WATSON PHARMACEUTICALS INC
Form 10-Q
August 06, 2007

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 EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 001-13305

WATSON PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Nevada	**95-3872914**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

311 Bonnie Circle

Corona, CA 92880-2882

(Address of principal executive offices, including zip code)

(951) 493-5300

(Registrant s telephone number, including area code)

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

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

The number of shares outstanding of the Registrant s only class of common stock as of July 30, 2007 was approximately 103,479,000.

WATSON PHARMACEUTICALS, INC.

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Part I. FINANCIAL INFORMATION

WATSON PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited; in thousands)

	June 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 74,852	$ 154,171
Marketable securities	10,513	6,649
Accounts receivable, net	301,602	384,692
Inventories	553,869	517,236
Prepaid expenses and other current assets	53,740	86,115
Deferred tax assets	99,994	112,813
Total current assets	1,094,570	1,261,676
Property and equipment, net	694,440	697,415
Investments and other assets	70,015	76,377
Deferred tax assets	63,351	55,348
Product rights and other intangibles, net	691,560	779,284
Goodwill	875,443	890,477
Total assets	$ 3,489,379	$ 3,760,577
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 436,776	$ 516,875
Income taxes payable		46,773
Current portion of long-term debt	5,602	107,059
Deferred revenue	17,468	19,222
Total current liabilities	459,846	689,929
Long-term debt	974,276	1,124,145
Deferred revenue	50,834	58,086
Other long-term liabilities	8,048	4,169
Other taxes payable	45,669	
Deferred tax liabilities	185,810	203,860
Total liabilities	1,724,483	2,080,189
Commitments and contingencies		
Stockholders equity:		
Preferred stock		
Common stock	372	369
Additional paid-in capital	956,154	937,308
Retained earnings	1,106,728	1,041,638
Accumulated other comprehensive income	1,642	1,073
Treasury stock, at cost	(300,000)	(300,000)
Total stockholders equity	1,764,896	1,680,388
Total liabilities and stockholders equity	$ 3,489,379	$ 3,760,577

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited; in thousands, except per share amounts)

	Three Months Ended June 30, 2007	2006 Restated (Note 1)	Six Months Ended June 30, 2007	2006 Restated (Note 1)
Net revenues	$ 603,005	$ 510,356	$ 1,274,610	$ 917,589
Cost of sales (excluding amortization, presented below)	360,438	330,860	785,158	565,614
Gross profit	242,567	179,496	489,452	351,975
Operating expenses:				
Research and development	35,503	31,125	73,311	60,962
Selling and marketing	51,897	43,291	107,060	85,204
General and administrative	45,261	27,483	93,316	52,320
Amortization	44,159	41,101	88,092	82,201
Loss on impairment		66,981		66,981
Total operating expenses	176,820	209,981	361,779	347,668
Operating income (loss)	65,747	(30,485)	127,673	4,307
Other (expense) income:				
Early extinguishment of debt	(1,681)	195	(4,410)	(525)
Interest income	1,803	6,913	4,732	13,165
Interest expense	(11,475)	(3,322)	(25,351)	(6,623)
Other income	3,034	1,561	6,437	5,076
Total other (expense) income, net	(8,319)	5,347	(18,592)	11,093
Income (loss) before income taxes	57,428	(25,138)	109,081	15,400
Provision (benefit) for income taxes	21,019	(9,527)	41,060	5,837
Net income (loss)	$ 36,409	$ (15,611)	$ 68,021	$ 9,563
Earnings (loss) per share:				
Basic	$ 0.36	$ (0.15)	$ 0.67	$ 0.09
Diluted	$ 0.33	$ (0.15)	$ 0.62	$ 0.09
Weighted average shares outstanding:				
Basic	102,093	101,666	102,178	101,742
Diluted	117,080	101,666	116,909	102,125

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited; in thousands)

	Six Months Ended June 30, 2007	2006 Restated (Note 1)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 68,021	$ 9,563
Reconciliation to net cash provided by operating activities:		
Depreciation	37,522	24,569
Amortization	88,091	82,201
Loss on asset impairment		66,981
Deferred income tax benefit	(20,188)	(61,887)
Provision for inventory reserve	26,946	10,701
Restricted stock and stock option compensation	6,910	6,653
Earnings on equity method investments	(3,723)	(1,373)
Gain on sale of securities	(2,472)	(3,695)
Loss on early extinguishment of debt	4,410	525
Loss on sale of fixed assets	917	166
Tax benefits from employee stock plans	767	785
Mark to market on derivative	119	(732)
Other	2,016	(1,899)
Changes in assets and liabilities (net of acquisition of business):		
Accounts receivable, net	86,090	(13,618)
Inventories	(67,980)	(38,542)
Prepaid expenses and other current assets	33,873	(776)
Accounts payable and accrued expenses	(76,366)	84,425
Deferred revenue	(6,176)	(1,485)
Income taxes payable	18,058	35,106
Other assets	2,407	(1,443)
Total adjustments	131,221	186,662
Net cash provided by operating activities	199,242	196,225
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property and equipment	(35,465)	(18,179)
Acquisition of product rights	(368)	(302)
Acquisition of business, net of cash acquired		(29,664)
Proceeds from sale of marketable equity securities	2,548	2,203
Proceeds from sale of investments		4,695
Additions to marketable securities	(4,230)	(3,944)
Additions to long-term investments	(1,144)	(12,500)
Distribution from joint venture	715	5,942
Other, net	92	
Net cash used in investing activities	(37,852)	(51,749)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on term debt	(251,881)	(18,799)
Proceeds from stock plans	11,172	7,283
Net cash used in financing activities	(240,709)	(11,516)
Net (decrease) increase in cash and cash equivalents	(79,319)	132,960
Cash and cash equivalents at beginning of period	154,171	467,451
Cash and cash equivalents at end of period	$ 74,852	$ 600,411

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 GENERAL

Watson Pharmaceuticals, Inc. (Watson or the Company) is primarily engaged in the development, manufacture, marketing, sale and distribution of brand and off-patent (generic) pharmaceutical products. Watson was incorporated in 1985 and began operations as a manufacturer and marketer of off-patent pharmaceuticals. Through internal product development and synergistic acquisitions of products and businesses, the Company has grown into a diversified specialty pharmaceutical company. Watson operates manufacturing, distribution, research and development and administrative facilities primarily in the United States of America (U.S.).

The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2006. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted from the accompanying Condensed Consolidated Financial Statements. The year end balance sheet was derived from the audited financial statements. The accompanying interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, necessary to present fairly Watson s consolidated financial position, results of operations and cash flows for the periods presented. Unless otherwise noted, all such adjustments are of a normal, recurring nature. Certain reclassifications, none of which affected net income or retained earnings, have been made to prior period amounts to conform to current period presentation. The Company s results of operations and cash flows for the interim periods are not necessarily indicative of the results of operations and cash flows that it may achieve in future periods or for the full year.

Acquisition of Andrx Corporation

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx Corporation (Andrx) for $1.9 billion (the Andrx Acquisition). Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders equity, net of any related tax effect. As required by Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements (ARB 51), earnings (loss) on equity method investments has been restated for the three and six months ended June 30, 2006 to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18). Other comprehensive income has also been restated for the three and six months ended June 30, 2006 to reflect these changes.

Comprehensive Income

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company s stockholders. Other comprehensive income refers to revenues, expenses, gains and losses that, under generally accepted accounting principles, are included in comprehensive income, but excluded from net income as these amounts are recorded directly as an adjustment to stockholders equity. Watson s other comprehensive income is composed of unrealized (losses) gains on its holdings of publicly traded debt and equity securities and foreign currency translation adjustments. The components of comprehensive income, including attributable income taxes, consisted of the following (in thousands):

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006 Restated	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006 Restated
Net income (loss)	$ 36,409	$ (15,611)	$ 68,021	$ 9,563
Other comprehensive income (loss):				
Unrealized (loss) gain on securities	(805)	(14)	(815)	1,110
Less related income taxes	295	5	299	(421)
Total unrealized (loss) gain on securities, net	(510)	(9)	(516)	689
Translation gain (loss)	867	(595)	1,085	(430)
Total other comprehensive income (loss)	357	(604)	569	259
Total comprehensive income (loss)	$ 36,766	$ (16,215)	$ 68,590	$ 9,822

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Preferred and Common Stock

As of June 30, 2007 and December 31, 2006, 2,500,000 shares of no par value per share preferred stock were authorized, with none issued. As of June 30, 2007 and December 31, 2006, 500,000,000 shares of $0.0033 par value per share common stock were authorized, with 112,856,000 and 111,867,000 shares issued and 103,456,000 and 102,467,000 outstanding, respectively. Of the issued shares, 9,399,800 shares were held as treasury shares as of June 30, 2007 and December 31, 2006, respectively.

On February 15, 2006, the Company s Board of Directors authorized the expenditure of $300.0 million to repurchase shares of the Company s outstanding common stock (the 2006 Repurchase Program). No common stock was repurchased under the 2006 Repurchase Program which expired on February 15, 2007.

Provisions for Sales Returns and Allowances

As customary in the pharmaceutical industry, the Company s gross product sales are subject to a variety of deductions in arriving at reported net product sales. When the Company recognizes revenue from the sale of its products, an estimate of sales returns and allowances (SRA) is recorded which reduces product sales and accounts receivable. These adjustments include estimates for chargebacks, rebates, cash discounts and returns and other allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with direct and indirect customers. The estimation process used to determine our SRA provision has been applied on a consistent basis and no material adjustments have been necessary to increase or decrease our reserves for SRA as a result of a significant change in underlying estimates. The Company uses a variety of methods to assess the adequacy of our SRA reserves to ensure that our financial statements are fairly stated. This includes periodic reviews of customer inventory data, customer contract programs and product pricing trends to analyze and validate the SRA reserves.

The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to the Company by our wholesale customer for a particular product and the negotiated contract price that the wholesaler s customer pays for that product. The Company s chargeback provision and related reserve vary with changes in product mix, changes in customer pricing and changes to estimated wholesaler inventory. The provision for chargebacks also takes into account an estimate of the expected wholesaler sell-through levels to indirect customers at contract prices. The Company validates the chargeback accrual quarterly through a review of the inventory reports obtained from its largest wholesale customers. This customer inventory information is used to verify the estimated liability for future chargeback claims based on historical chargeback and contract rates. These large wholesalers represent 85% - 90% of the Company s chargeback payments. The Company continually monitors current pricing trends and wholesaler inventory levels to ensure the liability for future chargebacks is fairly stated. The following table summarizes the activity in the Company s major categories of SRA (in thousands):

	Chargebacks	**Rebates**	**Returns and Other Allowances**	**Cash Discounts**	**Total**
Balance at December 31, 2005	$ 139,605	$ 128,293	$ 45,293	$ 12,094	$ 325,285
Provision related to sales in six months ended June 30, 2006	567,776	201,959	83,987	34,570	888,292
Credits and payments	(539,685)	(191,298)	(85,178)	(33,167)	(849,328)
Balance at June 30, 2006	167,696	138,954	44,102	13,497	364,249
Add: Andrx opening balances	15,911	27,667	8,992	1,601	54,171
Provision related to sales in six months ended December 31, 2006	622,678	219,441	89,222	36,115	967,456
Credits and payments	(641,805)	(205,524)	(99,827)	(37,141)	(984,297)
Balance at December 31, 2006	164,480	180,538	42,489	14,072	401,579
Provision related to sales in six months ended June 30, 2007	600,978	215,883	98,362	35,104	950,327
Credits and payments	(616,994)	(229,595)	(66,985)	(36,072)	(949,646)
Balance at June 30, 2007	$ 148,464	$ 166,826	$ 73,866	$ 13,104	$ 402,260

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted earnings per share is based on the treasury stock method and includes the effect from potential issuance of common stock, such as shares issuable upon conversion of the $575 million convertible contingent senior debentures (CODES), and the dilutive effect of stock options and restricted stock awards outstanding during the period. Potential common shares have been excluded where their inclusion would be anti-dilutive. In accordance with Emerging Issues Task Force (EITF) Issue No. 04-8, The Effect of Contingently Convertible Debt on Diluted Earnings per Share, the Company is required to add approximately 14.4 million shares associated with the conversion of the CODES to the number of shares outstanding for the calculation of diluted earnings per share for all periods in which the securities were outstanding. A reconciliation of the numerators and denominators of basic and diluted earnings per share consisted of the following (in thousands, except per share amounts):

	Three months ended June 30, 2007	**2006 Restated**	**Six months ended June 30, 2007**	**2006 Restated**
Earnings (loss) per share - basic				
Net income (loss)	$ 36,409	$ (15,611)	$ 68,021	$ 9,563
Basic weighted average common shares outstanding	102,093	101,666	102,178	101,742
Earnings (loss) per share - basic	$ 0.36	$ (0.15)	$ 0.67	$ 0.09
Earnings (loss) per share - diluted				
Net income (loss)	$ 36,409	$ (15,611)	$ 68,021	$ 9,563
Add: Interest expense on CODES, net of tax	2,058		4,001	
Net income (loss), adjusted	$ 38,467	$ (15,611)	$ 72,022	$ 9,563
Basic weighted average common shares outstanding	102,093	101,666	102,178	101,742
Effect of dilutive securities:				
Conversion of CODES	14,357		14,357	
Dilutive stock options	630		374	383
Diluted weighted average common shares outstanding	117,080	101,666	116,909	102,125
Earnings (loss) per share - diluted	$ 0.33	$ (0.15)	$ 0.62	$ 0.09

Stock awards to purchase 7.1 million and 10.4 million common shares for the three months ended June 30, 2007 and 2006, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive. Stock awards to purchase 8.6 million common shares for the six months ended June 30, 2007 and 2006, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive. Potential common shares related to the CODES convertible into 14.4 million common shares were not included in the computation of diluted earnings per share for the three and six months ended June 30, 2006 because they were antidilutive.

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for the uncertainty in recognizing income taxes in an organization in accordance with FASB Statement No. 109 by providing detailed guidance for financial statement recognition, measurement and disclosure involving uncertain tax positions. FIN 48 requires an uncertain tax position to meet a more-likely-than-not recognition threshold at the effective date to be recognized both upon the adoption of FIN 48 and in subsequent periods. FIN 48 is effective for fiscal years beginning after December 15, 2006. As the provisions of FIN 48 will be applied to all tax positions upon initial adoption, the cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. As a result of the adoption of FIN 48, the Company recorded a $2.9 million increase in the liability for unrecognized tax benefits resulting in a decrease to the January 1, 2007 retained earnings balance of $2.9 million (for additional information on the adoption of FIN 48, see NOTE 9 INCOME TAXES).

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair-Value Measurements (SFAS 157) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair-value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently reviewing SFAS 157 and has not yet determined the impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, (SFAS 159) which is effective for fiscal years beginning after November 15, 2007. SFAS 159 permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The Company is currently reviewing SFAS 159 and has not yet determined the impact, if any, on its consolidated financial statements.

NOTE 2 SHARE-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the modified prospective method of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R) which requires the measurement and recognition of compensation expense for all share-based compensation awards made to employees and directors based on estimated fair values.

Stock Option Plans

A summary of the changes in the Company s stock option plans during the six months ended June 30, 2007 is presented below (in thousands, except per share amounts):

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2006	10,985	$ 36.39		
Granted	69	30.10		
Exercised	(435)	25.71		
Cancelled	(779)	37.15		
Outstanding at June 30, 2007	9,840	$ 36.75	5.3	$ 21,207
Vested and expected to vest at June 30, 2007	9,285	$ 37.24	5.1	$ 18,837
Options exercisable at June 30, 2007	7,595	$ 39.18	4.5	$ 11,422

As of June 30, 2007, the Company had $6.8 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 1.4 years. Total intrinsic value of stock options exercised for the three months ended June 30, 2007 and 2006 was $2.1 million and $1.6 million, respectively. Total intrinsic value of stock options exercised for the six months ended June 30, 2007 and 2006 was $2.3 million and $1.9 million, respectively.

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Restricted Stock

A summary of the changes in restricted stock grants during the six months ended June 30, 2007 is presented below (in thousands, except per share amounts):

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Restricted shares outstanding at December 31, 2006	569	$ 30.26	1.9	$ 17,211
Granted	590	32.38		19,103
Vested	(27)	29.71		(792)
Cancelled	(36)	31.35		(1,122)
Restricted shares outstanding at June 30, 2007	1,096	$ 31.38	2.1	$ 34,400

As of June 30, 2007, the Company had $18.0 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 2.1 years.

Share-Based Compensation

The impact of share-based compensation on the Company s results of operations for the three and six months ended June 30, 2007 and 2006, respectively, was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Total share-based compensation expense	$ 3,429	$ 3,535	$ 6,553	$ 5,773
Tax benefit	(1,255)	(1,340)	(2,467)	(2,188)
Share-based compensation expense, net of tax	$ 2,174	$ 2,195	$ 4,086	$ 3,585
Share-based compensation capitalized to inventory	$ 860	$ 605	$ 1,783	$ 1,080

NOTE 3 ACQUISITIONS

Acquisition of Andrx Corporation

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion. Andrx, whose capabilities both augment and complement those of Watson, distributes pharmaceutical products primarily to independent and chain pharmacies and physicians offices and is considered a leader in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products. As a result of the Andrx Acquisition, Watson now has three operating segments: Generic, Brand and Distribution.

Acquisition of Sekhsaria Chemicals Ltd.

On March 16, 2006, the Company acquired Sekhsaria Chemicals Ltd. (Sekhsaria), a private company located in Mumbai, India that provides active pharmaceutical ingredient and finished dosage formulation expertise to the global pharmaceutical industry. The Company acquired all the outstanding shares of Sekhsaria for approximately $29.5 million plus acquisition costs. The transaction was accounted for as a purchase in accordance with SFAS 141, Business Combinations (SFAS 141) and accordingly, the assets acquired and liabilities assumed were recorded at fair value on the acquisition date.

Additional Investment in Scinopharm

The Company holds an equity interest in Scinopharm Taiwan Ltd. (Scinopharm). In January 2006, the Company made an additional investment in Scinopharm of approximately $12.0 million which increased its ownership interest to approximately 31%. Additionally, the Company has an option, which expires in October 2007, to acquire an additional 44% interest in Scinopharm at a cost of approximately $80 million.

NOTE 4 OTHER INCOME

Other income consisted of the following (in thousands):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2007	**2006**	**2007**	**2006**
Earnings on equity method investments - restated	$ 2,284	$ 1,658	$ 3,723	$ 1,373
Gain on sale of securities	683		2,472	3,695
Other income (expense)	67	(97)	242	8
	$ 3,034	$ 1,561	$ 6,437	$ 5,076

As discussed in NOTE 1 GENERAL, earnings on equity method investments has been restated to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with APB 18.

NOTE 5 OPERATING SEGMENTS

Watson has three reportable operating segments: Generic, Brand and Distribution. The Generic segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Brand segment includes the Company s lines of Specialty Products and Nephrology products. Watson has aggregated its Brand product lines in a single segment because of similarities in regulatory environment, methods of distribution and types of customer. This segment includes patent-protected products and certain trademarked off-patent products that Watson sells and markets as Brand pharmaceutical products. The Company sells its Brand and Generic products primarily to pharmaceutical wholesalers, drug distributors and chain drug stores in the U.S. Following the Andrx Acquisition, a third operating segment was added representing the Anda distribution business (Anda). The Distribution segment distributes generic pharmaceutical products manufactured by third parties to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians offices in the U.S. Sales are principally generated through an in-house telemarketing staff and through internally developed ordering systems. The Distribution segment operating results are included in Watson results since the date of the Andrx Acquisition and exclude sales by Anda of Watson Generic and Brand products, which are included in their respective segment results.

Other revenue consists primarily of royalties, commissions, co-promotional revenue and the recognition of deferred revenue associated with manufacturing, development and licensing arrangements.

Net revenues and segment contribution information for the Company s Generic, Brand and Distribution segments, consisted of the following:

	Three Months Ended June 30, 2007				Three Months Ended June 30, 2006		
	Generic	**Brand**	**Distribution**	**Total**	**Generic**	**Brand**	**Total**
Product sales	$ 327,446	$ 96,924	$ 146,631	$ 571,001	$ 419,441	$ 88,051	$ 507,492
Other	18,195	13,809		32,004	990	1,874	2,864
Net revenues	345,641	110,733	146,631	603,005	420,431	89,925	510,356
Cost of sales (1)	210,342	26,795	123,301	360,438	306,564	24,296	330,860
Gross profit	135,299	83,938	23,330	242,567	113,867	65,629	179,496
Gross margin	39 %	76 %	16 %	40 %	27 %	73 %	35 %
Research and development	23,968	11,535		35,503	18,124	13,001	31,125
Selling and marketing	13,197	26,373	12,327	51,897	13,526	29,765	43,291
Contribution	$ 98,134	$ 46,030	$ 11,003	155,167	$ 82,217	$ 22,863	105,080
Contibution margin	28 %	42 %	8 %	26 %	20 %	25 %	21 %
General and administrative				45,261			27,483
Amortization				44,159			41,101
Loss on impairment							66,981
Operating income (loss)				$ 65,747			$ (30,485)
Operating margin				11 %			(6)%

	Six Months Ended June 30, 2007				Six Months Ended June 30, 2006		
	Generic	**Brand**	**Distribution**	**Total**	**Generic**	**Brand**	**Total**
Product sales	$ 738,921	$ 187,562	$ 292,071	$ 1,218,554	$ 740,856	$ 171,288	$ 912,144
Other	31,345	24,711		56,056	1,665	3,780	5,445
Net revenues	770,266	212,273	292,071	1,274,610	742,521	175,068	917,589
Cost of sales (1)	482,965	52,010	250,183	785,158	523,948	41,666	565,614
Gross profit	287,301	160,263	41,888	489,452	218,573	133,402	351,975
Gross margin	37 %	75 %	14 %	38 %	29 %	76 %	38 %
Research and development	50,481	22,830		73,311	38,619	22,343	60,962
Selling and marketing	27,746	52,784	26,530	107,060	26,464	58,740	85,204
Contribution	$ 209,074	$ 84,649	$ 15,358	309,081	$ 153,490	$ 52,319	205,809
Contibution margin	27 %	40 %	5 %	24 %	21 %	30 %	22 %
General and administrative				93,316			52,320
Amortization				88,092			82,201
Loss on impairment							66,981
Operating income				$ 127,673			$ 4,307
Operating margin				10 %			0 %

(1) Excludes amortization of acquired intangibles including product rights.

NOTE 6 INVENTORIES

Inventories consist of finished goods held for sale and distribution, raw materials and work-in-process. Included in inventory at June 30, 2007 and December 31, 2006 is approximately $26.6 million and $34.2 million, respectively, of inventory that is pending approval by the U.S. Food and Drug Administration (FDA) or has not been launched due to contractual restrictions. This inventory consists of generic pharmaceutical products that are capitalized only when the bioequivalence of the product is demonstrated or the product is already FDA approved and is awaiting a contractual triggering event to enter the marketplace.

Inventories are stated at the lower of cost (first-in, first-out method) or market (net realizable value) and consisted of the following (in thousands):

	June 30, 2007	December 31, 2006
Raw materials	$ 114,677	$ 113,603
Work-in-process	76,151	69,621
Finished goods	363,041	334,012
Total inventories	$ 553,869	$ 517,236

NOTE 7 GOODWILL

Goodwill for the Company s reporting units consisted of the following (in thousands):

	June 30, 2007	December 31, 2006
Brand pharmaceutical products	$ 356,998	$ 368,105
Generic pharmaceutical products	432,662	433,774
Distributed products	85,783	88,598
Total goodwill	$ 875,443	$ 890,477

The $15 million decrease in goodwill during 2007 primarily relates to an adjustment to acquired income tax contingencies.

NOTE 8 LONG-TERM DEBT

Long-term debt consisted of the following (in thousands):

	June 30, 2007	December 31, 2006
Senior Credit Facility, due 2011, bearing interest at LIBOR plus 0.75% (2006 Credit Facility)	$ 400,000	$ 650,000
CODES, face amount of $575 million, due 2023, net of unamortized discount	574,264	574,125
Other notes payable	5,614	7,079