LANNETT CO INC
Form 10-Q
May 09, 2014
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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, 2014

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, Pennsylvania 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 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 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 x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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 April 30, 2014**
Common stock, par value $0.001 per share	35,570,221

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

(In thousands, except share and per share data)

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

(In thousands)

	Three months ended March 31,		Nine months ended March 31,	
	2014	**2013**	**2014**	**2013**
Net Income	$ 23,006	$ 3,963	$ 33,611	$ 9,765
Other comprehensive income, before taxes:				
Foreign currency translation loss	(11)	(53)	(2)	(16)
Total other comprehensive loss, before taxes	(11)	(53)	(2)	(16)
Income tax related to items of other comprehensive income				
Total other comprehensive loss, net of taxes	(11)	(53)	(2)	(16)
Comprehensive income	22,995	3,910	33,609	9,749
Less: Total comprehensive income attributable to noncontrolling interest	11	16	45	11
Comprehensive income attributable to Lannett Company Inc.	$ 22,984	$ 3,894	$ 33,564	$ 9,738

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(UNAUDITED)

(In thousands)

	Stockholders Equity Attributable to Lannett Company Inc.							
	Common Stock		Additional		Accumulated Other		Stockholders Equity		Total
	Shares Issued	Amount	Paid-In Capital	Retained Earnings	Comprehensive Loss	Treasury Stock	Attributable to Lannett Co., Inc.	Noncontrolling Interest	Stockholders Equity
Balance, July 1, 2013	29,285	$ 29	$ 104,075	$ 26,553	$ (47)	$ (2,034)	$ 128,576	$ 233	$ 128,809
Shares issued in connection with share-based compensation plans	795	1	4,670				4,671		4,671
Share-based compensation			5,833				5,833		5,833
Shares issued in connection with the JSP contract renewal	1,500	2	20,098				20,100		20,100
Shares issued in connection with stock offering	4,250	4	71,474				71,478		71,478
Tax benefits on stock options exercised			5,234				5,234		5,234
Purchase of treasury stock						(695)	(695)		(695)
Other comprehensive loss, net of income tax					(2)		(2)		(2)
Net income				33,566			33,566	45	33,611
Balance, March 31, 2014	**35,830**	**$ 36**	**$ 211,384**	**$ 60,119**	**$ (49)**	**$ (2,729)**	**$ 268,761**	**$ 278**	**$ 269,039**

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(In thousands)

	Nine Months Ended March 31,	
	2014	**2013**
OPERATING ACTIVITIES:		
Net income	**$ 33,611**	$ 9,765
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**4,775**	4,622
Deferred income tax expense (benefit)	**(7,240)**	625
Share-based compensation	**5,833**	1,192
Tax benefits on stock options exercised	**(5,234)**	
Loss (gain) on sale of assets	**55**	(51)
Gain on investment securities	**(1,765)**	(843)
JSP contract renewal cost	**20,100**	
Other noncash expenses	**175**	12
Changes in assets and liabilities which provided (used) cash:		
Accounts receivable, net	**(32,823)**	920
Inventories	**(8,834)**	(5,783)
Prepaid income taxes/income taxes payable	**2,489**	1,907
Prepaid expenses and other assets	**(210)**	(395)
Accounts payable	**(1,398)**	(2,280)
Accrued expenses	**6,063**	1,528
Accrued payroll and payroll related	**172**	2,149
Net cash provided by operating activities	**15,769**	13,368
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	**(20,194)**	(5,889)
Proceeds from sale of property, plant and equipment	**48**	279
Proceeds from sale of investment securities	**20,640**	17,646
Purchase of investment securities	**(49,778)**	(16,041)
Net cash used in investing activities	**(49,284)**	(4,005)
FINANCING ACTIVITIES:		
Repayments of debt	**(5,345)**	(379)
Proceeds from issuance of stock in connection with share-based compensation plans	**4,671**	1,995
Tax benefits on stock options exercised	**5,234**	
Proceeds from stock offering	**71,478**	
Deferred financing fees	**(402)**	
Purchase of treasury stock	**(695)**	(440)
Distribution to noncontrolling interest		(19)
Net cash provided by financing activities	**74,941**	1,157
Effect on cash and cash equivalents of changes in foreign exchange rates	**(2)**	(16)
NET INCREASE IN CASH AND CASH EQUIVALENTS	**41,424**	10,504
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	**42,689**	22,562
CASH AND CASH EQUIVALENTS, END OF PERIOD	**$ 84,113**	$ 33,066
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid	**$ 117**	$ 194
Income taxes paid	**$ 23,589**	$ 2,821

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

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LANNETT COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with United States generally accepted accounting principles (U.S. GAAP) 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, 2014 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2014. 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 Consolidated Financial Statements, including the Notes to the Consolidated Financial Statements, included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2013.

Note 2. The Business And Nature of Operations

Lannett Company, Inc. (a Delaware corporation) and subsidiaries (the Company or Lannett) develop, manufacture, package, market, and distribute solid oral (tablets and capsules), extended release, topical, and oral solution finished dosage forms of drugs, that address a wide range of therapeutic areas. The Company also manufactures active pharmaceutical ingredients through its Cody Laboratories, Inc. (Cody Labs) subsidiary, providing a vertical integration benefit.

The Company operates pharmaceutical manufacturing plants in Philadelphia, Pennsylvania and Cody, Wyoming. Customers of the Company s pharmaceutical products include generic pharmaceutical distributors, drug wholesalers, chain drug stores, private label distributors, mail-order pharmacies, other pharmaceutical manufacturers, managed care organizations, hospital buying groups, governmental entities and health maintenance organizations.

Note 3. Summary of Significant Accounting Policies

Principles of consolidation

The Consolidated Financial Statements include the accounts of Lannett Company, Inc., and its wholly owned subsidiaries, as well as Cody LCI Realty, LLC (Realty), a variable interest entity (VIE) in which the Company has a 50% ownership interest. See Note 12 Consolidation of Variable Interest Entity for more information. Noncontrolling interest in Realty is recorded net of tax as net income attributable to the noncontrolling interest. Additionally, all intercompany accounts and transactions have been eliminated.

Reclassifications

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

Use of estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions are required in the determination of revenue recognition and sales deductions for estimated chargebacks, rebates, returns and other adjustments including a provision for the Company s liability under the Medicare Part D program. Additionally, significant estimates and assumptions are required when determining the fair value of long-lived and indefinite-lived assets, income taxes, contingencies, and share-based compensation. Because of the inherent subjectivity and complexity involved in these estimates and assumptions, actual results could differ from those estimates.

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Foreign currency translation

The Consolidated Financial Statements are presented in U.S. Dollars, the reporting currency of the Company. The financial statements of the Company s foreign subsidiary are maintained in local currency and translated into U.S. dollars at the end of each reporting period. Assets and liabilities are translated at period-end exchange rates, while revenues and expenses are translated at average exchange rates during the period. The adjustments resulting from the use of differing exchange rates are recorded as part of stockholders equity in accumulated comprehensive income (loss). Gains and losses resulting from transactions denominated in foreign currencies are recognized in the Consolidated Statements of Operations under Other income (expense).

Cash and cash equivalents

The Company considers all highly liquid investments with original maturities less than or equal to three months at the date of purchase to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximates fair value, and consist of bank deposits and certificates of deposit that are readily convertible into cash. The Company maintains its cash deposits and cash equivalents at well-known, stable financial institutions. Such amounts frequently exceed insured limits.

Investment securities

The Company s investment securities consist of publicly traded equity securities and certificates of deposit with original maturities greater than three months which are classified as trading investments. Investment securities are recorded at fair value based on quoted market prices from broker or dealer quotations or transparent pricing sources at each reporting date. Gains and losses are included in the Consolidated Statements of Operations under Other income (expense).

Allowance for doubtful accounts

The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses. The Company determines its allowance for doubtful accounts by considering a number of factors, including the length of time balances are past due, the Company s previous loss history, the customer s current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they are determined to be uncollectible.

Inventories

Inventories are stated at the lower of cost or market determined by the first-in, first-out method. Inventories are regularly reviewed and provisions for excess and obsolete inventory are recorded based primarily on current inventory levels and estimated sales forecasts. During the

three months ended March 31, 2014 and 2013, the Company recorded provisions for excess and obsolete inventory of $811 thousand and $333 thousand, respectively. During the nine months ended March 31, 2014 and 2013, the Company recorded provisions for excess and obsolete inventory of $1.9 million and $853 thousand, respectively.

Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is computed on a straight-line basis over the assets estimated useful lives. Depreciation expense for each of the three months ended March 31, 2014 and 2013 was $1.2 million and $1.1 million, respectively. Depreciation expense for each of the nine months ended March 31, 2014 and 2013 was $3.4 million and $3.2 million, respectively.

Intangible Assets

Intangible assets are stated at cost less accumulated amortization. Amortization is computed on a straight-line basis over the assets estimated useful lives, generally for periods ranging from 10 to 15 years. The Company continually evaluates the reasonableness of the useful lives of these assets. Indefinite-lived and definite-lived intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Costs to renew or extend the term of a recognized intangible asset are expensed as incurred. The Company has one indefinite-lived intangible asset related to a product Abbreviated New Drug Application (ANDA), valued at $149 thousand. Amortization on this indefinite-lived intangible will begin at such time as the Company begins shipping the product and determines a finite useful life.

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Segment Information

The Company operates one reportable segment, generic pharmaceuticals. As such, the Company aggregates its financial information for all products. The following table identifies the Company s net sales by medical indication for the three and nine months ended March 31, 2014 and 2013:

(In thousands)	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
Medical Indication	**2014**	**2013**	**2014**	**2013**
Antibiotic	$ 3,361	$ 3,496	$ 11,069	$ 6,267
Cardiovascular	21,331	6,988	42,779	21,356
Gallstone	988	1,390	3,490	4,676
Glaucoma	4,538	1,627	7,474	4,608
Gout	3,383	1,776	7,445	2,907
Migraine	4,787	1,299	9,851	3,995
Obesity	915	1,074	2,890	3,488
Pain Management	8,407	4,980	20,418	14,752
Thyroid Deficiency	28,292	14,024	74,560	42,135
Other	3,995	2,368	13,176	6,696
Total	$ 79,997	$ 39,022	$ 193,152	$ 110,880

Customer, Supplier and Product Concentration

The following table presents the percentage of total net sales, for the three and nine months ended March 31, 2014 and 2013, for certain of the Company s products, defined as products containing the same active ingredient or combination of ingredients, which accounted for at least 10% of net sales in any of those periods:

	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
	2014	**2013**	**2014**	**2013**
Product 1	35%	36%	39%	38%
Product 2	24%	6%	19%	8%
Product 3	9%	10%	8%	9%
Product 4	2%	12%	3%	11%

The following table presents the percentage of total net sales, for the three and nine months ended March 31, 2014 and 2013, for certain of the Company s customers which accounted for at least 10% of net sales in any of those periods:

	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
	2014	**2013**	**2014**	**2013**

Customer A	23%	11%	21%	12%
Customer B	14%	16%	15%	16%
Customer C	7%	10%	9%	10%

At March 31, 2014 and June 30, 2013, four customers accounted for 65% and 78% of the Company s net accounts receivable balance, respectively. Credit terms are offered to customers based on evaluations of the customers financial condition and collateral is generally not required.

The Company s primary finished goods inventory supplier is Jerome Stevens Pharmaceuticals, Inc. (JSP), in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for 65% and 61% of the Company s inventory purchases during the three months ended March 31, 2014 and 2013, respectively. Purchases of finished goods inventory from JSP accounted for 67% and 58% of the Company s inventory purchases during the nine months ended March 31, 2014 and 2013, respectively. See Note 21 Material Contracts with Suppliers for more information.

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Revenue Recognition

The Company recognizes revenue when 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. The Company also considers all other relevant criteria specified in Securities and Exchange Commission Staff Accounting Bulletin No. 104, Topic No. 13, Revenue Recognition , in determining when to recognize revenue.

Net Sales Adjustments

When revenue is recognized a simultaneous adjustment to revenue is made for chargebacks, rebates, returns, promotional adjustments, price adjustments known as shelf-stock adjustments and price-protections, and other potential adjustments. These provisions are primarily estimated based on historical experience, future expectations, contractual arrangements with wholesalers and indirect customers, and other factors known to management at the time of accrual. Accruals for provisions are presented in the Consolidated Financial Statements as a reduction to gross sales with the corresponding reserve presented as a reduction of accounts receivable or in accrued expenses, depending on the nature of the reserve. The reserves, presented as a reduction of accounts receivable, totaled $40.6 million and $17.5 million at March 31, 2014 and June 30, 2013, respectively. Accrued expenses at March 31, 2014 and June 30, 2013 included $6.2 million and $1.0 million, respectively, for certain rebate programs, primarily related to Medicare Part D and Medicaid, and certain sales allowances and other adjustments paid to indirect customers.

Cost of Sales

Cost of sales includes all costs related to bringing products to their final selling destination, which includes direct and indirect costs, such as direct material, labor, and overhead expenses. Additionally, cost of sales includes product royalties, depreciation, amortization and costs to renew and extend recognized intangible assets, freight charges and other shipping and handling expenses.

Research and Development

Research and development costs are expensed as incurred, including all production costs until a drug candidate is approved by the FDA. Research and development expenses include costs associated with internal projects as well as costs associated with third-party research and development contracts.

Valuation of Long-Lived Assets

The Company s long-lived assets primarily consist of property, plant and equipment as well as definite-lived intangible assets. Long-lived assets are reviewed for impairment whenever events or changes in circumstances (triggering events) indicate that the carrying amount of the asset may not be recoverable. If a triggering event is determined to have occurred the first step in the impairment test is to compare the asset s carrying value to the future undiscounted cash flows expected to be generated by the asset. If the carrying value exceeds the undiscounted cash flow of the asset then impairment exists. An impairment loss is measured as the excess of the asset s carrying value over its fair value, which in most cases is calculated using a discounted cash flow model. Discounted cash flow models are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates, and the probability of achieving the estimated cash flows.

Contingencies

Loss contingencies, including litigation related contingencies, are included in the Consolidated Statements of Operations when the Company concludes that a loss is both probable and reasonably estimable. Legal fees related to litigation-related matters are expensed as incurred and included in the Consolidated Statements of Operations under the Selling, general and administrative line item.

Advertising Costs

The Company expenses advertising costs when incurred. Historically these costs have not been significant to the financial statements, including all periods presented.

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Share-based Compensation

Share-based compensation costs are recognized over the vesting period, using a straight-line method, based on the fair value of the instrument on the date of grant less an estimate for forfeitures. The Company uses the Black-Scholes valuation model to determine the fair value of stock options and the stock price on the grant date to value restricted stock. The Black-Scholes valuation model includes various assumptions, including the expected volatility, the expected life of the award, dividend yield, and the risk-free interest rate. These assumptions involve inherent uncertainties based on market conditions which are generally outside the Company s control. Changes in these assumptions could have a material impact on share-based compensation costs recognized in the financial statements.

Income Taxes

The Company uses the asset and liability method to account for income taxes as prescribed by Accounting Standards Codification (ASC) 740, 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. Deferred income tax assets and liabilities are adjusted to recognize the effects of changes in tax laws or enacted tax rates in the period during which they are signed into law.

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 Financial Accounting Standards Board (FASB) also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. The factors used to assess the likelihood of realization are the Company s forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Under ASC 740, Income Taxes, a valuation allowance is required when it is more likely than not that all or some portion of the deferred tax assets will not be realized through generating sufficient future taxable income. Failure to achieve forecasted taxable income in applicable tax jurisdictions could affect the ultimate realization of deferred tax assets and could result in an increase in the Company s effective tax rate on future earnings.

Earnings Per Common Share

Basic earnings per common share attributable to Lannett Company, Inc. is computed by dividing net income attributable to Lannett Company, Inc. common stockholders by the weighted average number of shares outstanding during the period. Diluted earnings per common share attributable to Lannett Company, Inc. is computed by dividing net income attributable to Lannett Company, Inc. common stockholders by the weighted average number of shares outstanding during the period including additional shares that would have been outstanding related to potentially dilutive securities. Anti-dilutive securities are excluded from the calculation. These potentially dilutive securities primarily consist of stock options and unvested restricted stock.

Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in equity during a period except those that resulted from investments by or distributions to a company s stockholders. Other comprehensive income or loss refers to revenues, expenses, gains and losses that are included in comprehensive income (loss), but excluded from net income as these amounts are recorded directly as an adjustment to stockholders equity.

Recent Accounting Pronouncements

In February 2013, the FASB issued authoritative guidance which requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. This authoritative guidance is effective for reporting periods beginning after December 15, 2012. The adoption of this guidance by the Company did not have a significant impact on the Company s consolidated financial statements.

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Note 4. Accounts Receivable

Accounts receivable consisted of the following components at March 31, 2014 and June 30, 2013:

(In thousands)	March 31, 2014	June 30, 2013
Gross accounts receivable	$ 99,853	$ 43,923
Less Chargebacks reserve	(19,712)	(7,267)
Less Rebates reserve	(9,720)	(2,513)
Less Returns reserve	(9,223)	(6,689)
Less Other deductions	(1,892)	(1,000)
Less Allowance for doubtful accounts	(70)	(41)
Accounts receivable, net	$ 59,236	$ 26,413

For the three months ended March 31, 2014, the Company recorded a provision for chargebacks, rebates, returns, and other deductions of $33.3 million, $20.5 million, $2.3 million, and $1.1 million, respectively. For the three months ended March 31, 2013, the Company recorded a provision for chargebacks, rebates, returns, and other deductions of $14.8 million, $5.5 million, $907 thousand, and $3.6 million, respectively.

For the nine months ended March 31, 2014, the Company recorded a provision for chargebacks, rebates, returns, and other deductions of $78.5 million, $40.5 million, $5.5 million, and $18.8 million, respectively. For the nine months ended March 31, 2013, the Company recorded a provision for chargebacks, rebates, returns, and other deductions of $51.5 million, $17.6 million, $3.4 million, and $9.3 million, respectively.

Note 5. Inventories

Inventories, net of allowances, at March 31, 2014 and June 30, 2013 consisted of the following:

(In thousands)	March 31, 2014	June 30, 2013
Raw Materials	$ 20,294	$ 14,224
Work-in-process	4,186	3,122
Finished Goods	14,806	13,133
Packaging Supplies	2,079	2,052
Total	$ 41,365	$ 32,531

The reserve for excess and obsolete inventory was $2.1 million and $2.0 million at March 31, 2014 and June 30, 2013, respectively.

Note 6. Property, Plant and Equipment

Property, plant and equipment at March 31, 2014 and June 30, 2013 consisted of the following:

(In thousands)	Useful Lives	March 31, 2014	June 30, 2013
Land		$ 4,641	$ 1,350
Building and improvements	10 - 39 years	39,684	32,992
Machinery and equipment	5 - 10 years	35,660	32,620
Furniture and fixtures	5 - 7 years	1,392	1,290
Construction in progress		9,937	2,892
Property, plant and equipment, at cost		91,314	71,144
Less accumulated depreciation		(34,309)	(31,003)
Property, plant and equipment, net		$ 57,005	$ 40,141

During each of the three and nine months ended March 31, 2014 and 2013 the Company had no impairment charges related to property, plant and equipment. Property, plant and equipment, net included amounts held in foreign countries in the amount of $1.2 million and $1.3 million at March 31, 2014 and June 30, 2013, respectively.

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Note 7. Fair Value Measurements

The Company s financial instruments recorded in the Consolidated Balance Sheets include cash and cash equivalents, accounts receivable, investment securities, accounts payable, accrued expenses, and debt obligations. Included in cash and cash equivalents are certificates of deposit with maturities less than or equal to three months at the date of purchase and money market funds. The carrying value of certain financial instruments, primarily cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses approximate their estimated fair values based upon the short-term nature of their maturity dates. The carrying amount of the Company s debt obligations approximates fair value based on current interest rates available to the Company on similar debt obligations.

The Company follows the authoritative guidance of ASC Topic 820 Fair Value Measurements and Disclosures , which clarifies the definition of fair value, establishes a framework for measuring fair value, and expands disclosure requirements. 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. Observable inputs reflect those inputs which market participants would use in pricing an asset or liability and are derived from independent market data. Unobservable inputs reflect management s own assumptions related to market data and the market data which market participants would use in pricing an asset or liability. Unobservable inputs are developed based on the best information available to management at the measurement date. The hierarchy includes three levels which are described below:

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

Level 2 Directly or indirectly observable inputs, other than quoted 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.

Level 3 Unobservable inputs that are supported by little or no market activity and that are material to the fair value of the asset or liability. 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 are examples of Level 3 assets and liabilities.

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 Company s financial assets and liabilities measured at fair value on a recurring basis at March 31, 2014 and June 30, 2013, were as follows:

	March 31, 2014			
(In thousands)	**Level 1**	**Level 2**	**Level 3**	**Total**

Assets				
Equity securities	$ 13,863	$	$	13,863
Certificates of Deposit	25,500			25,500
Total Investment Securities	$ 39,363	$	$	39,363

	June 30, 2013			
(In thousands)	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets				
Equity securities	$ 8,461	$	$	8,461
Total Investment Securities	$ 8,461	$	$	8,461

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Note 8. Investment Securities

The Company uses the specific identification method to determine the cost of securities sold, which consisted entirely of securities classified as trading.

The Company had a net gain on investment securities of $200 thousand during the three months ended March 31, 2014, which included an unrealized loss related to securities still held at March 31, 2014 of $174 thousand. The Company had a net gain on investment securities of $538 thousand during the three months ended March 31, 2013, which included an unrealized gain related to securities still held at March 31, 2013 of $186 thousand.

The Company had a net gain on investment securities of $1.8 million during the nine months ended March 31, 2014, which included an unrealized gain related to securities still held at March 31, 2014 of $740 thousand. The Company had a net gain on investment securities of $843 thousand during the nine months ended March 31, 2013, which included an unrealized gain related to securities still held at March 31, 2013 of $190 thousand.

Note 9. Intangible Assets

Intangible assets, net as of March 31, 2014 and June 30, 2013, consisted of the following:

	Gross Carrying Amount		Accumulated Amortization		Intangible Assets, Net	
(In thousands)	March 31, 2014	June 30, 2013	March 31, 2014	June 30, 2013	March 31, 2014	June 30, 2013
JSP Marketing and Dist. Rights	$ 16,062	$ 16,062	$ (16,062)	$ (14,723)	$	$ 1,339
Cody Labs Import License	582	582	(221)	(193)	361	389
Morphine Sulfate Oral Solution NDA	202	398	(63)	(51)	139	347
Other ANDA Product Rights (A)	600	600	(152)	(128)	448	472
	$ 17,446	$ 17,642	$ (16,498)	$ (15,095)	$ 948	$ 2,547

(A) Amounts include the product line covered by the ANDA purchased in August 2009 for $149 thousand. This ANDA is not being amortized at this time and will not be amortized until such time as the Company begins shipping the product.

For the three months ended March 31, 2014 and 2013, the Company incurred amortization expense of $467 thousand and $471 thousand, respectively. For the nine months ended March 31, 2014 and 2013, the Company incurred amortization expense of $1.4 million. There were no impairments related to intangible assets during each of the three and nine months ended March 31, 2014 and 2013.

On September 30, 2013, the Company received a letter from the FDA indicating that a portion of the nonrefundable Morphine Sulfate Oral Solution NDA fee, originally estimated at $398 thousand, would be refunded to the Company. As a result of this letter, the Company adjusted the carrying value of the Morphine Sulfate Oral Solution NDA intangible asset. Further adjustments to the Morphine Sulfate Oral Solution NDA intangible asset may be necessary in the future should the Company receive additional refunds.

Future annual amortization expense consisted of the following as of March 31, 2014:

(In thousands)		
Fiscal Year Ending June 30,	**Annual Amortization Expense**	
2014	$	21
2015		82
2016		82
2017		82
2018		82
Thereafter		450
	$	799

The amounts above do not include the product line covered by the ANDA purchased in August 2009 for $149 thousand, as amortization will begin when the Company begins shipping the product.

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Note 10. Bank Line of Credit

In December 2013, the Company entered into a credit agreement (the Citibank Line of Credit) with Citibank, N.A., as administrative agent, and another financial institution. The Citibank Line of Credit provides for a revolving loan commitment in the amount of up to $50.0 million. Any loans under the Citibank Line of Credit will bear interest at either a Eurodollar Rate or a Base Rate plus a specified margin. The Company is also required to pay a commitment fee on any undrawn commitments under the Citibank Line of Credit ranging from 0.2% - 0.3% per annum according to the average daily balance of borrowings under the agreement. The Citibank Line of Credit is collateralized by substantially all of the Company s assets. In connection with securing the Citibank Line of Credit, the Company repaid substantially all of its outstanding debt. See Note 11 Long-Term Debt for more information. As of March 31, 2014, the Company had $50.0 million available under the Citibank Line of Credit.

The Citibank Line of Credit contains representations and warranties, affirmative, negative and financial covenants, and events of default, applicable to the Company and its subsidiaries which are customary for credit facilities of this type. As of March 31, 2014 the Company was in compliance with all financial covenants.

Note 11. Long-Term Debt

Long-term debt consisted of the following:

(In thousands)	March 31, 2014	June 30, 2013
Pennsylvania Industrial Development Authority loan	$	$ 696
Tax-exempt bond loan (PAID)		150
Wells Fargo N.A. Townsend Road mortgage		2,614
Pennsylvania Industrial Development Authority Townsend Road mortgage		1,794
First National Bank of Cody mortgage	1,169	1,260
Total debt	1,169	6,514
Less current portion	128	670
Long term debt	$ 1,041	$ 5,844

Current Portion of Long Term Debt:

(In thousands)	March 31, 2014	June 30, 2013
Pennsylvania Industrial Development Authority loan	$	$ 84
Tax-exempt bond loan (PAID)		150
Wells Fargo N.A. Townsend Road mortgage		204
Pennsylvania Industrial Development Authority Townsend Road mortgage		109
First National Bank of Cody mortgage	128	123
Total current portion of long term debt	$ 128	$ 670

The Company financed $1.3 million 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 2.75% per annum. In December 2013 the Company repaid, in full, the PIDA loan.

In April 1999, the Company entered into a loan 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 $3.7 million 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 $170 thousand. In February 2014, the Company repaid, in full, the PAID bond. The Trust Indenture required that the Company repay the Authority loan through installment payments beginning in May 2003 and continuing through May 2014, the year the bonds matured. The bonds interest rate had been a floating variable rate determined by the organization responsible for selling the bonds. The interest rate fluctuated on a weekly basis. The effective interest rate at June 30, 2013 was 0.26%.

The Company negotiated a set of mortgages on its Townsend Road facility with both Wells Fargo and the PIDA. In December 2013 the Company repaid, in full, both mortgages associated with its Townsend Road facility. The Wells Fargo portion of the loan was originally for $3.1 million, had a floating interest rate of the one month LIBOR rate plus 2.95%, was amortized over a 15 year term and had an 8 year maturity date. The effective interest rate at June 30, 2013 was 3.14%. The PIDA portion of the loan was originally for $2.0 million, had an interest rate of 3.75% and matured in 15 years. As of June 30, 2013, the Company was in compliance with the financial covenants under the agreements. The Company had also previously executed Security Agreements with Wells Fargo, PIDA

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and Philadelphia Industrial Development Corporation (PIDC) in which the Company had agreed to pledge its working capital, some equipment and its Townsend Road property to collateralize the amounts due. These Security Agreements were terminated in December 2013 as a result of the Company s repayment of both mortgages associated with the Townsend Road facility.

The Company is the primary beneficiary to a VIE called Realty. See Note 12 Consolidation of Variable Interest Entity for additional description. The VIE owns land and a building which is leased to Cody Labs. 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. The mortgage requires monthly principal and interest payments of $15 thousand. Effective February 2011, the interest rate was modified from a fixed rate of 7.5% to a floating rate based on the New York Prime Rate with a floor of 4.5% and a ceiling of 9.0%, with payments to be made through April 2022. As of March 31, 2014 and June 30, 2013, the effective interest rate was 4.5%. The mortgage is collateralized by the land and building.

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

(In thousands)		Amounts Payable to Institutions
2014	$	128
2015		133
2016		139
2017		146
2018		153
Thereafter		470
Total	$	1,169

Note 12. Consolidation of Variable Interest Entity

The Company consolidates any VIE for which it is the primary beneficiary. The liabilities recognized as a result of consolidating a VIE do not represent additional claims on the Company s 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 each of the March 31, 2014 and June 30, 2013 Consolidated Balance Sheets are consolidated VIE assets of $1.7 million, which are comprised mainly of land and a building. VIE liabilities consist primarily of a mortgage on that property in the amount of $1.2 million and $1.3 million at March 31, 2014 and June 30, 2013, respectively. Cody Labs leases the building and property from Realty for $20 thousand per month. All intercompany rent expense is eliminated in the Consolidated Financial Statements.

Realty is the only VIE that is consolidated. Realty is a 50/50 joint venture with a former officer of Cody Labs. Its purpose was to acquire the facility used by Cody Labs. Until the acquisition of Cody Labs in April 2007, the Company had not consolidated the VIE because Cody Labs had been the primary beneficiary of the VIE. Risk associated with our interest 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 the Company s 50% ownership share.

Note 13. Contingencies

On April 16, 2013, Richard Asherman (Asherman), the former President of and a member in Realty, filed a complaint (Complaint) in Wyoming state court against the Company and Cody Labs. At the same time, he also filed an application for a temporary restraining order to enjoin certain operations at Cody Labs, claiming, among other things, that Cody Labs is in violation of certain zoning laws and that Cody Labs is required to increase the level of its property insurance and to secure performance bonds for work being performed at Cody Labs. Mr. Asherman claims Cody Labs is in breach of his employment agreement and is required to pay him severance under his employment agreement, including 18 months of base salary, vesting of unvested stock options and continuation of benefits. The Company estimates that the aggregate value of the claimed severance benefits is approximately $350 thousand to $400 thousand, plus the value of any stock options. Mr. Asherman also asserts that the Company is in breach of the Realty Operating Agreement and, among other requested remedies, he seeks to have the Company (i) pay him 50% of the value of 1.66 acres of land that Realty previously agreed to donate to an economic development entity associated with the City of Cody, Wyoming, which contemplated transaction has since been avoided and cancelled and (ii) acquire Mr. Asherman s interest in Realty for an unspecified price. Alternatively, Mr. Asherman seeks to dissolve Realty. The Company and Cody Labs opposed the application for a temporary restraining order and, following a hearing on April 18, 2013, the Court denied the relief to Mr. Asherman.

On August 2, 2013, Asherman filed his First Amended Complaint, naming as Defendants Arthur P. Bedrosian, the President and Chief Executive Officer of the Company (Bedrosian), the Company, Cody Labs and Realty. The Amended Complaint is substantially

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similar to the Complaint respecting the relief sought and adds Bedrosian as a defendant, claiming that Bedrosian defamed Asherman in a Form 10-Q filed by the Company, by reporting that he had been fired for cause .

On August 30, 2013, Lannett and Cody Labs jointly moved to dismiss the Amended Complaint. Bedrosian and Realty have filed separate motions to dismiss. On March 14, 2014, the Wyoming court dismissed Realty from the case. The motions to dismiss filed by Lannett, Cody Labs and Bedrosian are pending. The Company strongly disputes the claims in the Amended Complaint, including that the Company is required to acquire Mr. Asherman s interest in Realty. Specifically, the Company asserts that it is and has always been in compliance with local zoning laws, which permit the operation of a pharmaceutical facility, and that Mr. Asherman, in fact, previously represented this to both the Company and the EPA. It also asserts that the City of Cody has never taken the position or advised Cody Labs that the Cody Labs facility was operating in violation of the local zoning laws. The Company also asserts that Cody Labs has in place a sufficient level of property insurance coverage. Cody Labs also strongly disputes the claims in the Complaint, including that it is required to pay Mr. Asherman severance, as Cody Labs advised Mr. Asherman that he was being terminated for cause following the issuance of a letter of reprimand. If Mr. Asherman were successful on his claim for breach of his employment agreement, he would be entitled to his contractual severance 18 months salary plus the vesting of certain stock options and continuation of benefits. The amount the Company would be required to pay to Mr. Asherman if he were successful in compelling the buyout of his interest in Realty is dependent upon the value of the real property owned by Realty. If a buyout were required, Realty would become wholly owned by the Company. At this time the Company is unable to reasonably estimate a range or aggregate dollar amount of Mr. Asherman s claims or of any potential loss, if any, to the Company.The Company does not believe that the ultimate resolution of the matter will have a significant impact on the Company s financial position or results of operations.

Note 14. Commitments

Leases

The Company s subsidiary, Cody Labs, leases a 73,000 square foot facility in Cody, Wyoming. This location houses Cody Lab s manufacturing and production facilities. Cody Labs leases the facility from Realty, a Wyoming limited liability company which is 50% owned by the Company. See Note 12 Consolidation of Variable Interest Entity.

Rental and lease expense for the three months ended March 31, 2014 and 2013 was $60 thousand and $24 thousand, respectively. Rental and lease expense for the nine months ended March 31, 2014 and 2013 was $111 thousand and $75 thousand, respectively.

Note 15. Accumulated Other Comprehensive Loss

The Company s Accumulated Other Comprehensive Loss was comprised of the following components as of March 31, 2014 and 2013:

(In thousands)	**March 31, 2014**	**March 31, 2013**

Foreign Currency Translation				
Beginning Balance, July 1	$	(47)	$	(63)
Net loss on foreign currency translation (net of tax of $0 and $0)		(2)		(16)
Reclassifications to net income (net of tax of $0 and $0)				
Other comprehensive loss, net of tax		(2)		(16)
Ending Balance, March 31		(49)		(79)
Total Accumulated Other Comprehensive Loss	$	(49)	$	(79)

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Note 16. Earnings Per Common Share

A dual presentation of basic and diluted earnings per common share is required on the face of the Company s Consolidated Statement of Operations as well as a reconciliation of the computation of basic earnings per common share to diluted earnings per common share. Basic earnings per common share excludes the dilutive impact of potentially dilutive securities and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per common share includes the effect of potential dilution from the exercise of outstanding stock options and treats unvested restricted stock as if it were vested. Potentially dilutive securities have been excluded in the weighted average number of common 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 earnings per common share was as follows:

	Three Months Ended March 31, 2014	
(In thousands, except share and per share data)	**2014**	**2013**
Net Income Attributable to Lannett Company, Inc.	$ 22,995	$ 3,947
Basic weighted average common shares outstanding	35,025,968	28,490,175
Effect of potentially dilutive options and restricted stock awards	1,743,625	625,766
Diluted weighted average common shares outstanding	36,769,593	29,115,941
Earnings per common share attributable to Lannett Company, Inc.:		
Basic	$ 0.66	$ 0.14
Diluted	$ 0.63	$ 0.14

	Nine Months Ended March 31, 2014	
(In thousands, except share and per share data)	**2014**	**2013**
Net Income Attributable to Lannett Company, Inc.	$ 33,566	$ 9,754
Basic weighted average common shares outstanding	33,082,460	28,371,189
Effect of potentially dilutive options and restricted stock awards	1,503,547	273,642
Diluted weighted average common shares outstanding	34,586,007	28,644,831
Earnings per common share attributable to Lannett Company, Inc.:		
Basic	$ 1.01	$ 0.34
Diluted	$ 0.97	$ 0.34

The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the three months ended March 31, 2014 and 2013 were 3 thousand and 265 thousand, respectively. The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the nine months ended March 31, 2014 and 2013 were 9 thousand and 1.5 million, respectively.

Note 17. Share-based Compensation

At March 31, 2014, the Company had four share-based employee compensation plans (the 2003 Plan, the 2006 Long-term Incentive Plan (LTIP), or 2006 LTIP , the 2011 LTIP and the 2014 LTIP). In January 2014, the stockholders of the Company approved the 2014 LTIP, which authorized 3.0 million new shares of common stock for future issuances under this plan. No awards have been granted from the 2014 LTIP plan as of March 31, 2014.

At March 31, 2014, there were 2.3 million options outstanding. Of those, 834 thousand were options issued under the 2006 LTIP, 276 thousand were issued under the 2003 Plan, and 1.2 million were issued under the 2011 Plan. Under the 2003 Plan, 1.1 million shares were authorized to be issued, with 450 thousand shares under options having already been exercised under that plan since its inception. The 2003 Plan expired on February 13, 2013 and continues to exist only to administer outstanding options. Under the 2006 LTIP, 2.5 million shares were authorized to be issued, with 937 thousand shares under options having already been exercised and 719 thousand shares of restricted stock having already vested under the plan since its inception. At March 31, 2014, a balance of 10 thousand shares was still available under the 2006 LTIP for future issuances. Under the 2011 LTIP, 1.5 million shares were authorized to be issued. As of March 31, 2014, 182 thousand shares of unvested restricted stock were outstanding and an additional

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54 thousand shares of restricted stock have vested under the plan. Additionally 50 thousand shares under options were exercised, leaving a balance of 59 thousand shares available in the 2011 LTIP for future issuances at March 31, 2014.

The Company issues share-based compensation awards with a vesting period ranging up to 3 years and a maximum contractual term of 10 years. The Company issues new shares of stock when stock options are exercised. As of March 31, 2014, there was $6.9 million of total unrecognized compensation cost related to non-vested share-based compensation awards granted under the Plans. That cost is expected to be recognized over a weighted average period of 1.8 years.

Stock Options

The Company measures 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 during the nine months ended March 31 and the estimated annual forfeiture rates used to recognize the associated compensation expense:

	Stock Options FY 2014	**Stock Options FY 2013**
Risk-free interest rate	2.1%	1.0%
Expected volatility	62.9%	61.5%
Expected dividend yield	0.0%	0.0%
Forfeiture rate	7.5%	7.5%
Expected term (in years)	5.9 years	6.1 years
Weighted average fair value	$8.14	$2.36

Expected volatility is based on the historical volatility of the price of our common shares during the historical period equal to the expected term of the option. The Company uses historical information to estimate the expected term, which represents the period of time that options granted are expected to be outstanding. The risk-free rate for the period equal to the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. 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. Additionally, the expected dividend yield is equal to zero, as the Company has not historically issued, and has no immediate plans to issue, a dividend.

A summary of stock option award activity under the Plans as of March 31, 2014 and changes during the nine months then ended, is presented below:

(In thousands, except for weighted average price and life data)	**Awards**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**	**Weighted Average Remaining Contractual Life (yrs.)**
Outstanding at July 1, 2013	2,319	$ 5.71		

Granted	770	$	13.97				
Exercised	(718)	$	6.15	$	22,373		
Forfeited, expired or repurchased	(105)	$	16.27				
Outstanding at March 31, 2014	2,266	$	7.89	$	63,070	7.5	
Vested and expected to vest at March 31, 2014	2,152	$	7.73	$	60,234	7.4	
Exercisable at March 31, 2014	902	$	5.27	$	27,464	5.5	

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Restricted Stock

The Company measures restricted stock compensation costs based on the stock price at the grant date less an estimate for forfeitures. The annual forfeiture rate used to calculate compensation expense was 7.5% for the nine months ended March 31, 2014 and 2013.

A summary of non-vested restricted stock awards as of March 31, 2014 and changes during the nine months then ended, is presented below:

(In thousands)	Awards	Weighted Average Grant - date Fair Value	Aggregate Intrinsic Value
Non-vested at July 1, 2013			
Granted	245	23.03	
Vested	(63)	18.79	$ 1,175
Forfeited			
Non-vested at March 31, 2014	182	$ 24.48	

Employee Stock Purchase Plan

In February 2003, the Company s stockholders 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 1.1 million shares of the Company s common stock for issuance under the ESPP. During the nine months ended March 31, 2014 and 2013, 14 thousand shares and 62 thousand shares were issued under the ESPP, respectively. As of March 31, 2014, 423 thousand total shares have been issued under the ESPP.

The following table presents the allocation of share-based compensation costs recognized in the Consolidated Statements of Operations by financial statement line item for the three and nine months ended March 31, 2014 and 2013:

	Three Months Ended March 31,		Nine Months Ended March 31,	
(In thousands)	2014	2013	2014	2013
Selling, general and administrative	$ 2,240	$ 200	$ 4,763	$ 975
Research and development	225	23	443	75
Cost of sales	324	29	627	142
Total	2,789	252	5,833	1,192
Tax benefit at statutory rate	$ 1,053	$ 42	$ 2,160	$ 99

Note 18. Employee Benefit Plan

The Company has a 401k defined contribution 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, not to exceed 4% of the employee s compensation for the Plan year. Contributions to the Plan during the three months ended March 31, 2014 and 2013 were $169 thousand and $141 thousand, respectively. Contributions to the Plan during the nine months ended March 31, 2014 and 2013 were $528 thousand and $438 thousand, respectively.

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Note 19. 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 federal, state and local income tax provision for the three months ended March 31, 2014 and 2013 was $13.3 million and $1.3 million, respectively. The effective tax rates for the three months ended March 31, 2014 and 2013 were 37% and 25%, respectively. The federal, state and local income tax provision for the nine months ended March 31, 2014 and 2013 was $18.8 million and $5.4 million, respectively. The effective tax rates were 36% and 35%, respectively. The effective tax rate for the three months ended March 31, 2014 was higher compared to the three months ended March 31, 2013 due primarily to higher benefits related to research and experimentation credits recorded during the third quarter of Fiscal 2013, as a result of a tax law extension passed in early 2013, with a retroactive January 1, 2012 effective date.

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.

As of March 31, 2014 and June 30, 2013, the Company reported total unrecognized tax benefits of $397 thousand and $360 thousand, 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, 2014 in the Consolidated Statements of Operations. Additionally, no cumulative interest and penalties have been recorded in the Company s Consolidated Balance Sheets as of March 31, 2014 and June 30, 2013. 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 2009 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.

Note 20. Related Party Transactions

The Company had sales of $375 thousand and $390 thousand during the three months ended March 31, 2014 and 2013, respectively, to a generic distributor, Auburn Pharmaceutical Company (Auburn). Sales to Auburn for the nine months ended March 31, 2014 and 2013 were $1.4 million and $1.1 million, respectively. Jeffrey Farber, Chairman of the Board and the son of William Farber, Chairman Emeritus of the Board and principal stockholder of the Company, is the owner of Auburn. Accounts receivable includes amounts due from Auburn of $421 thousand and $200 thousand at March 31, 2014 and June 30, 2013, respectively. In the Company s opinion, the terms of these transactions were not more favorable to Auburn than would have been to a non-related party.

Note 21. Material Contracts with Suppliers

Jerome Stevens Pharmaceuticals agreement:

The Company s primary finished goods inventory supplier is JSP, in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for 65% and 61% of the Company s inventory purchases in the three months ended March 31, 2014 and 2013, respectively. Purchases of finished goods inventory from JSP accounted for 67% and 58% of the Company s inventory purchases in the nine months ended March 31, 2014 and 2013, 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 4.0 million 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®. On August 19, 2013, the Company entered into an agreement with JSP to extend its initial contract to continue as the exclusive distributor in the United States of three JSP products: Butalbital, Aspirin, Caffeine with Codeine Phosphate Capsules USP, Digoxin Tablets USP, and Levothyroxine Sodium Tablets USP. The amendment to the original agreement extends the initial contract, which was due to expire on March 22, 2014, for five years. In connection with the amendment, the Company issued 1.5 million shares of the Company s common stock to JSP and JSP s designees. In accordance with its policy related to renewal and extension costs for recognized intangible assets, the Company recorded a $20.1 million expense in cost of sales, which represents the fair value of the shares on August 19, 2013. If the parties agree to a second five year extension from March 23, 2019 to March 23, 2024, the Company is required to issue to JSP or its designees an additional 1.5 million shares of

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the Company s common stock. 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 and related amendment, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP products. The Company has met the minimum purchase requirement for the first ten years of the contract, but there is no guarantee that the Company will be able to continue to do so in Fiscal 2015 and in the future. If the Company does not meet the minimum purchase requirements, JSP s sole remedy is to terminate the agreement.

Note 22. Common Stock Offering

The Company completed an offering of its common stock on October 4, 2013 at an offering price of $18.00 per share. The offering of 4.25 million shares yielded net proceeds of $71.5 million after deducting underwriting, legal and accounting fees totaling $5.0 million.

Note 23. Cody Expansion Project

On December 20, 2012, the Company, through its subsidiaries Realty and Cody, entered into an agreement (the Agreement) with the City of Cody, Wyoming (City of Cody) and Forward Cody Wyoming, Inc. (Forward Cody), an unrelated non-profit corporation, which involves the construction of a building of approximately 24,000 square feet (the Project). As part of the Agreement, Cody was obligated to make an additional capital investment in its existing facilities in the amount of $5.2 million and create an additional 45 full time positions within three years starting June 30, 2011; Realty was required to contribute 1.66 acres of land to Forward Cody and enter into a 25 year lease agreement with Forward Cody for the Project. Realty will make annual rent payments totaling $108 thousand beginning on the date a Certificate of Occupancy permit is issued by the City of Cody and the Project is legally available for occupancy. Cody will sublease the property from Realty. Upon the fifth anniversary of occupancy, Realty has the option to purchase the Project from Forward Cody. The purchase option continues until Realty purchases the Project. Nothing in the Agreement should be deemed to create any relationship between Forward Cody and Realty other than the relationship of landlord and tenant.

As of March 31, 2014, the Company was in the process of renegotiating certain terms of the Agreement, including changing the size of the building and eliminating the requirements to contribute any land and enter into a 25 year lease agreement with Forward Cody. None of the revisions are expected to be material to the Company s results of operations or financial position.

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

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, 2013.

This Report on Form 10-Q and certain information incorporated herein by reference contains 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.

Company Overview

Lannett Company, Inc. (a Delaware corporation) and subsidiaries (the Company or Lannett) develop, manufacture, package, market, and distribute solid oral (tablets and capsules), extended release, topical, and oral solution finished dosage forms of drugs, that address a wide range of therapeutic areas. The Company also manufactures active pharmaceutical ingredients through its Cody Labs subsidiary, providing a vertical integration benefit. Additionally the Company is pursuing partnerships, research contracts and internal expansion for the development and production of other dosage forms including: ophthalmic, nasal, patch, foam, buccal, sublingual, soft gel, injectable, and oral dosages.

The Company operates pharmaceutical manufacturing plants in Philadelphia, Pennsylvania and Cody, Wyoming. Customers of the Company s pharmaceutical products include generic pharmaceutical distributors, drug wholesalers, chain drug stores, private label distributors, mail-order pharmacies, other pharmaceutical manufacturers, managed care organizations, hospital buying groups, governmental entities and health maintenance organizations.

Financial Summary

For the third quarter of Fiscal 2014, net sales increased to $80.0 million representing 105% growth over the prior year period. Gross profit increased $41.0 million to $56.1 million, compared to the prior year period. R&D expenses increased 102% to $10.6 million compared to the prior year period while SG&A expenses increased 82% to $9.6 million. Operating income for the third quarter of Fiscal 2014 was $36.0 million compared to $4.7 million in the prior year period. Net income for the third quarter of Fiscal 2014 was $23.0 million, or $0.63 per diluted share. Comparatively, net income in the prior year period was $3.9 million, or $0.14 per diluted share.

For the first nine months of Fiscal 2014, net sales increased to $193.2 million representing 74% growth over the prior year period. Gross profit increased $56.3 million to $98.5 million, compared to the prior year period, and included the $20.1 million charge related to the JSP contract renewal. The JSP contract renewal charge equated to a 10 percentage-point reduction in gross profit percentage. R&D expenses increased 68% to $21.1 million compared to the prior year period while SG&A expenses increased 61% to $26.6 million. Operating income for the first nine months of Fiscal 2014 was $50.7 million compared to $13.1 million in the prior year period. Net income for the first nine months of Fiscal 2014 was $33.6 million, or $0.97 per diluted share, and included the $20.1 million pre-tax charge ($0.36 per diluted share) related to the JSP contract renewal. Comparatively, net income in the prior year period was $9.8 million, or $0.34 per diluted share.

A more detailed discussion of the Company s financial results can be found below.

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Results of Operations - Three months ended March 31, 2014 compared with the three months ended March 31, 2013

Net sales increased 105% to $80.0 million for the three months ended March 31, 2014. The following table identifies the Company s approximate net product sales by medical indication for the three months ended March 31, 2014 and 2013:

(In thousands)	Three Months Ended March 31,	
Medical Indication	**2014**	**2013**
Antibiotic	$ 3,361	$ 3,496
Cardiovascular	21,331	6,988
Gallstone	988	1,390
Glaucoma	4,538	1,627
Gout	3,383	1,776
Migraine	4,787	1,299
Obesity	915	1,074
Pain Management	8,407	4,980
Thyroid Deficiency	28,292	14,024
Other	3,995	2,368
Total	$ 79,997	$ 39,022

Product price increases contributed $42.5 million to the overall increase in net sales. A decrease in volumes slightly offset the overall increase in net sales by $1.6 million. The Company experienced favorable trends in product pricing on several key products during the period, as discussed below. Although the Company has benefited from these favorable pricing trends, the level of competition in the marketplace is constantly changing and the Company cannot guarantee that these pricing trends will continue.

The following chart details price and volume changes by medical indication:

Medical indication	**Sales volume change %**	**Sales price change %**
Antibiotic	9%	(13)%
Cardiovascular	(34)%	240%
Gallstone	(44)%	15%
Glaucoma	5%	174%
Gout	84%	6%
Migraine	33%	236%
Obesity	(1)%	(14)%
Pain Management	3%	66%
Thyroid Deficiency	(3)%	105%

Thyroid Deficiency. Net sales of drugs used for the treatment of thyroid deficiency increased by $14.3 million, primarily as a result of price increases on key products.

Cardiovascular. Net sales of drugs used for cardiovascular treatment increased by $14.3 million, primarily as a result of price increases on products used to treat congestive heart failure, partially offset by lower volumes. The increase in net sales was also partially offset by a decrease in net sales on products used to treat hypertension due to pricing pressures and lower volumes.

Migraine. Net sales of drugs used to treat migraines increased by $3.5 million. The increase in net sales was primarily attributable to price increases on key products within the indication as well as volume increases.

Pain Management. Net sales of pain management products increased $3.4 million. The increase in net sales was mainly attributable to a price increase on the Company s C-Topical® Solution product. The increase in net sales was partially offset by lower sales volume of the Company s C-Topical® Solution product. The Company had no net sales in either period of its Oxycodone HCl Oral Solution product due to FDA enforcement actions against market participants which caused the Company and others to voluntarily exit the market by October 4, 2012. The Company is awaiting FDA approval for this product and anticipates resuming product sales in the near future.

Glaucoma. Net sales of drugs used for glaucoma treatment increased by $3.0 million. The increase in net sales was primarily attributable to price increases.

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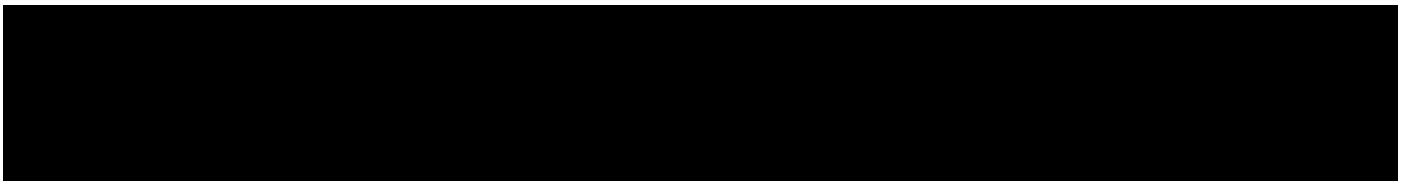
The Company sells its products to customers in various distribution channels. The table below presents the Company s net sales to each distribution channel for the three months ended March 31:



Net sales to wholesaler/distributor increased primarily as a result of increased sales in a variety of products for thyroid deficiency and cardiovascular, as discussed above. Additionally, increased sales to wholesaler/distributor was the result of a strategic partnership between a wholesale and retail chain customer. Retail chain net sales increased primarily as a result of increased sales of drugs for the treatment of thyroid deficiency and cardiovascular, as discussed above. The increase in retail chain net sales was partially offset by lower volumes of products used to treat congestive heart failure as well as offsets due a strategic partnership between a wholesale and retail chain customer.

Cost of Sales. Cost of sales for the third quarter of Fiscal 2014 was flat quarter over quarter at $23.9 million. Amortization expense included in cost of sales totaled $467 thousand for the third quarter of Fiscal 2014 and $471 thousand for the third quarter of Fiscal 2013.

Gross Profit. Gross profit for the third quarter of Fiscal 2014 increased 270% to $56.1 million or 70% of net sales. In comparison, gross profit for the third quarter of Fiscal 2013 was $15.2 million or 39% of net sales. The third quarter Fiscal 2014 gross profit percentage increase was mainly attributable to product price increases and changes in the mix of products sold.

While the Company is continuously striving to keep product costs low, there can be no guarantee that gross profit percentages will stay consistent in future periods. Pricing pressure from competitors and costs of producing or purchasing new drugs may also fluctuate in future periods. Changes in future product sales mix may also occur.

Research and Development. Research and development expenses for the third quarter increased 102% to $10.6 million in Fiscal 2014 from $5.2 million in Fiscal 2013. The increase is primarily due to increased costs for third-party laboratory services totaling $1.7 million and other costs for products in development totaling $3.1 million.

Selling, General and Administrative. Selling, general and administrative expenses increased 82% to $9.6 million in the third quarter of Fiscal 2014 compared with $5.2 million in Fiscal 2013. The increase is primarily due to additional compensation-related costs totaling $1.8 million, expenses related to marketing the Company s C-Topical® Solution product totaling $535 thousand, and other general corporate spending totaling $774 thousand.

The Company is focused on controlling selling, general and administrative costs, however increases in personnel and other costs to facilitate improvements in the Company s infrastructure and expansion may impact selling, general and administrative expenses in future periods.

Other Income (Expense). Interest expense in the third quarter of Fiscal 2014 totaled $13 thousand compared to $59 thousand in Fiscal 2013. Interest and dividend income totaling $109 thousand in the third quarter of Fiscal 2014 was higher compared with $22 thousand in the third quarter of Fiscal 2013. The Company also recorded a net gain on investment securities during the third quarter of Fiscal 2014 totaling $200 thousand compared to a net gain on investment securities totaling $538 thousand in Fiscal 2013.

Income Tax. The Company recorded income tax expense in the third quarter of Fiscal 2014 of $13.3 million compared to $1.3 million in the third quarter of Fiscal 2013. The effective tax rate for the three months ended March 31, 2014 was 37%, compared to 25% for the three months ended March 31, 2013. The effective tax rate for the three months ended March 31, 2014 was higher compared to the three months ended March 31, 2013 due primarily to higher benefits related to research and experimentation credits recorded during the third quarter of Fiscal 2013, as a result of a tax law extension passed in early 2013, with a retroactive January 1, 2012 effective date.

Net Income. For the three months ended March 31, 2014, the Company reported net income attributable to Lannett Company, Inc. of $23.0 million, or $0.63 per diluted share. Comparatively, net income in the prior year was $3.9 million, or $0.14 per diluted share.

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Results of Operations - Nine months ended March 31, 2014 compared with the nine months ended March 31, 2013

Net sales increased 74% to $193.2 million for the nine months ended March 31, 2014. The following table identifies the Company s approximate net product sales by medical indication for the nine months ended March 31, 2014 and 2013:

(In thousands)	Nine Months Ended March 31,	
Medical Indication	**2014**	**2013**
Antibiotic	$ 11,069	$ 6,267
Cardiovascular	42,779	21,356
Gallstone	3,490	4,676
Glaucoma	7,474	4,608
Gout	7,445	2,907
Migraine	9,851	3,995
Obesity	2,890	3,488
Pain Management	20,418	14,752
Thyroid Deficiency	74,560	42,135
Other	13,176	6,696
Total	$ 193,152	$ 110,880

Product price increases contributed $73.3 million to the overall increase in net sales, while increased volumes added $9.0 million. The Company experienced favorable trends in product pricing on several key products during the period, as discussed below. Although the Company has benefited from these favorable pricing trends, the level of competition in the marketplace is constantly changing and the Company cannot guarantee that these pricing trends will continue.

The following chart details price and volume changes by medical indication:

Medical indication	**Sales volume change %**	**Sales price change %**
Antibiotic	79%	(2)%
Cardiovascular	(11)%	111%
Gallstone	(27)%	2%
Glaucoma	12%	50%
Gout	145%	11%
Migraine	59%	88%
Obesity	(8)%	(9)%
Pain Management	(5)%	43%
Thyroid Deficiency	7%	70%

Thyroid Deficiency. Net sales of drugs used for the treatment of thyroid deficiency increased by $32.4 million, primarily as a result of price increases on key products.

Cardiovascular. Net sales of drugs used for cardiovascular treatment increased by $21.4 million, primarily as a result of price increases on products used to treat congestive heart failure, partially offset by lower volumes. The increase in net sales was partially offset by a decrease in net sales on products used to treat hypertension due to pricing pressures and modest volume decreases on several products within the indication.

Migraine. Net sales of drugs used to treat migraines increased by $5.9 million. The increase in net sales was attributable to increased volumes as well as price increases on key products.

Pain Management. Net sales of pain management products increased $5.7 million. The increase in net sales was mainly attributable to a price increase on the Company s C-Topical® Solution product. The increase in net sales was partially offset by lower sales volume of the Company s C-Topical® Solution product. Net sales of the Company s Oxycodone HCl Oral Solution product were lower due to FDA enforcement actions against market participants which caused the Company and others to voluntarily exit the market by October 4, 2012. The Company is awaiting FDA approval for this product and anticipates resuming product sales in the near future.

Antibiotic. Net sales of antibiotics increased by $4.8 million. The increase in net sales was primarily attributable to increased volumes across various products.

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Gout. Net sales of drugs used for gout treatment increased by $4.5 million. The increase in net sales was primarily attributable to increased volumes.

The Company sells its products to customers in various distribution channels. The table below presents the Company s net sales to each distribution channel for the nine months ended March 31:

(In thousands) **Customer Distribution Channel**	**March 31, 2014**	**March 31, 2013**
Wholesaler/Distributor	$ 122,551	$ 60,324
Retail Chain	57,172	38,409
Mail-Order Pharmacy	13,429	12,147
Total	$ 193,152	$ 110,880

Net sales to wholesaler/distributor increased primarily as a result of increased sales in a variety of products for gout, thyroid deficiency and cardiovascular, as discussed above. Retail chain net sales increased primarily as a result of increased sales of drugs for the treatment of thyroid deficiency and cardiovascular, as discussed above.

Cost of Sales. Cost of sales for the first nine months of Fiscal 2014 increased $26.0 million to $94.7 million, which included the $20.1 million charge related to the JSP contract renewal. The remaining increase primarily reflected the impact of the increase in sales volumes. Amortization expense included in cost of sales totaled $1.4 million for the first nine months of Fiscal 2014 and the first nine months of Fiscal 2013.

Gross Profit. Gross profit for the first nine months of Fiscal 2014 increased 133% to $98.5 million or 51% of net sales. In comparison, gross profit for the first nine months of Fiscal 2013 was $42.2 million or 38% of net sales. The gross profit percentage change for the first nine months of Fiscal 2014 was mainly attributable to changes in the mix of products sold and product price increases, as discussed above, offset by the charge related to the JSP contract renewal which negatively impacted gross margin by 10 percentage-points.

While the Company is continuously striving to keep product costs low, there can be no guarantee that gross profit percentages will stay consistent in future periods. Pricing pressure from competitors and costs of producing or purchasing new drugs may also fluctuate in future periods. Changes in future product sales mix may also occur.

Research and Development. Research and development expenses for the first nine months increased 68% to $21.1 million in Fiscal 2014 from $12.6 million in Fiscal 2013. The increase is primarily due to increased costs for third-party laboratory services totaling $3.3 million and other costs for products in development totaling $4.1 million.

Selling, General and Administrative. Selling, general and administrative expenses increased 61% to $26.6 million in the first nine months of Fiscal 2014 compared with $16.6 million in Fiscal 2013. The increase is primarily due to additional compensation-related costs totaling $6.3 million and expenses related to marketing the Company s C-Topical® Solution product totaling $418 thousand. Additional increases were attributable to general corporate spending totaling $1.1 million.

The Company is focused on controlling selling, general and administrative costs, however increases in personnel and other costs to facilitate improvements in the Company s infrastructure and expansion may impact selling, general and administrative expenses in future periods.

Other Income (Expense). During the first nine months of Fiscal 2013, the Company entered into a favorable settlement agreement related to litigation the Company had been involved in since January 2010. As a result of the agreement the Company recorded a nonrecurring gain in the amount of $1.3 million. Interest expense in the first nine months of Fiscal 2014 totaled $117 thousand compared to $194 thousand in Fiscal 2013. Interest and dividend income totaling $204 thousand in the first nine months of Fiscal 2014 was higher compared with $84 thousand in the first nine months of Fiscal 2013. The Company also recorded a net gain on investment securities during the first nine months of Fiscal 2014 totaling $1.8 million compared to a net gain on investment securities totaling $843 thousand in Fiscal 2013.

Income Tax. The Company recorded income tax expense in the first nine months of Fiscal 2014 of $18.8 million compared to $5.4 million in the first nine months of Fiscal 2013. The effective tax rate for the nine months ended March 31, 2014 was 36% compared to 35% for the nine months ended March 31, 2013. Additionally, the Company expects its overall effective tax rate will be 36% to 38% for the full year ended June 30, 2014.

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Net Income. For the nine months ended March 31, 2014, the Company reported net income attributable to Lannett Company, Inc. of $33.6 million, or $0.97 per diluted share. Net income attributable to Lannett Company, Inc. included the charge related to the JSP contract renewal equal to $0.36 per diluted share. Comparatively, net income in the prior year was $9.8 million, or $0.34 per diluted share.

Liquidity and Capital Resources

Cash Flow

The Company has historically financed its operations with cash flow generated from operations supplemented with borrowings from various government agencies and financial institutions. At March 31, 2014, working capital was $199.9 million as compared to $83.0 million at June 30, 2013, an increase of $116.9 million. Current product portfolio sales as well as sales related to future product approvals are anticipated to continue to generate positive cash flow from operations.

Net cash provided by operating activities of $15.8 million for the nine months ended March 31, 2014 reflected net income of $33.6 million, adjustments for non-cash items of $16.7 million, as well as cash used by changes in operating assets and liabilities of $34.5 million. In comparison, net cash provided by operating activities of $13.4 million for the nine months ended March 31, 2013 reflected net income of $9.8 million, adjustments for non-cash items of $5.6 million, as well as cash used by changes in operating assets and liabilities of $2.0 million.

Significant changes in operating assets and liabilities from June 30, 2013 to March 31, 2014 were comprised of:

- An increase in accounts receivable of $32.8 million mainly due to an increase in gross accounts receivable as a result of increased sales, partially offset by increases in total revenue-related reserves. The Company s days sales outstanding (DSO) at March 31, 2014, based on annualized gross sales and gross accounts receivable at March 31, 2014, was 66 days. The level of DSO at March 31, 2014 was comparable to the Company s expectation that DSO will be in the 60 to 70 day range based on 60 day payment terms for most customers.

- A decrease in income taxes payable totaling $154 thousand and an increase in prepaid income taxes totaling $2.6 million, mainly resulting from Fiscal 2014 expected taxable income offset by the timing of estimated tax payments made during Fiscal 2014 and tax benefits from stock options exercised.

- An increase in inventories of $8.8 million primarily due to the timing of customer order fulfillment.

- An increase in accrued expenses of $6.1 million due to an increase in rebates accrued resulting from sales qualifying for existing rebate programs.

Significant changes in operating assets and liabilities from June 30, 2012 to March 31, 2013 were comprised of:

- A decrease in trade accounts receivable of $920 thousand resulting from the timing of receipts related to sales in the fourth quarter of Fiscal 2012 and a decrease in revenue-related reserves due primarily to a decrease in inventory levels at wholesale distribution centers as a result of increased gross sales during Fiscal 2013 as compared to Fiscal 2012. The Company s days sales outstanding (DSO), based on annualized gross sales and gross accounts receivable at March 31, 2013 was 59 days. The level of DSO at March 31, 2013 is comparable to the Company s expectation that DSO will be in the 60 to 70 day range based on 60 day payment terms for most customers.

- An increase in inventories of $5.8 million primarily due to the timing of fulfillment of customer orders and inventory on hand related to new product approvals.

- A decrease in prepaid income taxes of $1.9 million mainly as a result of a federal tax refund received in the amount of $2.2 million as well as estimated tax payments related to expected taxable income for Fiscal 2013.

- A decrease in accounts payable of $2.3 million due to the timing of payments at the end of the quarter.

- An increase in accrued payroll and payroll related costs of $2.1 million primarily related to incentive compensation costs accrued during Fiscal 2013, partially offset by Fiscal 2013 payments of incentive compensation accrued during Fiscal 2012.

Net cash used in investing activities of $49.3 million for the nine months ended March 31, 2014 is mainly the result of purchases of property, plant and equipment of $20.2 million, primarily two new building purchases, and purchases of investment securities of $49.8 million, partially offset by proceeds from the sale of investment securities of $20.6 million. Net cash used in investing activities of $4.0 million for the nine months ended March 31, 2013 is mainly the result of purchases of property, plant and equipment of $5.9 million and purchases of investment securities of $16.0 million, partially offset by proceeds of $17.6 million from the sale of investment securities.

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Net cash provided by financing activities of $74.9 million for the nine months ended March 31, 2014 was primarily due to proceeds from an offering of the Company s common stock of $71.5 million, proceeds from the issuance of stock pursuant to stock compensation plans of $4.7 million and tax benefits on stock option exercises of $5.2 million, partially offset by debt repayments of $5.3 million. Net cash provided by financing activities of $1.2 million for the nine months ended March 31, 2013 was primarily due to proceeds from the issuance of stock related to employee stock plans of $2.0 million, partially offset by the purchase of treasury stock pursuant to the Company s share repurchase program totaling $440 thousand, and scheduled debt repayments of $379 thousand.

Credit Facilities

The Company has entered into agreements with various government agencies and financial institutions to provide additional cash to help finance the Company s various capital investments and potential strategic opportunities. These borrowing arrangements as of March 31, 2014 are as follows:

In December 2013, the Company entered into a credit agreement (the Citibank Line of Credit) with Citibank, N.A., as administrative agent and another financial institution. The Citibank Line of Credit provides for a revolving loan commitment in the amount of up to $50.0 million. Any loans under the Citibank Line of Credit will bear interest at either a Eurodollar Rate or a Base Rate plus a specified margin. The Company is also required to pay a commitment fee on any undrawn commitments under the Citibank Line of Credit ranging from 0.2% - 0.3% per annum according to the average daily balance of borrowings under the agreement. The Citibank Line of Credit is collateralized by substantially all of the Company s assets. In connection with securing the Citibank Line of Credit, the Company repaid substantially all of its outstanding debt. As of March 31, 2014, the Company had $50.0 million available under the Citibank Line of Credit.

The Citibank Line of Credit contains representations and warranties, affirmative, negative and financial covenants, and events of default, applicable to the Company and its subsidiaries which are customary for credit facilities of this type. As of March 31, 2014 the Company was in compliance with all financial covenants.

The Company is the primary beneficiary to a VIE called Realty. See Note 12 Consolidation of Variable Interest Entity for additional description. The VIE owns land and a building which is leased to Cody Labs. 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. The mortgage requires monthly principal and interest payments of $15 thousand. Effective February 2011, the interest rate was modified from a fixed rate of 7.5% to a floating rate based on the New York Prime Rate with a floor of 4.5% and a ceiling of 9.0%, with payments to be made through April 2022. As of March 31, 2014 and June 30, 2013, the effective rate was 4.5%. The mortgage is collateralized by the land and building. As of March 31, 2014, $1.2 million is outstanding under the mortgage loan, of which $128 thousand is classified as currently due.

Other Liquidity Matters

On December 20, 2013, the Company acquired two separate properties located in Philadelphia, Pennsylvania for $4.0 million and $5.0 million, respectively. The buildings are 196,000 and 400,000 square feet, respectively, and the Company intends to use the two properties for future expansion including, but not limited to, additional manufacturing, product development, and warehousing capabilities. In connection with the purchase of these two buildings, the Company expects to incur significant capital expenditures for fit out costs over the next several years.

The Company completed an offering of its common stock on October 4, 2013 at an offering price of $18.00 per share. The offering of 4.25 million shares yielded net proceeds of $71.5 million after deducting underwriting, legal and accounting fees totaling $5.0 million.

The Company s shareholders approved a proposal, as part of our 2014 Annual Stockholder s Meeting, to increase the number of shares of common stock that are authorized to be issued from 50 million to 100 million.

We are continuously evaluating the potential for product and company acquisitions as a part of our future growth strategy. In conjunction with a potential acquisition, the Company may utilize current resources or seek additional sources of capital to finance any such acquisition which could have an impact on future liquidity.

Research and Development Arrangements

In the normal course of business the Company has entered into certain research and development and other arrangements. As part of these arrangements the Company has agreed to certain contingent payments which generally become due and payable only upon the achievement of certain developmental, regulatory, commercial and/or other milestones. In addition, under certain arrangements, we may be required to make royalty payments based on a percentage of future sales, or other metric, for products currently in

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development in the event that the Company begins to market and sell the product. Due to the inherent uncertainty related to these developmental, regulatory, commercial and/or other milestones, it is unclear if the Company will be required to make such payments.

Prospects for the Future

Lannett continues to see substantial growth year over year in many important financial metrics. Each year, our knowledge, skills and talent increase, as the Company learns from its experience. The Company is strengthening and building momentum to push to the next level within the generic pharmaceutical industry. There are several strategic initiatives on which the Company is embarking to continue its growth.

One initiative that is at the core of the Company s strategy is to continue leveraging the asset we acquired in Cody Labs in 2007. In July 2008, the DEA granted Cody Labs a license to directly import concentrated poppy straw for conversion into opioid-based APIs for use in various dosage forms for pain management. The value of this license comes from the fact that, to date, only six other companies in the U.S. have been granted this license. This license, along with Cody Labs expertise in API development and manufacture, allows the Company to perform in a market with high barriers to entry, no foreign competition, and limited domestic competition. Because of this vertical integration, the Company has direct control of its supply and can avoid increased costs associated with buying APIs from third-party manufacturers, thereby achieving higher margins. The Company can also leverage this vertical integration not only for direct supply of opioid-based APIs, but also for the manufacture of non-opioid-based APIs.

The Company believes that the demand for controlled substance, pain management drugs will continue to grow as the Baby Boomer generation ages. By concentrating additional resources in the development of opioid-based APIs and dosage forms, the Company is well-positioned to take advantage of this opportunity. The Company is currently vertically integrated on two products with several others in various stages of development.

One product in particular which the Company manufactures is a cocaine hydrochloride solution. This product is being manufactured and marketed under the brand name C-Topical® Solution. This product is an analgesic topical solution, with vasoconstriction as a side effect, for use primarily by ear, nose and throat doctors during surgical procedures. This product represents the Company s first foray into the brand market. Selling brand versus generic products requires a dedicated sales force to detail and educate physicians on the product. The Company believes that after the clinical trials are completed and the FDA has granted approval, C-Topical® will be a major contributor to total revenue, with higher than average profit margins as a result of being vertically integrated; both the API and the finished dosage form are manufactured in-house.

Due to the competitive advantage gained by being vertically integrated, in general, and in controlled substance products, in particular, the Company is poised to continue pushing the pace of sales growth in both the controlled substance and generic markets. The Company s strategic goal is to continue investing in controlled substance product development so that, within five years, 50% of revenues from manufactured products are derived from controlled substance products which carry with them higher-than-average gross margins. As the Company continues to invest in, and focus, on process and manufacturing optimization, Cody Labs will continue to be an exciting part of our future.

In addition to focusing on the development and manufacture of opioid-based APIs and dosage forms, the Company has made a strategic decision to develop products, both in-house and with external partners, which require a paragraph four (P-IV) certification when filing the ANDA. A

P-IV certification is required when an ANDA is submitted for a product for which the innovator s patent has not expired. The certification must state whether the patent on the reference listed drug (RLD) is being challenged on grounds of it being invalid, or if the patent is being circumvented. This path to product approval represents a major opportunity for generic drug companies because they do not have to wait until a particular patent expires to potentially enter the market. Secondly, if a company is the first to file a P-IV on a product, and they successfully invalidate or circumvent the patent, the FDA may grant 180 days of market exclusivity. This allows the generic manufacturer to be the sole competitor to the brand company for six months, during which time it will capture a significant portion of the market from the brand company, albeit at lower prices.

The challenge for generic manufacturers with this strategy is the legal costs involved. Before a product is selected for development, the Company must perform a thorough review of the existing patents and determine if they are going to try to invalidate the patent or try to circumvent it. In either case, once the Company submits a P-IV the brand company will have 45 days to respond with a determination on whether they are going to file a suit against the generic company to defend their patent. A generic company needs to be prepared not only for the time and effort associated with a protracted legal challenge, but the associated fees which can easily reach in excess of several million dollars. This strategy provides a high risk, high reward path to product approval. The Company filed its first ANDA with a P-IV certification in Fiscal 2013. With the right research and analysis performed up front, the Company believes it can target suitable products for which to file a P-IV certification, be successful, and reap the rewards of limited competition.

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Another area of focus for the Company is in mergers, acquisitions and other strategic alliances, whether new or continuing. The Company is party to supply and development agreements with international companies, including 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 JSP, Cerovene and Summit Bioscience. The Company is currently in negotiations on similar agreements with other companies, and is actively seeking additional strategic partnerships, through which it will market and distribute products manufactured in-house or by third parties. The Company continues to strengthen and leverage its customer relationships to build market share for such products and increase future revenues and income.

Critical Accounting Policies

The preparation of our consolidated financial statements in accordance with accounting principles generally accepted in the United States and the rules and regulations of the U.S. Securities & Exchange Commission requires the use of estimates and assumptions. A listing of the Company s significant accounting policies are detailed in Note 3 Summary of Significant Accounting Policies. A subsection of these accounting policies have been identified by management as Critical Accounting Policies . Critical accounting policies are those which require management to make estimates using assumptions that were uncertain at the time the estimate was made and for which the use of different assumptions, which reasonably could have been used, could have a material impact on the financial condition or results of operations.

Management has identified the following as Critical Accounting Policies : Revenue Recognition, Inventories, Income Taxes, Valuation of Long-Lived Assets, and Share-based Compensation.

Revenue Recognition

The Company recognizes revenue when title and risk of loss have transferred to the customer and provisions for estimates, including rebates, promotional adjustments, price adjustments, returns, chargebacks, and other potential adjustments are reasonably determinable. The Company also considers all other relevant criteria specified in Securities and Exchange Commission Staff Accounting Bulletin No. 104, Topic No. 13, Revenue Recognition , in determining when to recognize revenue.

When revenue is recognized a simultaneous adjustment to revenue is made for chargebacks, rebates, returns, promotional adjustments, price adjustments known as shelf-stock adjustments and price protections, and other potential adjustments. These provisions are primarily estimated based on historical experience, future expectations, contractual arrangements with wholesalers and indirect customers, and other factors known to management at the time of accrual. Accruals for provisions are presented in the Consolidated Financial Statements as a reduction to gross sales with the corresponding reserve presented as a reduction of accounts receivable or in accrued expenses. The reserves presented as a reduction of accounts receivable totaled $40.6 million and $17.5 million at March 31, 2014 and June 30, 2013, respectively. Accrued expenses at March 31, 2014 and June 30, 2013 included $6.2 million and $1.0 million, respectively, for certain rebate programs, primarily related to Medicare Part D and Medicaid, and certain sales allowances and other adjustments paid to indirect customers.

The following table identifies the activity and ending balances of each major category of revenue-related reserve for the nine months ended March 31, 2014 and 2013:

Reserve Category					
(In thousands)	**Chargebacks**	**Rebates**	**Returns**	**Other**	**Total**
Balance at July 1, 2013	$ 7,267	$ 3,581	$ 6,689	$ 1,000	$ 18,537
Current period provision	78,477	40,465	5,458	18,801	143,201
Credits issued during the period	(66,032)	(28,119)	(2,924)	(17,909)	(114,984)
Balance at March 31, 2014	$ 19,712	$ 15,927	$ 9,223	$ 1,892	$ 46,754

Reserve Category					
(In thousands)	**Chargebacks**	**Rebates**	**Returns**	**Other**	**Total**
Balance at July 1, 2012	$ 7,063	$ 4,436	$ 5,540	$ 705	$ 17,744
Current period provision	51,543	17,606	3,363	9,310	81,822
Credits issued during the period	(52,128)	(18,352)	(2,521)	(8,569)	(81,570)
Balance at March 31, 2013	$ 6,478	$ 3,690	$ 6,382	$ 1,446	$ 17,996

For the three months ending March 31, 2014 and 2013, as a percentage of gross sales the provision for chargebacks was 23.9% and 22.8%, the provision for rebates was 14.7% and 8.5%, the provision for returns was 1.6% and 1.4%, and the provision for other adjustments was 0.8% and 5.5%, respectively.

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For the nine months ending March 31, 2014 and 2013, as a percentage of gross sales the provision for chargebacks was 23.3% and 27.0%, the provision for rebates was 12.0% and 9.2%, the provision for returns was 1.6% and 1.8%, and the provision for other adjustments was 5.6% and 4.9%, respectively.

The increase in total reserves from June 30, 2013 to March 31, 2014 was mainly due to an increase in the rebates and chargebacks reserves. The increase in the rebates reserve resulted from the timing of credits issued, increased gross sales qualifying for rebate programs and pricing changes, while the increase in the chargebacks reserve resulted from increased inventory levels at wholesale distribution centers due to a strategic partnership between two of the companies customers, partially offset by reduced chargeback rates. The activity in the Other category for the nine months ended March 31, 2014 and 2013 includes shelf-stock, shipping and other sales adjustments including prompt payment discounts. The increased provision in the Other category during the nine months ended March 31, 2014, compared to the nine months ended March 31, 2013, primarily resulted from contractual price protection arrangements with customers in connection with various product price increases. Historically, we have not recorded any material amounts in the current period related to reversals or additions of prior period reserves. If the Company were to record a material reversal or addition of any prior period reserve amount it would be separately disclosed.

Provisions for chargebacks, rebates, returns and other adjustments require varying degrees of subjectivity. While rebates generally are based on contractual terms and require less in the way of estimates, chargebacks and returns on the other hand require management to make more subjective assumptions. Each major category is discussed in detail below:

Chargebacks

The provision for chargebacks is the most significant and complex estimate used in the recognition of revenue. The Company sells its products directly to wholesale distributors, generic distributors, retail pharmacy chains, and mail-order pharmacies. The Company also sells its products indirectly to independent pharmacies, managed care organizations, hospitals, nursing homes, and group purchasing organizations, collectively referred to as indirect customers. The Company enters into agreements with its indirect customers to establish pricing for certain products. The indirect customers then independently select a wholesaler from which to purchase the products. If the price paid by the indirect customers is lower than the price paid by the wholesaler, the Company will provide a credit, called a chargeback, to the wholesaler for the difference between the contractual price with the indirect customers and the wholesaler purchase price. 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 (decrease), the reserve for chargebacks will also generally increase (decrease). However, the size of the increase (decrease) depends on product mix and the amount of 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 may differ from the actual chargeback reserve.

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 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. Additionally, as a result of the Patient Protection and Affordable Care Act (PPACA) enacted in the U.S. in March 2010, the Company participates in a new cost-sharing program for certain Medicare Part D beneficiaries designed primarily for the sale of brand drugs and certain generic drugs if their FDA approval was granted under a New Drug Application (NDA) or 505(b) NDA versus an Abbreviated New Drug Application (ANDA). Because our drugs used for the treatment of thyroid deficiency and our Morphine Sulfate Oral Solution product were both approved by the FDA as

505(b)(2) NDAs, they are considered brand drugs for purposes of the PPACA. Drugs purchased within the Medicare Part D coverage gap (commonly referred to as the donut hole) result in additional rebates. The Company estimates the reserve for rebates and other promotional credit programs based on the specific terms in each agreement when revenue is recognized. The reserve for rebates increases (decreases) as sales to certain wholesale and retail customers increase (decrease). However, since these 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.

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Returns

Consistent with industry practice, the Company has a product returns policy that allows customers to return product within a specified time period prior to and subsequent to the product s 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, credit terms and any extenuating circumstances known to management. While historical experience has allowed for reasonable estimations in the past, future returns may or may not follow historical trends. The Company continually monitors the reserve for returns and makes adjustments when management believes that actual product returns may differ from the established reserve. Generally, the reserve for returns increases as net sales increase.

Other Adjustments

Other adjustments consist primarily of price adjustments, also known as shelf-stock adjustments and price protections, which are credits issued to reflect decreases or increases in the selling prices of the Company s products. In the case of a price decrease a credit is given to customers for product remaining in their inventories at the time of the price reduction. Contractual price protection results in a similar credit in the case of a price increase. Pricing changes 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 changes 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 also include prompt payment discounts.

Inventories

Inventories are stated at the lower of cost or market determined by the first-in, first-out method. Inventories are regularly reviewed and provisions for excess and obsolete inventory are recorded based primarily on current inventory levels and estimated sales forecasts. During the three months ended March 31, 2014 and 2013, the Company recorded provisions for excess and obsolete inventory of $811 thousand and $333 thousand, respectively. During the nine months ended March 31, 2014 and 2013, the Company recorded provisions for excess and obsolete inventory of $1.9 million and $853 thousand, respectively. The reserve for excess and obsolete inventory at March 31, 2014 and June 30, 2013 was $2.1 million and $2.0 million, respectively.

Income Taxes

The Company uses the asset and liability method to account for income taxes as prescribed by ASC 740, 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. Deferred income tax assets and liabilities are adjusted to recognize the effects of changes in tax laws or enacted tax rates in the period during which they are signed into law.

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. The factors used to assess the likelihood of realization are the Company s forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Under ASC 740, Income Taxes, a valuation allowance is required when it is more likely than not that all or some portion of the deferred tax assets will not be realized through generating sufficient future taxable income. Failure to achieve forecasted taxable income in applicable tax jurisdictions could affect the ultimate realization of deferred tax assets and could result in an increase in the Company s effective tax rate on future earnings.

The Company s future effective income tax rate is highly reliant on future projections of taxable income, tax legislation, and potential tax planning strategies. A change in any of these factors could materially affect the effective income tax rate of the Company.

For the three months ended March 31, 2014 and 2013, the Company recorded a provision for income taxes of $13.3 million and $1.3 million, respectively. Effective tax rates for the same periods were 37% and 25%, respectively.

For the nine months ended March 31, 2014 and 2013, the Company recorded a provision for income taxes of $18.8 million and $5.4 million, respectively. Effective tax rates for the same periods were 36% and 35%, respectively.

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Valuation of Long-Lived Assets

The Company s long-lived assets primarily consist of property, plant and equipment as well as definite-lived intangible assets. Intangible assets are stated at cost less accumulated amortization. Amortization is computed on a straight-line basis over the assets estimated useful lives, generally for periods ranging from 10 to 15 years. Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is computed on a straight-line basis over the assets estimated useful lives, generally for periods ranging from 5 to 39 years. The Company continually evaluates the reasonableness of the useful lives of these assets.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances (triggering events) indicate that the carrying amount of the asset may not be recoverable. The nature and timing of triggering events by their very nature are unpredictable; however management regularly considers the performance of an asset as compared to its expectations, industry events, industry and economic trends, as well as any other relevant information known to management when determining if a triggering event occurred.

If a triggering event is determined to have occurred, the first step in the impairment test is to compare the asset s carrying value to the undiscounted cash flows expected to be generated by the asset. If the carrying value exceeds the undiscounted cash flow of the asset then impairment exists. An impairment loss is measured as the excess of the asset s carrying value over its fair value, which in most cases is calculated using a discounted cash flow model. Discounted cash flow models are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates, and the probability of achieving the estimated cash flows.

During the three and nine months ended March 31, 2014 and 2013, the Company did not identify any triggering events. As a result no impairment charges were recorded in the Consolidated Statements of Operations. For the three months ended March 31, 2014 and 2013, the Company incurred depreciation and amortization expense of $1.6 million and $1.5 million, respectively. For the nine months ended March 31, 2014 and 2013, the Company incurred depreciation and amortization expense of $4.8 million and $4.6 million, respectively.

Share-based Compensation

Share-based compensation costs are recognized over the vesting period, using a straight-line method, based on the fair value of the instrument on the date of grant less an estimate for forfeitures. The Company uses the Black-Scholes valuation model to determine the fair value of stock options and the stock price on the grant date to value restricted stock. The Black-Scholes valuation model includes various assumptions, including the expected volatility, the expected life of the award, dividend yield, and the risk-free interest rate. These assumptions involve inherent uncertainties based on market conditions which are generally outside the Company s control. Changes in these assumptions could have a material impact on share-based compensation costs recognized in the financial statements.

The following table presents the weighted average assumptions used to estimate fair values of the stock options granted during the nine months ended March 31 and the estimated annual forfeiture rates used to recognize the associated compensation expense:

	Stock Options FY 2014	Stock Options FY 2013
Risk-free interest rate	2.1%	1.0%
Expected volatility	62.9%	61.5%
Expected dividend yield	0.0%	0.0%
Forfeiture rate	7.5%	7.5%
Expected term (in years)	5.9 years	6.1 years
Weighted average fair value	$8.14	$2.36

Expected volatility is based on the historical volatility of the price of our common shares during the historical period equal to the expected term of the option. The Company uses historical information to estimate the expected term, which represents the period of time that options granted are expected to be outstanding. The risk-free rate for the period equal to the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. 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. Additionally, the expected dividend yield is equal to zero, as the Company has not historically issued, and has no immediate plans to issue, a dividend.

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The following table presents the allocation of share-based compensation costs recognized in the Consolidated Statements of Operations by financial statement line item:

	Three Months Ended March 31,		Nine Months Ended March 31,	
(In thousands)	**2014**	**2013**	**2014**	**2013**
Selling, general and administrative	$ 2,240	$ 200	$ 4,763	$ 975
Research and development	225	23	443	75
Cost of sales	324	29	627	142
Total	2,789	252	5,833	1,192
Tax benefit at statutory rate	$ 1,053	$ 42	$ 2,160	$ 99

Recent Accounting Pronouncements

In February 2013, the FASB issued authoritative guidance which requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. This authoritative guidance is effective for reporting periods beginning after December 15, 2012. The adoption of this guidance by the Company did not have a significant impact on the Company s consolidated financial statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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. The mortgage requires monthly principal and interest payments of $15 thousand. Effective February 2011, the interest rate was modified from a fixed rate of 7.5% to a floating rate based on the New York Prime Rate with a floor of 4.5% and a ceiling of 9.0%, with payments to be made through April 2022. As of March 31, 2014 and June 30, 2013, the effective interest rate was 4.5%. The mortgage is collateralized by the land and building. As of March 31, 2014, $1.2 million is outstanding under the mortgage loan, of which $128 thousand is classified as currently due.

In December 2013, the Company entered into a credit agreement (the Citibank Line of Credit) with Citibank, N.A., as administrative agent and another financial institution. The Citibank Line of Credit provides for a revolving loan commitment in the amount of up to $50.0 million. Any loans under the Citibank Line of Credit will bear interest at either a Eurodollar Rate or a Base Rate plus a specified margin. The Company is also required to pay a commitment fee on any undrawn commitments under the Citibank Line of Credit ranging from 0.2% - 0.3% per annum according to the average daily balance of borrowings under the agreement. The Citibank Line of Credit is collateralized by substantially all of the Company s assets. As of March 31, 2014, the Company had $50.0 million available under the Citibank Line of Credit.

The Citibank Line of Credit contains representations and warranties, affirmative, negative and financial covenants, and events of default, applicable to the Company and its subsidiaries which are customary for credit facilities of this type. As of March 31, 2014, the Company was in compliance with all financial covenants.

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 Lannett 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 Lannett s internal control over financial reporting during the three and nine months ended March 31, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On April 16, 2013, Richard Asherman (Asherman), the former President of and a member in Realty, filed a complaint (Complaint) in Wyoming state court against the Company and Cody Labs. At the same time, he also filed an application for a temporary restraining order to enjoin certain operations at Cody Labs, claiming, among other things, that Cody Labs is in violation of certain zoning laws and that Cody Labs is required to increase the level of its property insurance and to secure performance bonds for work being performed at Cody Labs. Mr. Asherman claims Cody Labs is in breach of his employment agreement and is required to pay him severance under his employment agreement, including 18 months of base salary, vesting of unvested stock options and continuation of benefits. The Company estimates that the aggregate value of the claimed severance benefits is approximately $350 thousand to $400 thousand, plus the value of any stock options. Mr. Asherman also asserts that the Company is in breach of the Realty Operating Agreement and, among other requested remedies, he seeks to have the Company (i) pay him 50% of the value of 1.66 acres of land that Realty previously agreed to donate to an economic development entity associated with the City of Cody, Wyoming, which contemplated transaction has since been avoided and cancelled and (ii) acquire Mr. Asherman s interest in Realty for an unspecified price. Alternatively, Mr. Asherman seeks to dissolve Realty. The Company and Cody Labs opposed the application for a temporary restraining order and, following a hearing on April 18, 2013, the Court denied the relief to Mr. Asherman.

On August 2, 2013, Asherman filed his First Amended Complaint, naming as Defendants Arthur P. Bedrosian, the President and Chief Executive Officer of the Company (Bedrosian), the Company, Cody Labs and Realty. The Amended Complaint is substantially similar to the Complaint respecting the relief sought and adds Bedrosian as a defendant, claiming that Bedrosian defamed Asherman in a Form 10-Q filed by the Company, by reporting that he had been fired for cause .

On August 30, 2013, Lannett and Cody Labs jointly moved to dismiss the Amended Complaint. Bedrosian and Realty have filed separate motions to dismiss. On March 14, 2014, the Wyoming court dismissed Realty from the case. The motions to dismiss filed by Lannett, Cody Labs and Bedrosian are pending. The Company strongly disputes the claims in the Amended Complaint, including that the Company is required to acquire Mr. Asherman s interest in Realty. Specifically, the Company asserts that it is and has always been in compliance with local zoning laws, which permit the operation of a pharmaceutical facility, and that Mr. Asherman, in fact, previously represented this to both the Company and the EPA. It also asserts that the City of Cody has never taken the position or advised Cody Labs that the Cody Labs facility was operating in violation of the local zoning laws. The Company also asserts that Cody Labs has in place a sufficient level of property insurance coverage. Cody Labs also strongly disputes the claims in the Complaint, including that it is required to pay Mr. Asherman severance, as Cody Labs advised Mr. Asherman that he was being terminated for cause following the issuance of a letter of reprimand. If Mr. Asherman were successful on his claim for breach of his employment agreement, he would be entitled to his contractual severance 18 months salary plus the vesting of certain stock options and continuation of benefits. The amount the Company would be required to pay to Mr. Asherman if he were successful in compelling the buyout of his interest in Realty is dependent upon the value of the real property owned by Realty. If a buyout were required, Realty would become wholly owned by the Company. At this time the Company is unable to reasonably estimate a range or aggregate dollar amount of Mr. Asherman s claims or of any potential loss, if any, to the Company.The Company does not believe that the ultimate resolution of the matter will have a significant impact on the Company s financial position or results of operations.

Regulatory Proceedings

Lannett Company, Inc. 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.

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ITEM 1A. RISK FACTORS

Lannett Company, Inc s Annual Report on Form 10-K for the fiscal year ended June 30, 2013 includes a detailed description of its risk factors.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(b) Use of Proceeds

On December 7, 2012, our registration statement on Form S-3 (File No. 333-184721) was declared effective by the Securities and Exchange Commission. The Company completed an offering of its common stock on October 4, 2013 at an offering price of $18.00 per share. Roth Capital Partners and Canaccord Genuity acted as joint book-running managers, Oppenheimer & Co. as lead manager, and Craig-Hallum Capital Group as co-manager. The offering of 4.25 million shares yielded net proceeds of $71.5 million after deducting underwriting, legal and accounting fees totaling $5.0 million. There has been no material change in the planned use of proceeds from our offering as described in our prospectus supplement filed with the Securities and Exchange Commission on October 4, 2013, which is to use such net proceeds for general corporate purposes, including, without limitation, research and development, general and administrative, manufacturing and marketing expenses, and for potential acquisitions of companies, products, ANDAs, technologies and assets that complement its business. To date, all of the unused proceeds have been temporarily invested in short-term investments.

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.

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SIGNATURES

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

LANNETT COMPANY, INC.

Dated: May 9, 2014

By: /s/ Arthur P. Bedrosian
Arthur P. Bedrosian
President and Chief Executive Officer

Dated: May 9, 2014

By: /s/ Martin P. Galvan
Martin P. Galvan
Vice President of Finance,
Chief Financial Officer and Treasurer

Dated: May 9, 2014

By: /s/ G. Michael Landis
G. Michael Landis
Director of Financial Reporting and Principal Accounting Officer

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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
101.INS	XBRL Instance Document	
101.SCH	XBRL Extension Schema Document	
101.CAL	XBRL Calculation Linkbase Document	
101.DEF	XBRL Definition Linkbase Document	
101.LAB	XBRL Label Linkbase Document	
101.PRE	XBRL Presentation Linkbase Document	