PharMerica CORP
Form 10-Q
August 02, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2012

or

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

Commission File Number: 001-33380

PHARMERICA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**87-0792558**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification No.)**
1901 Campus Place	**40299**

Louisville, KY
(Address of Principal Executive Offices) **(Zip Code)**
(502) 627-7000

(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. x Yes ¨ No

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

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

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

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

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

Class of Common Stock	**Outstanding at July 27, 2012**
Common stock, $0.01 par value	29,528,958 shares

PHARMERICA CORPORATION

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED INCOME STATEMENTS

For the Three Months and Six Months Ended June 30, 2011 and 2012

(Unaudited)

(In millions, except share and per share amounts)

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2012	Six Months Ended June 30, 2011	Six Months Ended June 30, 2012
Revenues	$ 531.7	$ 458.5	$ 1,066.8	$ 957.4
Cost of goods sold	454.7	382.4	923.7	808.7
Gross profit	77.0	76.1	143.1	148.7
Selling, general and administrative expenses	55.7	55.1	107.7	107.5
Amortization expense	2.7	3.0	5.4	5.8
Merger, acquisition, integration costs and other charges	5.1	2.8	9.8	8.2
Operating income	13.5	15.2	20.2	27.2
Interest expense, net	2.6	2.5	3.7	5.2
Income before income taxes	10.9	12.7	16.5	22.0
Provision for income taxes	3.5	5.1	5.8	8.8
Net income	$ 7.4	$ 7.6	$ 10.7	$ 13.2
Earnings per common share:				
Basic	$ 0.25	$ 0.26	$ 0.37	$ 0.45
Diluted	$ 0.25	$ 0.26	$ 0.36	$ 0.44
Shares used in computing earnings per common share:				
Basic	29,331,854	29,489,766	29,302,287	29,459,978
Diluted	29,437,422	29,720,403	29,371,990	29,735,489

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

As of December 31, 2011 and June 30, 2012

(Unaudited)

(In millions, except share and per share amounts)

	(As Adjusted) **December 31, 2011**	**June 30, 2012**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17.4	$ 12.0
Accounts receivable, net	232.2	219.3
Inventory	130.6	109.1
Deferred tax assets, net	36.5	29.7
Prepaids and other assets	34.5	37.2
	451.2	407.3
Equipment and leasehold improvements	145.0	151.6
Accumulated depreciation	(92.6)	(101.5)
	52.4	50.1
Deferred tax assets, net	0.6	1.4
Goodwill	214.9	214.9
Intangible assets, net	100.2	95.7
Other	14.7	12.9
	$ 834.0	$ 782.3
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 54.7	$ 36.7
Salaries, wages and other compensation	35.1	31.7
Current portion of long-term debt	6.3	12.5
Other accrued liabilities	6.7	9.8
	102.8	90.7
Long-term debt	293.7	237.5
Other long-term liabilities	23.7	24.4
Commitments and contingencies (See Note 6)		
Stockholders equity:		
Preferred stock, $0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2011 and June 30, 2012	-	-
Common stock, $0.01 par value per share; 175,000,000 shares authorized; 30,794,000 and 30,894,793 shares issued as of December 31, 2011 and June 30, 2012, respectively	0.3	0.3
Capital in excess of par value	355.9	358.8
Retained earnings	68.4	81.6
Treasury stock at cost, 1,350,128 shares and 1,366,115 shares at December 31, 2011 and June 30, 2012, respectively	(10.8)	(11.0)
	413.8	429.7

	$ 834.0	$ 782.3

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three and Six Months Ended June 30, 2011 and 2012

(Unaudited)

(In millions)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012
Cash flows provided by (used in) operating activities:				
Net income	$ 7.4	$ 7.6	$ 10.7	$ 13.2
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation	5.0	4.5	10.1	9.3
Amortization	2.7	3.0	5.4	5.8
Merger, acquisition, integration costs and other charges	0.4	0.3	0.7	1.9
Stock-based compensation	1.8	1.3	3.2	2.9
Amortization of deferred financing fees	0.3	0.2	0.5	0.4
Deferred income taxes	4.6	3.4	6.9	6.0
Loss (gain) on disposition of equipment	0.1	-	0.2	(0.1)
Other	-	0.2	-	-
Change in operating assets and liabilities:				
Accounts receivable, net	1.1	25.0	(8.3)	12.9
Inventory	(24.9)	(4.9)	(39.9)	21.6
Prepaids and other assets	(2.6)	(2.3)	(8.8)	(2.8)
Accounts payable	(3.4)	(11.0)	7.0	(18.0)
Salaries, wages and other compensation	3.2	1.9	12.5	(4.6)
Other accrued liabilities	(0.8)	2.7	0.1	3.3
Net cash (used in) provided by operating activities	(5.1)	31.9	0.3	51.8
Cash flows provided by (used in) investing activities:				
Purchase of equipment and leasehold improvements	(3.8)	(4.4)	(6.2)	(6.9)
Acquistions, net of cash acquired	(8.5)	(0.4)	(8.5)	(0.4)
Cash proceeds from the sale of assets	-	0.2	-	0.3
Net cash used in investing activities	(12.3)	(4.6)	(14.7)	(7.0)
Cash flows provided by (used in) financing activities:				
Repayments of long-term debt	(240.0)	-	(240.0)	-
Proceeds from long-term debt	250.0	-	250.0	-
Net activity of long-term revolving credit facility	19.7	(22.1)	18.4	(50.0)
Payments of debt issuance costs	(9.8)	-	(9.8)	-
Repayments of capital lease obligations	(0.2)	-	(0.4)	(0.1)
Issuance of common stock	0.1	0.1	0.1	0.1
Treasury stock at cost	(0.1)	-	(0.1)	(0.2)
Net cash provided by (used in) financing activities	19.7	(22.0)	18.2	(50.2)
Change in cash and cash equivalents	2.3	5.3	3.8	(5.4)
Cash and cash equivalents at beginning of period	12.3	6.7	10.8	17.4
Cash and cash equivalents at end of period	$ 14.6	$ 12.0	$ 14.6	$ 12.0

Supplemental information:								
Cash paid for interest	$	1.5	$	2.2	$	2.5	$	5.0
Cash paid for taxes	$	0.3	$	0.9	$	0.3	$	2.2

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

For the Six Months Ended June 30, 2012

(Unaudited)

(In millions, except share amounts)

	Common Stock		Capital in Excess of Par Value	Retained Earnings	Treasury Stock	Total
	Shares	Amount				
Balance at December 31, 2011	29,443,872	$ 0.3	$ 355.9	$ 68.4	$ (10.8)	$ 413.8
Net income	-	-	-	13.2	-	13.2
Exercise of stock options and tax components of stock-based awards, net	5,158	-	-	-	-	-
Vested restricted stock units	95,635	-	-	-	-	-
Treasury stock at cost	(15,987)	-	-	-	(0.2)	(0.2)
Stock-based compensation-non-vested restricted stock	-	-	1.9	-	-	1.9
Stock-based compensation-stock options	-	-	1.0	-	-	1.0
Balance at June 30, 2012	29,528,678	$ 0.3	$ 358.8	$ 81.6	$ (11.0)	$ 429.7

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

PharMerica Corporation (the Corporation) is an institutional pharmacy services company that services healthcare facilities and provides pharmacy management services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States based on revenues, operating 95 institutional pharmacies in 44 states. The Corporation s customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings and generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 91 hospitals in the United States.

Principles of Consolidation

All intercompany transactions have been eliminated.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Corporation and related footnotes for the year ended December 31, 2011, included in the Corporation s Annual Report on Form 10-K. The balance sheet as of December 31, 2011 has been derived from the audited consolidated financial statements adjusted for acquisition related measurement period adjustments as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

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

Use of Estimates

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

Potential risks and uncertainties, many of which are beyond the control of the Corporation, include, but are not necessarily limited to, such factors as overall economic, financial and business conditions; delays and reductions in reimbursement by the government and other payers to the Corporation and/or its customers; the overall financial condition of the Corporation s customers and suppliers; retaining existing customers and service contracts and attracting new customers; the effects of renegotiating contract pricing relating to significant customers and suppliers; the Corporation s ability to successfully transition information technology services being provided by its current vendor to another vendor effectively; successfully pursuing development and acquisition activities; attracting and retaining key executives, pharmacists, and other healthcare personnel; the effect of new government regulations, executive orders and/or legislative initiatives, including those relating to reimbursement and drug pricing policies and changes in the interpretation and application of such policies; efforts by payers to control costs; the outcome of litigation; the outcome of audit, compliance, administrative or investigatory reviews, including governmental/regulatory inquiries; delays or difficulties in integrating acquired businesses; other contingent liabilities; changes in interest rates; changes in tax laws and regulations; the Corporation s ability to implement short cycle dispensing requirements of the 2010 Health Care Legislation; access to capital and financing; the demand for the Corporation s products and services; changes to safety risk profiles of drugs and/or drug transitioning to over-the-counter products; pricing and other competitive factors in the industry; changes in volatility of the Corporation s stock price; changes in manufacturers rebate programs; shifts in demand for generic drug equivalents; changes in insurance claims experience and related assumptions; variations in costs or expenses; changes to critical accounting estimates and changes in and interpretations of accounting rules and standards.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Unsolicited Tender Offer by Omnicare

On August 23, 2011, Omnicare, Inc. (Omnicare) made public an unsolicited proposal to acquire all of the outstanding shares of the Corporation s common stock for $15.00 per share in cash. On January 27, 2012, the Federal Trade Commission (FTC) issued an administrative complaint to block Omnicare s proposed acquisition of the Corporation. The complaint alleges that the proposed acquisition would be illegal and in violation of Section 15 of the FTC Act and Section 7 of the Clayton Act because it would harm competition and enable Omnicare to raise the price of drugs for Medicare Part D consumers and others. On February 21, 2012 the unsolicited tender offer expired and Omnicare did not extend the offer.

In connection with these matters, in the six months ended June 30, 2012, the Corporation expensed $1.9 million of legal, investment banking, and other fees, which are included in merger, acquisition, integration costs and other charges in the condensed consolidated financial statements.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and cash equivalents with original maturities of three months or less. The Corporation places its cash in financial institutions that are federally insured. As of December 31, 2011 and June 30, 2012, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets.

Fair Value of Financial Instruments

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

- Level 1: Observable inputs such as quoted prices in active markets;
- Level 2: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly; and
- Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

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

A. *Market approach:* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

B. *Cost approach:* Amount that would be required to replace the service capacity of an asset (replacement cost).

C. *Income approach:* Techniques to convert future amounts to a single present amount based upon market expectations (including present value techniques, option-pricing and excess earnings models).

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Financial liabilities and non-financial assets recorded at fair value at December 31, 2011 and June 30, 2012, are set forth in the tables below (dollars in millions):

As of December 31, 2011	**Asset/ (Liability)**	**Level 1**	**Level 2**	**Level 3**	**Valuation Technique**
Non-financial Assets					
Intangible Assets	$ -	$ -	$ -	$ -	C
Financial Assets/(Liabilities)					
Deferred Compensation Plan	$ (3.9)	$ -	$ (3.9)	$ -	A
Contingent Consideration	-	-	-	-	C

As of June 30, 2012	**Asset/ (Liability)**	**Level 1**	**Level 2**	**Level 3**	**Valuation Technique**
Financial Assets/(Liabilities)					
Deferred Compensation Plan	$ (4.7)	$ -	$ (4.7)	$ -	A
Contingent Consideration	-	-	-	-	C

The deferred compensation plan liability represents an unfunded obligation associated with the deferred compensation plan offered to eligible employees and members of the Board of Directors of the Corporation. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for similar assets or liabilities generated by market transactions. The contingent consideration represented a future earn-out associated with our acquisition of an institutional pharmacy business based in West Virginia (the West Virginia Acquisition). The fair value of the liability associated with the contingent consideration was derived using the income approach with unobservable inputs, which included future gross profit forecast and present value assumptions, and there was little or no market data. The Corporation no longer believes it is probable that contingent consideration will be paid to the sellers, therefore, at December 31, 2010, the liability was relieved and remained the same at June 30, 2012. The Corporation will continue to assess the fair value of the liability through the date of determination which is August 10, 2012. There were no transfers between the three-tier fair value hierarchy levels during the period.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, inventory and accounts payable approximate fair value because of the short-term maturity of these instruments. The Corporation s debt approximates fair value due to the terms of the interest being set at variable market interest rates (Level 2).

Accounts Receivable and Allowance for Doubtful Accounts

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

The Corporation has an established process to determine the adequacy of the allowance for doubtful accounts, which relies on analytical tools, specific identification, and benchmarks to arrive at a reasonable allowance. No single statistic or measurement determines the adequacy of the allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the Corporation considers a number of factors, which include, but are not limited to, the impact of changes in the regulatory and payer environment, historical trends, the financial viability of the payer, contractual reimbursement terms and other factors that may impact ultimate reimbursement. Accounts receivable are written off after collection efforts have been completed in accordance with the Corporation s policies.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

	December 31, 2011	June 30, 2012
Institutional healthcare providers	$ 169.0	$ 170.8
Medicare Part D	46.9	45.7
Private payer and other	33.3	31.6
Insured	10.7	9.3
Medicaid	20.1	13.8
Medicare	0.8	0.9
Allowance for doubtful accounts	(48.6)	(52.8)
	$ 232.2	$ 219.3
0 to 60 days	61.2 %	58.0 %
61 to 120 days	19.5 %	17.7 %
Over 120 days	19.3 %	24.3 %
	100.0 %	100.0 %

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

	Beginning Balance	Charges to Costs and Expenses	Write-offs	Ending Balance
Allowance for doubtful accounts:				
Year Ended December 31, 2011	$ 36.8	$ 24.8	$ (13.0)	$ 48.6
Six Months Ended June 30, 2012	$ 48.6	$ 12.4	$ (8.2)	$ 52.8

Concentration of Credit Risk

For the three months ended June 30, 2011 and 2012, the Corporation derived approximately 13.4% and 14.8%, respectively, of its revenues from a single customer, including all payer sources associated with the residents of its long-term care facilities. For the six months ended June 30, 2011 and 2012, the Corporation derived approximately 13.5% and 14.6%, respectively, of its revenues from a single customer, including all payer sources associated with the residents of its long-term care facilities.

Deferred Financing Fees

The Corporation capitalizes financing fees related to acquiring or issuing new debt instruments. These expenditures include bank fees and premiums, legal costs, and filing fees. The Corporation amortizes these deferred financing fees using the effective interest method.

Inventory

Inventory is primarily located at the Corporation s institutional pharmacy locations. Inventory consists solely of finished products (primarily prescription drugs) and is valued at the lower of first-in, first-out cost (FIFO) or market. Physical inventories are performed on a quarterly basis at the end of the quarter at all pharmacy sites. Cost of goods sold is recorded based upon the actual results of the physical inventory counts.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Equipment and Leasehold Improvements

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

	Estimated Useful Lives
Leasehold improvements	1-7
Equipment and software	3-10

Expenditures for maintenance, repairs and renewals of minor items are expensed as incurred. Major rebuilds and improvements are capitalized. For the three months ended June 30, 2011 and 2012, maintenance and repairs were $1.9 million. For the six months ended June 30, 2011 and 2012, maintenance and repairs were $3.8 million and $3.9 million, respectively.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset or asset group to the estimated future undiscounted net cash flows expected to be generated by the asset or group of assets. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset or asset group to its then fair value. The Corporation did not record impairment charges on equipment and leasehold improvements for the six months ended June 30, 2011 or 2012.

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

Capitalization of Internal Software Costs

The Corporation capitalizes the costs incurred during the application development stage, which include costs to design the software configuration and interfaces, coding, installation, and testing. Costs incurred during the preliminary project stage along with post-implementation stages of internal use computer software are expensed as incurred. Capitalized development costs are amortized over various periods up to three years and are subject to impairment evaluations. Costs incurred to maintain existing software development are expensed as incurred. The capitalization and ongoing assessment of recoverability of development costs requires judgment by management with respect to certain external factors, including, but not limited to, technological and economic feasibility and estimated economic life. For the three months ended June 30, 2011 and 2012, the Corporation capitalized internally developed software costs of $0.2 million and $1.5 million, respectively. For the six months ended June 30, 2011 and 2012, the Corporation capitalized internally developed software costs of $0.7 million and $2.4 million, respectively. As of December 31, 2011 and June 30, 2012, net capitalized software costs, including acquired assets and amounts for projects which have and have not been completed, totaled $13.2 million and $13.8 million, respectively.

Goodwill and Other Intangibles

Goodwill represents the excess purchase price of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. The Corporation s business is comprised of two reporting units, institutional pharmacy and hospital management, each of which are reviewed separately for impairment. The Corporation s policy is to perform a qualitative assessment on goodwill impairment to determine whether it is more likely than not (defined as having a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. The Corporation performed a qualitative assessment of its institutional pharmacy reporting unit, as of December 31, 2011, and did not find it necessary to perform the first step of the two-step impairment test based on that analysis. There were no triggering events during the six months ended June 30, 2012 requiring the Corporation to perform a qualitative assessment prior to the annual assessment.

The Corporation s finite-lived intangible assets are comprised primarily of trade names, customer relationship assets and non-compete agreements primarily originating from business acquisitions. Finite-lived intangible assets are amortized on a straight-line basis over the course of their lives ranging from 5 to 20 years. For impairment reviews, intangible assets are reviewed on a specific pharmacy basis or as a group of pharmacies depending on the intangible assets under review. The Corporation s goodwill and intangible assets are further described in Note 4.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Self-Insured Employee Health Benefits

The Corporation is self-insured for the majority of its employee health benefits. The Corporation s self-insurance for employee health benefits includes a stop-loss policy to limit the maximum potential liability of the Corporation for both individual and aggregate claims per year. The Corporation records a monthly expense for self-insurance based on historical claims data and inputs from third-party administrators. For the three months ended June 30, 2011 and 2012, the expense for employee health benefits was $5.1 million and $6.0 million, respectively, and for the six months ended June 30, 2011 and 2012 the expense for employee health benefits was $10.1 million and $11.5 million, respectively, the majority of which was related to its self-insured plans. As of December 31, 2011 and June 30, 2012, the Corporation had $3.1 million and $3.7 million, respectively, recorded as a liability for self-insured employee health benefits.

Supplier Rebates

The Corporation receives rebates on purchases from its vendors and suppliers. The Corporation generally accounts for these rebates and other incentives received from its vendors and suppliers, relating to the purchase or distribution of inventory, as a reduction of cost of goods sold and inventory. The Corporation considers these rebates to represent product discounts, and as a result, the rebates are allocated as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory.

Delivery Expenses

The Corporation incurred delivery expenses of $17.3 million and $15.8 million for the three months ended June 30, 2011 and 2012, respectively, and $34.7 million and $32.1 for the six months ended June 30, 2011 and 2012, respectively, to deliver products sold to its customers. Delivery expenses are reported as a component of cost of goods sold in the accompanying condensed consolidated income statements.

Stock Option Accounting

The Corporation recognizes stock-based compensation expense in its condensed consolidated financial statements using the Black-Scholes-Merton option valuation model (see Note 9).

Income Taxes

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

Measurement Period Adjustments

For the six months ended June 30, 2012, the Corporation has adjusted certain amounts on the condensed consolidated balance sheet as of December 31, 2011 as a result of measurement period adjustments related to the 2011 acquisitions (See Note 2).

NOTE 2 ACQUISITIONS

2011 Acquisitions

On April 1, 2011 the Corporation acquired an institutional pharmacy in Greenville, South Carolina. On December 31, 2011, the Corporation acquired the membership interests of an institutional pharmacy which operated three pharmacies in Ohio and Pennsylvania. Both acquisitions (the 2011 Acquisitions) were accounted for under the acquisition method of accounting. The aggregate purchase price of the 2011 Acquisitions was $51.3 million in cash and assumed liabilities, including, the working capital adjustment in the second quarter of 2012. During the three months ended June 30, 2012 the final working capital adjustment was completed for the 2011 acquisitions resulting in additional purchase price paid of $0.3 million. The total purchase price of the 2011 Acquisitions was allocated to the net tangible and identifiable intangible assets based on their fair values at the date of acquisition. The excess of the purchase price over the fair values of the net tangible and identifiable intangible assets was recorded as goodwill. For tax purposes, the transactions were considered asset acquisitions; therefore, the amount of goodwill recorded in the transactions of $35.5 million will be tax deductible to the Corporation. The Corporation believes the resulting amount of goodwill reflects its expectation of the synergistic benefits of the 2011 Acquisitions.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS (Continued)

The combined allocation of the purchase price associated with the 2011 Acquisitions was based upon the fair value of net tangible and identifiable intangible assets as of the date of acquisition. The purchase price allocations were as follows (dollars in millions):

	Amounts Previously Recognized as of Acquisition Date (1)	Measurement Period Adjustments	Amounts Recognized as of Acquisition Date (Adjusted)
Accounts receivable	$ 4.6	$ (0.2)	$ 4.4
Inventory	3.7	0.1	3.8
Other current assets	0.4	-	0.4
Equipment and leasehold improvements	0.4	-	0.4
Identifiable intangibles	12.5	-	12.5
Goodwill	34.8	0.7	35.5
Total assets	56.4	0.6	57.0
Current liabilities	(5.3)	(0.3)	(5.6)
Other long-term liabilities	(0.1)	-	(0.1)
Total liabilities	(5.4)	(0.3)	(5.7)
Purchase price of 2011 Acquisitions	$ 51.0	$ 0.3	$ 51.3

(1) As previously reported in the Corporation s 2011 Annual Report on Form 10-K.

The following is the fair value of the equipment and leasehold improvements of the 2011 Acquisitions acquired at the date of acquisition (dollars in millions):

Equipment and leasehold improvements	Fair-Value	Weighted Average Useful Life (Yr.)
Equipment and software	$ 0.4	4.7

The following are the fair values of the identifiable intangible assets of the 2011 Acquisitions acquired at the date of acquisition (dollars in millions):

Identifiable Intangibles	Fair-Value
Customer relationships	$ 11.1

Trade name		0.5
Non-compete agreement		0.9
	$	12.5

Other

For the three months ended June 30, 2011 and 2012, the Corporation incurred $4.5 million and $2.3 million, respectively, and $9.1 million and $4.8 million for the six months ended June 30, 2011 and 2012, respectively, of acquisition related costs, which have been classified as a component of merger, acquisition, integration costs and other charges.

Pro forma

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS (Continued)

The unaudited pro forma effect of the acquisitions assuming the acquisitions occurred on January 1, 2011, excluding the merger, acquisition, integration costs and other charges and assuming the Corporation s effective tax rate of 31.5% and 35.1% for the three and six months ended June 31, 2011, respectively, would be as follows (dollars in millions, except per share amounts):

	Three Months Ended June 30, 2011	Six Months Ended June 30, 2011
Revenues	$ 546.2	$ 1,099.6
Net income	$ 11.4	$ 18.0
Earnings per common share:		
Basic	$ 0.39	$ 0.61
Diluted	$ 0.39	$ 0.61

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS

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

	December 31, 2011	June 30, 2012
Leasehold improvements	$ 14.3	$ 14.6
Equipment and software	123.2	130.4
Leased equipment	2.9	-
Construction in progress	4.6	6.6
	145.0	151.6
Accumulated depreciation	(92.6)	(101.5)
Total Equipment and leasehold improvements	$ 52.4	$ 50.1

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS (Continued)

The following is a progression of equipment and leasehold improvements for the period presented (dollars in millions):

	Balance at December 31, 2011	Additions	Disposals	Balance at June 30, 2012
Equipment and leasehold improvements:				
Leasehold improvements	$ 14.3	$ 0.3	$ -	$ 14.6
Equipment and software	123.2	7.7	(0.5)	130.4
Leased equipment	2.9	(2.9)	-	-
Construction in progress	4.6	2.0	-	6.6
Sub-Total	145.0	7.1	(0.5)	151.6
Accumulated depreciation	(92.6)	(9.3)	0.4	(101.5)
Total	$ 52.4	$ (2.2)	$ (0.1)	$ 50.1

Depreciation expense totaled $5.0 million and $4.5 million for the three months ended June 30, 2011 and 2012, respectively. Depreciation expense totaled $10.1 million and $9.3 million for the six months ended June 30, 2011 and 2012, respectively.

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

Year Ending December 31,	
2012	$ 18.0*
2013	13.6
2014	8.8
2015	5.6
2016	3.1
Thereafter	10.3
Total	$ 59.4

* The 2012 amount shown includes depreciation expense for the six months ended June 30, 2012 of $9.3 million.

NOTE 4 GOODWILL AND INTANGIBLES

As of December 31, 2011 and June 30, 2012 the carrying amount of goodwill was $214.9 million.

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

Finite Lived Intangible Assets	Balance at December 31, 2011	Additions	Balance at June 30, 2012
Customer relationships	$ 96.0	$ -	$ 96.0
Trade name	30.0	-	30.0
Non-compete agreements	8.4	1.3	9.7
Sub Total	134.4	1.3	135.7
Accumulated amortization	(34.2)	(5.8)	(40.0)
Net intangible assets	$ 100.2	$ (4.5)	$ 95.7

Amortization expense relating to finite-lived intangible assets was $2.7 million and $3.0 million for the three months ended June 30, 2011 and 2012, respectively. Amortization expense relating to finite-lived intangible assets was $5.4 million and $5.8 million for the six months ended June 30, 2011 and 2012, respectively.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 GOODWILL AND INTANGIBLES (Continued)

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

Year Ending December 31,	
2012	$ 11.8 *
2013	10.4
2014	10.3
2015	10.3
2016	9.9
Thereafter	48.8
	$ 101.5

* The 2012 amount shown includes amortization expense for the six months ended June 30, 2012 of $5.8 million.

NOTE 5 CREDIT AGREEMENT

On May 2, 2011, the Corporation entered into a long-term credit agreement (the Credit Agreement) among the Corporation, the Lenders named therein, and Citibank, N.A. (Citibank), as Administrative Agent. The Credit Agreement consists of a $250.0 million term loan facility and a $200.0 million revolving credit facility. The terms and conditions of the Credit Agreement are customary to facilities of this nature.

As of June 30, 2012, $250.0 million was outstanding under the term loan facility and there was no outstanding balance under the revolving credit facility. Indebtedness under the Credit Agreement matures on June 30, 2016, at which time the commitments of the Lenders to make revolving loans also expire.

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

Credit Agreement:	**December 31, 2011**	**June 30, 2012**
Term Debt - payable to lenders at LIBOR plus applicable margin (2.99% as of June 30, 2012), matures June 30, 2016	$ 250.0	$ 250.0
Revolving Credit Facility payable to lenders, interest at base rate plus applicable margin (5.00% as of June 30, 2012), matures June 30, 2016	50.0	-
Total debt	300.0	250.0
Less: Current portion of long-term debt	6.3	12.5
Total long-term debt	$ 293.7	$ 237.5

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

The Corporation s indebtedness has the following maturities for the current year and the next four years and thereafter (dollars in millions):

Year Ending December 31,	Term Debt	Revolving Credit Facility	Total Maturities
2012	$ 6.3	$ -	$ 6.3
2013	12.5	-	12.5
2014	12.5	-	12.5
2015	112.5	-	112.5
2016	106.2	-	106.2
Thereafter	-	-	-
	$ 250.0	$ -	$ 250.0

The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of June 30, 2012 was $2.0 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $198.0 million as of June 30, 2012. The revolving credit facility contains a $100.0 million accordion feature, which permits the Corporation to increase the total debt capacity, up to an aggregate of $550.0 million, subject to securing additional commitments from existing or new lenders.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at the Corporation s option, a base rate plus a margin between 1.25% and 2.00% per annum, or an adjusted London Interbank Offered Rate (LIBO Rate or LIBOR) plus a margin between 2.25% and 3.00% per annum, in each case depending on the leverage ratio of the Corporation as defined by the Credit Agreement.

The base rate is the greater of the prime lending rate in effect on such day, the federal funds effective rate published by the Federal Reserve Bank of New York on such day plus 0.5%, or the adjusted LIBO Rate for deposits for a period equal to one month plus 1.0%. Any changes in the base rate, federal funds rate or adjusted LIBO Rate shall be effective from and including the effective date of such change in the rate, as applicable. The Credit Agreement also provides for letter of credit fees between 2.25% and 3.00% and a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.375% to 0.500%, in each case depending on the leverage ratio of the Corporation.

The Corporation s obligations under the Credit Agreement are secured by substantially all of the Corporation s assets. Those obligations are guaranteed by many of the Corporation s wholly-owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of the Corporation s direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries.

Covenants

The Credit Agreement requires the Corporation to satisfy an interest coverage ratio and a leverage ratio. The interest coverage ratio, which is tested as of the last day of any fiscal quarter on a trailing four quarter basis, can be no less than: 3.00:1.00. The leverage ratio, which also is tested quarterly, cannot exceed 4.00:1.00 from the end of the first full fiscal quarter ending after the effective date, through the quarter ending

December 31, 2012; cannot exceed 3.75:1.00 for each of the four quarters in the year ending December 31, 2013; and cannot exceed 3.50:1.00 for all remaining quarters through the expiration of the Credit Agreement. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance proceeds) are restricted in any fiscal year to 3.0% of revenues.

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

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

	Interest Coverage Ratio	Leverage Ratio	Capital Expenditures
Requirement	> = 3.00 to 1.00	< = 4.00 to 1.00	< = 3.00 %
June 30, 2012	10.45	2.01	**

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

Deferred Financing Fees

The Corporation capitalized a total of $9.8 million in deferred financing fees associated with the Credit Agreement and recorded them as other assets in the accompanying condensed consolidated balance sheets. As of June 30, 2012, the Corporation had $8.8 million of unamortized deferred financing fees.

NOTE 6 COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

On September 9, 2011, the Louisiana Municipal Police Employees Retirement System (LMPERS) filed a lawsuit in the Court of Chancery of the State of Delaware, purportedly on behalf of a class of the Corporation s stockholders, against the Corporation and the members of the Corporation s Board of Directors, styled Louisiana Municipal Police Employees Retirement System v. Frank Collins, et al., Civil Action No. 6851-CS. In the action, LMPERS alleged that the members of the Board of Directors breached their fiduciary duties to the Corporation and its stockholders by, among other things, adopting the Rights Agreement and failing to respond appropriately to the tender offer. LMPERS sought declaratory and injunctive relief, including an order certifying the case as a class action and an order enjoining application of the Rights Agreement and Section 203 of the DGCL to the tender offer and proposed merger.

On September 22, 2011, Hugh F. Drummond as Trustee of the FBO Hugh F. Drummond Trust (Drummond) filed a lawsuit in the Court of Chancery of the State of Delaware, purportedly on behalf of a class of the Corporation s stockholders, against the Corporation and the members of the Corporation s Board of Directors, styled Hugh F. Drummond as Trustee of the FBO Hugh F. Drummond Trust v. PharMerica Corp., et al., Civil Action No. 6882. In the action, Drummond alleged that the members of the Board of Directors breached their fiduciary duties to the Corporation and the Corporation s stockholders by, among other things, adopting the Rights Agreement and failing to respond appropriately to the tender offer. Drummond sought declaratory and injunctive relief, including an order certifying the case as a class action and an order enjoining the directors and the Corporation from excluding strategic bidders, including Omnicare, imposing unreasonable preconditions on such strategic bidders, refusing to provide due diligence to strategic bidders, and conducting a limited sale process not designed to produce the best transaction for PharMerica s stockholders.

On October 3, 2011, the Court of Chancery of the State of Delaware entered an order consolidating the LMPERS and Drummond actions under the caption *In re PharMerica Corporation Shareholders Litigation*, Consolidated Civil Action No. 6851-CS. Plaintiffs in the consolidated action designated the complaint filed in the *Drummond* action as operative. On May 15, 2012, the case was dismissed.

The Corporation is responding to an investigation by the U.S. Attorney for the Eastern District of Wisconsin and by the Drug Enforcement Agency into the Corporation s alleged failure to comply with various laws and regulations relating to the control and dispensing of certain controlled substances as well as the potential filing of false claims for payments of certain controlled substances that the Corporation dispensed to nursing home residents. The Corporation has been informed that the government believes that the claims at issue were not eligible for payment due to the alleged non-compliance with various Medicare, Medicaid and other laws and regulations relating to the dispensing, control, sale, billing and reimbursement for such controlled substances. The Corporation denies the allegations made by the government and will defend itself in the event any actions are brought by the government. At this time, we are unable to estimate the outcome of the investigation. If the government brings claims and the Corporation is not successful in defending them, it could result in fines and recoupment of government claims.

In addition, the Corporation is involved in certain legal actions and regulatory investigations arising in the ordinary course of business. At this time, the Corporation is unable to determine the impact of these investigations on its consolidated financial position, results of operations, or liquidity.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)