognized in Fiscal 2011 as a result of the FDA s action to force Lannett and all but one competitor to cease manufacturing and/or distributing Morphine Sulfate Oral Solution effective July 24, 2010.

The Company sells its products to customers in various categories. The table below identifies the Company s approximate net sales to each category for the nine months ended March 31, 2011 and 2010:

	Nine Months Ended March 31,	
Customer Category	**2011**	**2010**
Wholesaler/ Distributor	$ 43,841,000	$ 41,710,000
Retail Chain	34,577,000	45,015,000
Mail-Order Pharmacy	2,910,000	4,693,000
Total	$ 81,328,000	$ 91,418,000

The sales to wholesaler/distributor increased as a result of an increase in the demand for products for which the Company is the major supplier and also an increase in the number of products available for sale. The sales to retail chains decreased primarily as a result of the competitive price reductions on two products in order to retain one of our major customers as discussed above. Sales to retail chains also declined as a result of the settlement agreement reached with KV which requires the Company to cease selling products covered by the licensed patents as discussed above.

Cost of sales for the first nine months increased 1% to $61,763,000 in Fiscal 2011 from $61,409,000 in Fiscal 2010. Cost of sales reflected the impact of the 11% decrease in sales as well as a change in the mix of products sold. Cost of sales includes the additional inventory reserves totaling approximately $1,546,000 related to Morphine Sulfate Oral Solution. The Company increased its reserves related to Morphine Sulfate Oral Solution as a result of new information obtained during the January 2011 meeting with the FDA in that the FDA now requires a PAI as part of the MS NDA approval process. Cost of sales also included the reversal of royalty expense totaling approximately $618,000 as a result of the settlement agreement reached with KV (see note 10).

Amortization expense primarily relates to the JSP Distribution Agreement. For the remaining term of the JSP Distribution Agreement, the Company will incur annual amortization expense of approximately $1,785,000.

36

Table of Contents

Gross profit margins for the first nine months of Fiscal 2011 and Fiscal 2010 were 24% and 33%, respectively. Gross profit percentage decreased due to the overall decline in sales described above and due to product mix. Gross profit margins were also reduced by the additional inventory reserves recorded during Fiscal 2011 totaling $1,546,000 related to Morphine Sulfate Oral Solution as discussed above. Partially offsetting the decrease was an increase due to the reversal of royalty expense totaling approximately $618,000 as a result of the settlement agreement reached with KV. While the Company is continuously striving to keep product costs low, there can be no guarantee that profit margins will not fluctuate in future periods. Pricing pressure from competitors and costs of producing or purchasing new drugs may also fluctuate in the future. Changes in the future sales product mix may also occur. These changes may affect the gross profit percentage in future periods.

Research and development (R&D) expenses in the first nine months decreased 39% to $5,557,000 for Fiscal 2011 from $9,110,000 for Fiscal 2010. The decrease is primarily due to the timing of milestone achievements for costs of products in development and completed phases for several biostudies. The Company expenses all production costs as R&D until the drug is approved by the FDA. R&D expenses may fluctuate from period to period, based on R&D plans for submission to the FDA.

Selling, general and administrative (SG&A) expenses in the first nine months decreased 4% to $11,755,000 in Fiscal 2011 from $12,205,000 in Fiscal 2010. The decrease is primarily due to incentive compensation costs incurred in Fiscal 2010, but not incurred in Fiscal 2011, as well as the reversal of the remaining Fiscal 2010 accrued bonuses totaling approximately $1,391,000 in the second quarter of Fiscal 2011 (see Note 11), of which approximately $1,010,000 was included in SG&A. Partially offsetting the overall decrease are increased legal costs of approximately $640,000 related to the litigation with the FDA regarding the status of Grandfathered products, including our Morphine Sulfate Oral solution. While the Company is focused on controlling costs, increases in personnel costs may have an ongoing and longer lasting impact on the administrative cost structure. Other costs are being incurred to facilitate improvements in the Company s infrastructure. These costs are expected to be temporary investments in the future of the Company and may not continue at the same level.

Interest expense in the first nine months of Fiscal 2011 decreased to $175,000 compared to $204,000 in Fiscal 2010 primarily due to lower levels of long-term debt. Interest and dividend income in the first nine months decreased to $40,000 in Fiscal 2011 from $49,000 in Fiscal 2010 due to lower interest earned on smaller investment securities balances.

The Company recorded income tax expense in the first nine months of 2011 of $555,000 compared to income tax expense of $3,525,000 in the first nine months of Fiscal 2010. The effective tax rate for the nine months ended March 31, 2011 was 26%, compared to 41% for the nine months ended March 31, 2010. The effective tax rate for the nine months ended March 31, 2011 was lower compared to the nine months ended March 31, 2010 due primarily to the impact of income tax credits and the reversal of a portion of our liability for unrecognized tax benefits totaling $263,793 related to a settlement with the IRS. These decreases were partially offset by the effect of nondeductible incentive stock option compensation expenses relative to the expected pretax income for Fiscal 2011. The effective tax rate for the nine months ended March 31, 2010 includes the impact of a change in Pennsylvania tax law which lowered the Company s apportionment factor within this state. The impact of this change caused the Company to reduce its deferred tax assets by approximately $650,000, and therefore increased the effective tax rate by 8% for the nine months ended March 31, 2010. The increase in effective tax rate related to this change in Pennsylvania tax law was essentially offset by the impact of the settlement reached with the IRS related to its review of the federal income tax return for Fiscal 2008. As a result of the settlement, the Company recorded a refund receivable totaling approximately $418,000 and reduced its liability for unrecognized tax benefits by approximately $216,000. The Company expects its overall effective tax rate will be approximately 27% to 29% for the full year ended June 30, 2011 primarily as a result of the reversal of the liability for unrecognized tax benefits totaling $263,793 related to a settlement with the IRS.

Table of Contents

The Company reported net income attributable to Lannett of approximately $1,588,000 in the first nine months of Fiscal 2011, or $0.06 basic and diluted earnings per share, as compared to net income attributable to Lannett of approximately $5,005,000 in the first nine months of Fiscal 2010, or $0.20 basic and diluted earnings per share.

Liquidity and Capital Resources

The Company has historically financed its operations with cash flow generated from operations, supplemented with borrowings from various government agencies and financial institutions. During the second quarter of 2011, the Company completed a secondary stock offering of 3,250,000 shares which generated net proceeds of approximately $14,950,000. At March 31, 2011, working capital was $56,838,000 as compared to $40,105,000 at June 30, 2010, an increase of $16,733,000.

Net cash used in operating activities of $4,624,000 in the first nine months of Fiscal 2011 reflected net income of $1,608,000, after adjusting for non-cash items of $8,200,000, as well as cash used by changes in operating assets and liabilities of $14,432,000. Significant changes in operating assets and liabilities are comprised of:

- A decrease in trade accounts receivable of $3,456,000 primarily as a result of decreased sales in the third quarter of Fiscal 2011 compared to the fourth quarter of Fiscal 2010.

- An increase in inventories of $5,689,000 primarily due to an increase in raw material stocking levels for certain products as of March 31, 2011 which are being carried to fulfill customer back orders as well as products currently under development.

- An increase in prepaid taxes of $2,407,000 from an income taxes payable balance of $1,480,000 due to estimated tax payments made in September 2010 related to Fiscal 2010.

- An increase in accounts payable of $823,000 due to the timing of payments at the end of the month.

- A decrease in accrued expenses of $2,469,000 primarily due to the settlement agreement with KV, which resulted in a payment of $850,000 to KV and a $618,000 reversal of accrued royalty expense, as well as due to the timing of biostudy and product development milestone achievements.

- A decrease in rebates, chargebacks and returns payable of $1,413,000 primarily due to a decrease in the rebates reserve as a result of a timing of credits taken by customers, and a decrease in chargeback reserves due primarily to a decrease in inventory levels at wholesaler distribution centers.

- A decrease in accrued payroll and payroll related costs of $5,219,000 primarily related to the payment in the first quarter of Fiscal 2011 of the Fiscal 2010 accrued incentive compensation costs totaling approximately $3,421,000 , as well as the reversal of the remaining Fiscal 2010 accrued bonuses totaling approximately $1,391,000 in the second quarter of Fiscal 2011.

Net cash used in investing activities of $13,146,000 for the nine months ended March 31, 2011 is mainly the result of purchases of property, plant and equipment of $5,663,000 and purchases of investment securities of $11,926,000 partially offset by proceeds of $4,435,000 from the sale of investment securities.

Net cash provided by financing activities of $10,332,000 for the nine months ended March 31, 2011 was primarily due to the net proceeds received from the Company s secondary public stock offering totaling $14,950,000. We intend to use the net proceeds we received from these offerings for general corporate purposes, including, without limitation, research and development expenses, general and administrative expenses, manufacturing expenses, potential acquisitions of companies, technologies and properties that complement our business (although we are not currently party to any binding agreements or commitments with respect to any such acquisitions) and working capital. Pending these uses described above, we expect to invest our net proceeds in investment-grade, interest-bearing instruments. Partially offsetting these proceeds were scheduled debt repayments of $4,735,000, which included the repayment of the $4,500,000 PIDC Regional Center, LP III loan

Table of Contents

which was repaid on December 13, 2010. Additional financing activities included the purchase of shares of treasury stock totaling $221,000 partially offset by proceeds from the issuance of stock related to employee stock plans of $398,000.

Long-term debt amounts due, for the twelve month periods ended March 31 are as follows:

Twelve Month Periods		Amounts Payable to Institutions
2011	$	281,236
2012		284,471
2013		297,157
2014		315,062
2015		173,672
Thereafter		1,633,334
	$	2,984,932

The Company had a $3,000,000 line of credit from Wells Fargo, N. A., formerly Wachovia Bank, N.A. (Wells Fargo) that bears interest at the prime interest rate less 0.25% (3.0% at March 31, 2011 and June 30, 2010, respectively). Availability under the line of credit is reduced by outstanding letters of credit. As of March 31, 2011 and June 30, 2010, the Company had $2,995,000 and $3,000,000, respectively, of availability under this line of credit. The line of credit was collateralized by substantially all of the Company s assets. The agreement contained covenants with respect to working capital, net worth and certain ratios, as well as other covenants.

Effective as of March 31, 2011, the Company renegotiated this line of credit as part of establishing a mortgage on its new Townsend Road property (see Note 9 - Long Term-Debt). As part of this renegotiation, the line which expires on March 31, 2012, is now only collateralized by the working capital assets of the Company. As of March 31, 2011, the Company was in compliance with the new financial covenants under the agreement. The availability fee on the unused balance of the line of credit is 0.375%. Under the previous agreement with Wells Fargo, the existing line of credit would have expired on November 30, 2011.

In December 2005, the Company financed $4,500,000 through the Philadelphia Industrial Development Corporation (PIDC). The outstanding principal balance, which was due and payable on December 13, 2010, was repaid on that date. The Company paid a bi-annual interest payment at a rate equal to two and one-half percent per annum.

The Company borrowed $1,250,000 through the Pennsylvania Industrial Development Authority (PIDA). 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 $876,019 outstanding as of March 31, 2011 with $78,686 currently due.

The Company borrowed $500,000 from 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, 2011, $8,898 is outstanding and currently due.

In April 1999, the Company entered into a loan agreement with 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

Table of Contents

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, 2011 was 0. 46%. At March 31, 2011, the Company has $555,000 outstanding on the Authority loan, of which $130,000 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 Wells Fargo to secure payment of the Authority Loan and a portion of the related accrued interest. At March 31, 2011, no portion of the letter of credit has been utilized.

The Company has negotiated a set of mortgages on its new Townsend Road facility with both Wells Fargo N.A. and the PIDA. The Wells Fargo portion of the loan is for $3.1 million, bears a floating interest rate of the One Month LIBOR rate plus 2.95%, amortizes the loan over a 15 year term and has an eight year maturity date. The PIDA portion of the loan is for $2.0 million, is expected to bear a 3.75% interest rate and mature in 15 years. Both loans are expected to close shortly.

The Company has executed Security Agreements with Wells Fargo, PIDA and PIDC in which the Company has agreed to pledge its working capital, some equipment and its Townsend Road property to collateralize the amounts due.

The Company consolidates Cody LCI Realty, LLC, a variable interest entity (VIE), for which Cody Labs is the primary beneficiary. See note 17 to our Consolidated Financial Statements for Consolidation of Variable Interest Entities. A mortgage loan with First National Bank of Cody related to the purchase of land and building by the VIE has also been consolidated in the Company s consolidated balance sheets. The mortgage requires monthly principal and interest payments of $14,782, at a fixed rate of 7.5%, to be made through June 2026. As of March 31, 2011, $1,545,015 is outstanding under the mortgage loan, of which $63,652 is classified as currently due. The mortgage is collateralized by the land and building.

In July 2004, 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 has recorded the unearned grant funds as a liability until the Company complies with all of the requirements of the grant funding program. As of March 31, 2011, the Company has had preliminary discussions with the Commonwealth of Pennsylvania to determine whether it will be required to repay any of the funds provided under the grant funding program. Based on information available at March 31, 2011, the Company has recorded the grant funding as a long-term liability under the caption of Unearned Grant Funds.

Prospects for the Future

Generic pharmaceutical manufacturers and distributors are constantly faced by pricing pressure in the marketplace as competitors attempt to lure business from distributors, wholesalers and chain retailers by offering lower prices than the incumbent supplier. Lannett tries to differentiate itself in the marketplace by complementing its lower cost offerings with higher levels of customer service and quality of the products. But as Lannett enters Fiscal Year 2012, there is an increasing number of competitors on our key products that are attempting to supplant Lannett as the preferred vendor. Lannett will continue to evaluate each event as it arises,

Table of Contents

but any reductions in either volumes or pricing will have a negative impact on the gross profit margins of the Company.

Beginning in the first quarter of Fiscal 2011, Lannett faced significant pricing challenges on its top two selling products. In order to keep the volume of business with the specific customers involved, Lannett chose to reduce its selling price on both of the products. These price reductions will have a significant impact to the gross profit margins and profitability of Lannett expected in the future.

Starting in the third quarter of Fiscal 2011, Lannett is no longer marketing its OB Natal One product as the terms of the March 2009 settlement with KV pharmaceuticals required, and was confirmed in our December 2010 settlement with KV. Additionally, the Company will stop marketing its Oxycodone HCL Solution product during the fourth quarter of Fiscal 2011 when supplies run out due to the current denial by the DEA to grant additional manufacturing quota to Cody Labs for its production. Both of these products combined contributed approximately $7.0 million in revenue in Fiscal 2010. The loss of these products will have a significant impact to the gross profit margins and profitability of Lannett expected in the future.

The Company has several generic products under development. These products are all orally-administered, topical and parenteral 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 one of the oldest generic drug manufacturers in the country, formed in 1942, Lannett currently owns several ANDAs for products which it does not manufacture and market. These ANDAs are 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. 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. 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. Recently, the FDA has announced that it will prioritize its review of 3,800 Chemistry Manufacturing and Control (CMC) supplements in order to make progress on reviewing a backlog of over 2,200 ANDAs. This could negatively impact the sales of existing products.

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 and can range from $100,000 to $1.7 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.

The Company views its April 2007 acquisition of Cody Laboratories, Inc. (Cody Labs or Cody) as an important step in becoming a vertically integrated narcotics manufacturer and distributor by allowing it to concentrate on developing and completing its dosage form manufacturing in order to reduce narcotic API costs. In July 2008, the DEA granted Cody Labs a license to directly import raw poppy straw for conversion into API and/or various pharmaceutical products. Only six other companies in the U.S. have been granted this license to date. This license allows the Company to avoid increased costs associated with buying narcotic API from other manufacturers. The Company anticipates that it can use this license to become a vertically integrated

Table of Contents

manufacturer of narcotic products, as well as a supplier of API to the pharmaceutical industry. The Company believes that the aging domestic population may result in a higher demand for pain management pharmaceutical products and that it will be well-positioned to take advantage of this increased demand.

Cody Labs manufacturing expertise in narcotic APIs will allow Lannett to build a market with limited domestic competition. The Company anticipates that the demand for narcotics and controlled drugs will continue to grow with the Baby Boomer generation demographics and that it is well-positioned to take advantage of these opportunities by concentrating additional resources in the narcotic area. The sale of pain management products approximated 11% of Net Sales for the full year Fiscal 2010. Additionally, the API and dosage form production of these products were performed at our Cody Labs operations and, due to the increased volumes of sales on these products, allowed Cody to be profitable for the entire 2010 fiscal year. Due to the FDA s actions against Morphine Sulfate Oral Solution and a slow down in the demand for one other product that is manufactured at Cody, Lannett expects a decrease in the percentage of sales related to pain management products in the short term. When the FDA approves the Company s current 505(b)(2) New Drug Application for Morphine Sulfate Oral Solution, the Company expects the portion of net sales related to pain management products to increase again.

In addition to the efforts of its internal product development group, Lannett has contracted with several outside firms 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, topical or parenterals intended to treat a diverse range of medical indications. We intend to ultimately transfer the formulation technology and manufacturing process for all of these R&D products to our own commercial manufacturing sites. The Company initiated these outsourced R&D efforts to complement 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. Certain prescription drugs do not require prior FDA approval before marketing. They include, for instance, drugs listed as DESI drugs (Drug Efficacy Study Implementation) which are under evaluation by FDA, Grandfathered Drugs, and prescription multivitamin drugs. A generic manufacturer may sell products which are chemically equivalent to innovator drugs, under FDA rules by simply performing and internally documenting the normal research and development involved in bringing a new product to market. Under this scenario, a generic company can forego the time required for FDA approval.

More specifically, certain products, marketed prior to the Federal Food, Drug and Cosmetic Act may be considered GRASE (Generally Recognized As Safe and Effective) or Grandfathered. GRASE products are those old drugs that do not require prior approval from FDA in order to be marketed because they are generally recognized as safe and effective based on published scientific literature. Similarly, Grandfathered products are those which entered the market before the passage of the 1938 act or the 1962 amendments to the act. Under the grandfather clause, such a product is exempted from the effectiveness requirements [of the act] if its composition and labeling have not changed since 1962 and if, on the day before the 1962 amendments became effective, it was (1) used or sold commercially in the United States, (2) not a new drug as defined by the act at that time, and (3) not covered by an effective application. Recently, the FDA has increased its efforts to force companies to file and seek FDA approval for these GRASE products. Efforts have included granting market exclusivity to approved GRASE products and issuing notices to companies currently producing these products.

The Company has entered supply and development agreements with certain international companies, including Wintac of India, Orion Pharma of Finland, Azad Pharma AG and Swiss Caps of Switzerland, Pharma 2B (formerly Pharmaseed) and the GC Group of Israel, as well as certain domestic companies, including Jerome Stevens, Banner Pharmacaps, Cerovene, Summit Bioscience LLC and Inverness. The Company is currently in

42

Table of Contents

negotiations on similar agreements with other international companies, through which Lannett will market and distribute products manufactured by Lannett or 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. Hence, the Company does not believe that its outside contracts for product development and manufacturing supply are material in nature, nor is the Company substantially dependent on the services rendered by such outside firms.

Lannett may increase its focus on certain specialty markets in the generic pharmaceutical industry. Such a focus is intended to provide Lannett customers with increased product alternatives in categories with relatively few market participants. While there is no guarantee that Lannett has the market expertise or financial resources necessary to succeed in such a market specialty, management is confident that such future focus will be well received by Lannett customers and increase shareholder value in the long run.

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. The Company plans to continue to explore such areas for potential opportunities to enhance shareholder value.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has debt instruments with variable interest rates**.** The Company had a $3,000,000 line of credit from Wells Fargo, N. A., formerly Wachovia Bank, N.A. (Wells Fargo) that bears interest at the prime interest rate less 0.25% (3.0% at March 31, 2011 and June 30, 2010, respectively). Availability under the line of credit is reduced by outstanding letters of credit. As of March 31, 2011 and June 30, 2010, the Company had $2,995,000 and $3,000,000, respectively, of availability under this line of credit. The line of credit was collateralized by substantially all of the Company s assets. The agreement contained covenants with respect to working capital, net worth and certain ratios, as well as other covenants. Effective as of March 31, 2011, the Company renegotiated this line of credit as part of establishing a mortgage on its new Townsend Road property. As part of this renegotiation, the line which expires on March 31, 2012, is now only collateralized by the working capital assets of the Company. As of March 31, 2011, the Company was in compliance with the new financial covenants under the agreement. Under the previous agreement with Wells Fargo, the existing line of credit would have expired on November 30, 2011.

The Company invests in equity securities, U.S. government agency securities and corporate bonds, which are exposed to market and interest rate fluctuations. The interest and dividends earned on these investments may vary based on fluctuations in interest rate and market conditions.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Form 10-Q, management performed, with the participation of our Chief Executive Officer and Chief Financial Officer, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act). Our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective as of the end of the period covered by this report.

Change in Internal Control Over Financial Reporting

There has been no change in the Company s internal control over financial reporting during the three months ended March 31, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In January 2010, the Company initiated an arbitration proceeding against Olive Healthcare (Olive) for damages arising out of Olive s delivery of defective soft-gel prenatal vitamin capsules. The Company seeks damages in excess of $3.5 million. Olive has denied liability and filed a counterclaim in February 2010 for breach of contract. The arbitration proceeding is still in its initial stages. A mediation was scheduled to take place in mid-December 2010, but Olive did not appear. The Company is now moving forward with the arbitration proceeding. Olive also filed a lawsuit against the Company in December 2010 in Daman, India seeking to enjoin the United States arbitration and claiming damages in excess of $4.0 million arising out of a contract for the soft-gel capsules. The Company has engaged Indian counsel and is actively defending that suit.

In June 2008, the Company filed a declaratory judgment suit in the Federal District Court of Delaware (Civil Action No. 08-338 (JJF)) against KV Pharmaceuticals, DrugTech Corp. and Ther-Rx Corp (collectively, KV). The complaint sought declaratory judgment for non-infringement and invalidity of certain patents owned by KV. The complaint further sought declaratory judgment of anti-trust violations and federal and state unfair competition violations for actions taken by KV in securing and enforcing these patents. KV also countered with claims of infringement by the Company of KV s patents seeking the Company s profits for sales of MMCs or other monetary relief, preliminary and permanent injunctive relief, attorney s fees and a finding of willful infringement. In March 2009, the Company and KV settled the litigation. In May 2010, the Company filed an action for declaratory relief in the Delaware Superior Court against KV seeking a declaration that KV breached its obligations under a settlement agreement entered into with the Company (the Binding Agreement). In June 2010, KV filed a counterclaim to the complaint and asserted claims for breach of contract, declaratory judgment, negligent misrepresentation and fraud in connection with the Binding Agreement, alleging among other things that the Company has improperly withheld royalties from KV arising out of its sales of a pre-natal vitamin product. On December 15, 2010, the Company executed a settlement agreement with KV in which the Company paid KV $850,000 to satisfy all royalties earned through December 31, 2010. In addition, effective January 1, 2011, the license granted to Lannett in the Binding Agreement was terminated, and the Company and its affiliates were required to cease making, using or offering to sell products covered by the licensed patents.

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.

ITEM 6. EXHIBITS

(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.

45

Table of Contents

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 13, 2011	By:	/s/ Arthur P. Bedrosian Arthur P. Bedrosian President and Chief Executive Officer
Dated: May 13, 2011	By:	/s/ Keith R. Ruck Keith R. Ruck Vice President of Finance and Chief Financial Officer

Table of Contents

Exhibit Index

31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith