

MEDICIS PHARMACEUTICAL CORP

Form 10-Q

November 09, 2005

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q**

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

For the quarterly period ended September 30, 2005
OR

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

For the transition period from _____ to _____
Commission file number: 0-18443

MEDICIS PHARMACEUTICAL CORPORATION
(Exact name of Registrant as specified in its charter)

Delaware

52-1574808

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification No.)

8125 North Hayden Road
Scottsdale, Arizona 85258-2463

(Address of principal executive offices)
(602) 808-8800

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) YES NO

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2) YES NO

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

Class	Outstanding at November 3, 2005
Class A Common Stock \$.014 Par Value	54,404,052

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MEDICIS PHARMACEUTICAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	September 30, 2005 (unaudited)	June 30, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 250,338	\$ 177,785
Short-term investments	378,066	425,783
Accounts receivable, net	43,326	47,220
Inventories, net	19,700	20,701
Deferred tax assets, net	8,482	11,001
Other current assets	13,102	16,435
Total current assets	713,014	698,925
Property and equipment, net	5,812	6,143
Intangible assets:		
Intangible assets related to product line acquisitions and business combinations	326,780	326,780
Other intangible assets	4,787	4,507
	331,567	331,287
Less: accumulated amortization	77,350	71,749
Net intangible assets	254,217	259,538
Goodwill	64,672	64,672
Deferred financing costs, net	4,861	5,397
Other non-current assets	11,362	8,576
	\$ 1,053,938	\$ 1,043,251

See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS, Continued
(in thousands, except share amounts)

	September 30, 2005 (unaudited)	June 30, 2005
Liabilities		
Current liabilities:		
Accounts payable	\$ 26,633	\$ 30,832
Short-term contract obligation	27,407	27,407
Income taxes payable	7,484	10,236
Other current liabilities	26,077	30,379
 Total current liabilities	 87,601	 98,854
 Long-term liabilities:		
Contingent convertible senior notes	453,065	453,065
Deferred tax liability, net	7,635	4,986
 Stockholders Equity		
Preferred stock, \$0.01 par value; shares authorized: 5,000,000; no shares issued		
Class A common stock, \$0.014 par value; shares authorized: 150,000,000; issued and outstanding: 67,037,580 and 67,007,330 at September 30, 2005 and June 30, 2005, respectively		
	938	938
Class B common stock, \$0.014 par value; shares authorized: 1,000,000; no shares issued and outstanding at September 30, 2005 and June 30, 2005		
Additional paid-in capital	548,070	539,443
Accumulated other comprehensive income	90	(606)
Deferred compensation		(697)
Accumulated earnings	299,269	288,474
Less: Treasury stock, 12,647,554 and 12,620,554 shares at cost at September 30, 2005 and June 30, 2005, respectively	(342,730)	(341,206)
 Total stockholders equity	 505,637	 486,346
	\$ 1,053,938	\$ 1,043,251

See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(unaudited)
(in thousands, except per share data)

	Three Months Ended	
	September 30, 2005	September 30, 2004
Net product revenues	\$ 79,398	\$ 72,107
Net contract revenues	3,866	16,711
Net revenues	83,264	88,818
Cost of product revenue (1)	12,024	13,833
Gross profit	71,240	74,985
Operating costs and expenses:		
Selling, general and administrative (2)	41,487	32,926
Research and development (3)	5,053	35,763
Depreciation and amortization	6,308	5,032
Operating costs and expenses	52,848	73,721
Operating income	18,392	1,264
Interest income	4,116	2,520
Interest expense	2,666	2,666
Income before income tax expense	19,842	1,118
Income tax expense	7,382	95
Net income	\$ 12,460	\$ 1,023
Basic net income per common share	\$ 0.23	\$ 0.02
Diluted net income per common share	\$ 0.20	\$ 0.02

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Cash dividend declared per common share	\$ 0.03	\$ 0.03
Basic common shares outstanding	54,310	57,228
Diluted common shares outstanding	69,850	60,268

(1) amounts exclude amortization of intangible assets related to acquired products	\$ 5,560	\$ 4,432
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(2) amounts include share-based compensation expense	\$ 7,184	\$ 129
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(3) amounts include share-based compensation expense	\$ 505	
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See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Three Months Ended	
	September 30, 2005	September 30, 2004
Operating Activities:		
Net income	\$ 12,460	\$ 1,023
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,844	5,568
Loss on disposal of property and equipment	31	37
Loss on sale of available-for-sale investments	599	20
Share-based compensation expense	7,689	129
Deferred income tax expense (benefit)	5,169	(5,185)
Tax benefit from exercise of stock options	30	2,616
Excess tax benefits from exercise of stock options	(72)	
Provision for doubtful accounts and returns	(4,862)	300
Accretion of premium on investments	17	1,308
Changes in operating assets and liabilities:		
Accounts receivable	8,757	1,776
Inventories	1,001	(81)
Other current assets	3,332	2,114
Accounts payable	(5,838)	4,611
Income taxes payable	(2,753)	3,381
Other current liabilities	(4,338)	(3,711)
Net cash provided by operating activities	28,066	13,906
Investing Activities:		
Purchase of property and equipment	(408)	(1,002)
Payment of direct merger costs	(1,147)	(25)
Payment for purchase of product rights	(280)	(578)
Purchase of available-for-sale investments	(110,453)	(297,629)
Sale of available-for-sale investments	94,762	380,033
Maturity of available-for-sale investments	63,224	15,655
Net cash provided by investing activities	45,698	96,454
Financing Activities:		
Payment of dividends	(1,629)	(1,435)
Purchase of treasury stock		(65,855)
Excess tax benefits from exercise of stock options	72	
Proceeds from the exercise of stock options	81	8,208
Net cash used in financing activities	(1,476)	(59,082)

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Effect of exchange rate on cash and cash equivalents	265	510
Net increase in cash and cash equivalents	72,553	51,788
Cash and cash equivalents at beginning of period	177,785	46,621
Cash and cash equivalents at end of period	\$ 250,338	\$ 98,409

See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2005
(unaudited)

1. NATURE OF BUSINESS

Medicis Pharmaceutical Corporation (Medicis or the Company) is a leading specialty pharmaceutical company focusing primarily on the development and marketing of products in the United States (U.S.) for the treatment of dermatological, aesthetic and podiatric conditions. Medicis also markets products in Canada for the treatment of dermatological and aesthetic conditions. Medicis has built its business by executing a four-part growth strategy. This strategy consists of promoting existing core brands, developing new products and important product line extensions, entering into strategic collaborations, and acquiring complementary products, technologies and businesses.

The Company offers a broad range of products addressing various conditions including acne, fungal infections, rosacea, hyperpigmentation, photoaging, psoriasis, eczema, skin and skin-structure infections, seborrheic dermatitis and cosmesis (improvement in the texture and appearance of skin). Medicis currently offers 15 branded products. Its core brands are DYNACIN® (minocycline HCl), LOPROX® (ciclopirox), OMNICEF® (cefdinir), PLEXION® (sodium sulfacetamide/sulfur), RESTYLANE® (hyaluronic acid), TRIAZ® (benzoyl peroxide), and VANOS (fluocinonide) Cream, 0.1%.

In March 2003, Medicis expanded into the dermal aesthetic market through its acquisition of the exclusive U.S. and Canadian rights to market, distribute and commercialize the dermal restorative product lines known as RESTYLANE®, PERLANE and RESTYLANE FINE LINES from Q-Med AB, a Swedish biotechnology/medical device company and its affiliates, collectively Q-Med. RESTYLANE® has been approved by the Food and Drug Administration (the FDA) for use in the U.S. as a medical device for the correction of moderate to severe facial wrinkles and folds, such as nasolabial folds. RESTYLANE®, PERLANE and RESTYLANE FINE LINES have been approved for use in Canada.

On March 20, 2005, Medicis, Masterpiece Acquisition Corp. (a wholly-owned subsidiary of Medicis), and Inamed Corporation (Inamed) entered into an Agreement and Plan of Merger. Inamed is a global healthcare company that develops, manufactures, and markets a diverse line of products that enhance the quality of people s lives. These products include breast implants for aesthetic augmentation and reconstructive surgery following a mastectomy, a range of dermal products to correct facial wrinkles, the BioEnterics® LAP-BAND® System designed to treat severe and morbid obesity, and the BioEnterics® IntraGastric Balloon (BIB®) system for the treatment of obesity. Inamed s common stock trades on the NASDAQ National Market under the symbol IMDC. The completion of the transaction is subject to several customary conditions. See Note 4.

The consolidated financial statements include the accounts of Medicis Pharmaceutical Corporation and its wholly owned subsidiaries (Medicis or the Company). The Company does not have any subsidiaries in which it does not own 100% of the outstanding stock. All of the Company s subsidiaries are included in the consolidated financial statements. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying interim condensed consolidated financial statements of Medicis have been prepared in conformity with U.S. generally accepted accounting principles, consistent in all material respects with those applied in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2005 (fiscal 2005), except for the adoption of Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS No. 123R) See Note 2. The financial information is unaudited but reflects all adjustments, consisting only of normal recurring accruals, which are, in the opinion of the Company s management, necessary to a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Company s Annual Report on Form 10-K for fiscal 2005. Certain prior period amounts have been reclassified to conform with current period presentation.

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At September 30, 2005, the Company had six active share-based employee compensation plans. Stock option awards granted from these plans are granted at the fair market value on the date of grant, and vest over a period determined at the time the options are granted, ranging from one to five years, and generally have a maximum term of ten years. Certain options provide for accelerated vesting if there is a change in control (as defined in the plans). When options are exercised, new shares of the Company's Class A common stock are issued. Prior to July 1, 2005, the Company accounted for share-based employee compensation, including stock options, using the method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related Interpretations (APB Opinion No. 25). Under APB Opinion No. 25, stock options are granted at market price and no compensation cost is recognized, and a disclosure is made regarding the pro forma effect on net earnings assuming compensation cost had been recognized in accordance with Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123). During December 2004, the FASB issued SFAS No. 123R, which requires companies to measure and recognize compensation expense for all share-based payments at fair value. SFAS No. 123R eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, and generally requires that such transactions be accounted for using prescribed fair-value-based methods. SFAS No. 123R permits public companies to adopt its requirements using one of two methods: (a) a modified prospective method in which compensation costs are recognized beginning with the effective date based on the requirements of SFAS No. 123R for all share-based payments granted or modified after the effective date, and based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date or (b) a modified retrospective method which includes the requirements of the modified prospective method described above, but also permits companies to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either for all periods presented or prior interim periods of the year of adoption. Effective July 1, 2005, the Company adopted SFAS No. 123R using the modified prospective method. Other than restricted stock, no share-based employee compensation cost has been reflected in net income prior to the adoption of SFAS No. 123R. Results for prior periods have not been restated.

The adoption of SFAS No. 123R reduced income before income tax expense for the three months ended September 30, 2005 by approximately \$7.4 million and reduced net income for the three months ended September 30, 2005 by approximately \$4.9 million. Basic and diluted net income per common share for the three months ended September 30, 2005 would have been \$0.32 and \$0.27, respectively, if the Company had not adopted SFAS No. 123R, compared to reported basic and diluted net income per common share of \$0.23 and \$0.20, respectively. The total value of the stock options awards is expensed ratably over the service period of the employees receiving the awards. As of September 30, 2005, total unrecognized compensation cost related to stock option awards was approximately \$71.5 million and the related weighted-average period over which it is expected to be recognized is approximately 3.1 years.

Prior to the adoption of SFAS No. 123R, the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the condensed consolidated statements of cash flows. SFAS No. 123R requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The \$0.1 million excess tax benefit classified as a financing cash inflow in the Company's accompanying condensed consolidated statements of cash flows for the three months ended September 30, 2005 would have been classified as an operating cash inflow if the Company had not adopted SFAS No. 123R.

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A summary of stock options activity within the Company's share-based compensation plans and changes for the three months ended September 30, 2005 is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Balance at June 30, 2005	13,648,378	\$ 26.89		
Granted	843,550	\$ 32.43		
Exercised	(3,250)	\$ 24.76		
Terminated/expired	(61,461)	\$ 30.27		
Balance at September 30, 2005	14,427,217	\$ 27.20	6.8	\$ 93,334,580

The intrinsic value of options exercised during the three months ended September 30, 2005 was \$30,683. Options exercisable under the Company's share-based compensation plans at September 30, 2005 were 7,283,726, with an average exercise price of \$24.23, an average remaining contractual term of 5.7 years, and an aggregate intrinsic value of \$63,577,619.

The fair value of each stock option award is estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004
Expected dividend yield	0.4%	0.3%
Expected stock price volatility	0.36	0.44
Risk-free interest rate	4.1% to 4.2%	3.6%
Expected life of options	6 to 8 Years	5 Years

The expected dividend yield is based on expected annual dividend to be paid by the Company as a percentage of the market value of the Company's stock as of the date of grant. The Company determined that a blend of implied volatility and historical volatility is more reflective of market conditions and a better indicator of expected volatility than using purely historical volatility. The risk-free interest rate is based on the U.S. treasury security rate in effect as of the date of grant. The expected lives of options are based on historical data of the Company.

The weighted average fair value of stock options granted during the three months ended September 30, 2005 and 2004 was \$14.15 and \$16.08, respectively.

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The following table illustrates the effect on net income (loss) and net income (loss) per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to all outstanding stock option awards for periods presented prior to the Company's adoption of SFAS No. 123R (amounts in thousands, except per share amounts):

	THREE MONTHS ENDED SEPTEMBER 30, 2004
Net income, as reported	\$ 1,023
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	4,899
Pro-forma net loss	\$ (3,876)
Net income (loss) per common share:	
Basic, as reported	\$ 0.02
Basic, pro forma	\$ (0.07)
Diluted, as reported	\$ 0.02
Diluted, pro forma	\$ (0.07)

The Company also grants restricted stock awards to certain employees. Restricted stock awards are valued at the closing market value of the Company's Class A common stock on the date of grant, and the total value of the award is expensed ratably over the service period of the employees receiving the grants. During the three months ended September 30, 2005, 147,710 shares of restricted stock were granted to certain employees. Share-based compensation expense related to all restricted stock awards outstanding during the three months ended September 30, 2005 and 2004, was approximately \$0.3 million and \$0.1 million, respectively. As of September 30, 2005, the total amount of unrecognized compensation cost related to nonvested restricted stock awards was approximately \$5.1 million, and the related weighted-average period over which it is expected to be recognized is approximately 4.4 years.

A summary of restricted stock activity within the Company's share-based compensation plans and changes for the three months ended September 30, 2005 is as follows:

Nonvested Shares	Shares	Weighted- Average Grant-Date Fair Value
Nonvested at June 30, 2005	92,000	\$ 23.41
Granted	147,710	\$ 32.41
Vested	(27,000)	\$ 23.44
Forfeited		\$
Nonvested at September 30, 2005	212,710	\$ 29.65

The total fair value of restricted shares vested during the three months ended September 30, 2005 and 2004 was \$0.6 million and \$0.4 million, respectively.

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3. RESEARCH AND DEVELOPMENT COSTS AND ACCOUNTING FOR STRATEGIC COLLABORATIONS

All research and development costs, including payments related to products under development and research consulting agreements, are expensed as incurred. The Company may continue to make up-front, non-refundable payments to third parties for new technologies and for research and development work that has been completed. These up-front payments may be expensed at the time of payment depending on the nature of the payment made.

The Company's policy on accounting for costs of strategic collaborations determines the timing of the recognition of certain development costs. In addition, this policy determines whether the cost is classified as development expense or capitalized as an asset. Management is required to form judgments with respect to the commercial status of such products in determining whether development costs meet the criteria for immediate expense or capitalization. For example, when the Company acquires certain products for which there is already an Abbreviated New Drug Application (ANDA) or a New Drug Application (NDA) available, and there is net realizable value based on projected sales for these products, the Company capitalizes the amount paid as an intangible asset. In addition, if the Company acquires product rights that are in the development phase and as to which the Company has no assurance that the third party is required to perform additional research efforts, the Company expenses such payments.

On July 15, 2004, the Company entered into an exclusive license agreement and other ancillary documents with Q-Med to market, distribute, sell and commercialize in the U.S. and Canada Q-Med's product currently known as SubQ™. Q-Med has the exclusive right to manufacture SubQ™ for Medicis. SubQ™ is currently not approved for use in the U.S. or Canada. Under terms of the agreement, Medicis Aesthetics Holdings Inc., a wholly owned subsidiary of Medicis, licenses SubQ™ for approximately \$80 million, due as follows: approximately \$30 million on July 15, 2004, which was recorded as a charge to research and development expense during the first quarter of fiscal 2005; approximately \$10 million upon completion of certain clinical milestones; approximately \$20 million upon satisfaction of certain defined regulatory milestones; and approximately \$20 million upon U.S. launch of SubQ™. In addition, the Company incurred approximately \$0.7 million of professional fees related to the completion of the agreements during the first quarter of fiscal 2005, which was included in selling, general and administrative expenses. The Company also will make additional milestone payments to Q-Med upon the achievement of certain commercial milestones.

4. DEFINITIVE MERGER AGREEMENT WITH INAMED

On March 20, 2005, Medicis, Masterpiece Acquisition Corp. (a wholly-owned subsidiary of Medicis), and Inamed entered into an Agreement and Plan of Merger. Inamed is a global healthcare company that develops, manufactures, and markets a diverse line of products that enhance the quality of people's lives. These products include breast implants for aesthetic augmentation and reconstructive surgery following a mastectomy, a range of dermal filler products to correct facial wrinkles, the BioEnterics® LAP-BAND® System designed to treat severe and morbid obesity, and the BioEnterics® IntraGastric Balloon (BIB®) system for the treatment of obesity. Inamed's common stock trades on the NASDAQ National Market under the symbol IMDC.

Under the terms of the Agreement and Plan of Merger, Inamed will merge with and into Masterpiece Acquisition Corp. and each share of Inamed common stock will be converted into the right to receive 1.4205 shares of Medicis common stock and \$30.00 in cash. The completion of the transaction is subject to several customary conditions, including the receipt of applicable approvals from Medicis and Inamed's stockholders, the absence of any material adverse effect on either party's business and the receipt of regulatory approvals. The discussions in this report relate to Medicis as a stand-alone entity and do not include or reflect the operating results of Inamed or the impact of the proposed merger with Inamed following the closing of the transaction.

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The Company has incurred approximately \$11.4 million of professional and other costs related to the transaction. The costs are included in other non-current assets in the accompanying consolidated balance sheets. Business integration costs related to the transaction, including the planning for and implementation of integration activities, are being expensed as incurred. During the first quarter of fiscal 2006, the Company incurred approximately \$0.7 million of business integration planning costs, which are included in selling, general and administrative expenses in the accompanying consolidated statements of income.

Restrictions in the merger agreement on solicitation generally prohibit the Company from soliciting any acquisition proposal or offer for a merger or business combination with any other party, including a proposal that might be advantageous to its stockholders when compared to the terms and conditions of the merger with Inamed. If the merger is not completed, the Company may not be able to conclude another merger, sale or combination on as favorable terms, in a timely manner, or at all. If the merger agreement is terminated, the Company, in certain specified circumstances, may be required to pay a termination fee of up to \$70.0 million to Inamed. In addition, under certain circumstances, the Company may be required to pay Inamed an expense fee or regulatory termination fee of \$10.0 million. As consideration for Inamed's dismissal of pending litigation against Medicis, the Company agreed to pay Inamed an aggregate of \$16.5 million if either the \$70.0 million termination fee or the \$10.0 million expense fee becomes payable by Medicis or if the merger agreement is terminated because its stockholder approval is not obtained at the stockholders meeting relating to the merger. If the transaction is terminated as a result of Inamed's stockholders voting against the adoption of the merger agreement, these fees will not be payable by Medicis.

The Agreement and Plan of Merger was filed with the SEC by the Company as part of a Current Report on Form 8-K filed on March 21, 2005. A Registration Statement on Form S-4 relating to the Inamed merger was filed with the SEC on November 2, 2005.

5. LICENSE OF PRODUCTS TO TARO PHARMACEUTICAL INDUSTRIES, INC.

On July 27, 2004, the Company entered into an exclusive license and optional purchase agreement with Taro Pharmaceutical Industries, Inc. (Taro) pursuant to which Taro will market, distribute and sell the LUSTRA® family of products and two development stage products in the U.S., Canada and Puerto Rico. The LUSTRA® family of products are topical therapies prescribed for the treatment of ultraviolet-induced skin discolorations and hyperpigmentation usually associated with the use of oral contraceptives, pregnancy, hormone replacement therapy, sun damage and superficial trauma. The license agreement extends through July 1, 2007, after which Taro may purchase the product lines.

6. LICENSE OF ORAPRED® TO BIOMARIN

On May 18, 2004, the Company closed an asset purchase agreement and license agreement and executed a securities purchase agreement with BioMarin. The asset purchase agreement involves BioMarin's purchase of assets related to ORAPRED®, including assets concerning the Ascent field sales force. ORAPRED® and related pediatric intellectual property is owned by Ascent, a wholly owned subsidiary of Medicis. The license agreement granted BioMarin, among other things, the exclusive worldwide rights to ORAPRED®. The securities purchase agreement granted BioMarin the option to purchase all outstanding shares of common stock of Ascent, based on certain conditions. As part of the transaction, the name of Ascent Pediatrics, Inc. was changed to Medicis Pediatrics, Inc.

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Under terms of the original agreements, BioMarin was to make license payments to Ascent of approximately \$93 million payable over a five-year period as follows: approximately \$10 million as of the date of the transaction; approximately \$12.5 million per quarter for four quarters beginning in July 2004; approximately \$2.5 million per quarter for the subsequent four quarters beginning in July 2005; approximately \$2 million per quarter for the subsequent eight quarters beginning in July 2006; and approximately \$1.75 million per quarter for the last four quarters of the five-year period beginning in July 2008. BioMarin was also to make payments of \$2.5 million per quarter for six quarters beginning in July 2004 for reimbursement of certain contingent payments as discussed in Note 8. The license agreement will terminate in July 2009. At that time, based on certain conditions, BioMarin would have the option to purchase all outstanding shares of Ascent for approximately \$82 million. The payment was to consist of \$62 million in cash and \$20 million in BioMarin common stock, based on the fair value of the stock at that time. The Company was responsible for the manufacture and delivery of finished goods inventory to BioMarin, and BioMarin was responsible for paying the Company for finished goods inventory delivered through June 30, 2005. As a result, the Company was required to recognize the first \$60 million of license payments ratably through June 30, 2005. The license payments received after June 30, 2005 and the reimbursement of contingent payments will be recognized as revenue when all four criteria of SAB 104 have been met.

As of the closing date of the transaction, BioMarin is responsible for all marketing and promotional efforts regarding the sale of ORAPRED®. As a result, Medicis no longer advertises and promotes any oral liquid prednisolone sodium phosphate solution product or any related line extension. During the term of the license agreement, Medicis will maintain ownership of the intellectual property and, consequently, will continue to amortize the related intangible assets. Payments received from BioMarin under the license agreement will be treated as contract revenue, which is included in net revenues in the condensed consolidated statements of income.

On January 12, 2005, BioMarin and the Company entered into amendments to the Securities Purchase Agreement and License Agreement entered into on May 18, 2004, a Convertible Promissory Note (Convertible Note) and a Settlement and Mutual Release Agreement (collectively the Agreements). Under the terms of the Agreements, transaction payments from BioMarin to Medicis previously totaling \$175 million were reduced to \$159 million. Beginning with license payments relating to ORAPRED® to be made by BioMarin after July 2005, license payments totaling \$93 million were reduced pro rata to \$88.4 million. Consideration to be received by Medicis from BioMarin in 2009 for the option relating to the purchase of all outstanding shares of Ascent Pediatrics were reduced from \$82 million to \$70.6 million. Medicis will take full financial responsibility for contingent payments due to former Ascent Pediatric shareholders without the \$5 million in offset payments that would have been paid by BioMarin to Medicis after July 1, 2005. Contingent payments are due to former Ascent Pediatric shareholders from Medicis only if revenue from Ascent Pediatric products exceeds certain thresholds. In addition, Medicis reimbursed BioMarin for actual returns, up to certain agreed-upon limits, of ORAPRED® finished goods received by BioMarin during the quarters ended December 31, 2004, March 31, 2005 and June 30, 2005.

Additionally, per the terms of the Agreements, Medicis has made available to BioMarin the ability to draw down on a Convertible Note up to \$25 million beginning July 1, 2005. The Convertible Note is convertible based on certain terms and conditions including a change of control provision. Money advanced under the Convertible Note is convertible into BioMarin shares at a strike price equal to the BioMarin average closing price for the 20 trading days prior to such advance. The Convertible Note matures on the option purchase date in 2009 as defined in the Securities Purchase Agreement but may be repaid by BioMarin at any time prior to the option purchase date. No monies have been advanced to-date. In conjunction with the Agreements, BioMarin and Medicis have entered into a settlement and Mutual Release Agreement to forever discharge each other from any and all claims, demands, damages, debts, liabilities, actions and causes of action relating to the transaction consummated by the parties other than certain continuing obligations in accordance with the terms of the parties agreements. As of September 30, 2005, BioMarin had paid \$72.1 million to Medicis under the license agreement, which represents all scheduled payments due through that date under the license agreement.

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On March 10, 2003, Medicis acquired all outstanding shares of HA North American Sales AB from Q-Med, a Swedish biotechnology/medical device company. HA North American Sales AB holds a license for the exclusive U.S. and Canadian rights to market, distribute and commercialize the dermal restorative product lines known as RESTYLANE®, PERLANE and RESTYLANE FINE LINES. RESTYLANE® has been approved by the FDA for use in the U.S. RESTYLANE®, PERLANE and RESTYLANE FINE LINES have been approved for use in Canada. Under terms of the agreements, a wholly owned subsidiary of Medicis acquired all outstanding shares of HA North American Sales AB for total consideration of approximately \$160.0 million, payable upon the successful completion of certain milestones or events. Medicis paid \$58.2 million upon closing of the transaction, \$53.3 million in December 2003 upon FDA approval of RESTYLANE®, \$19.4 million in May 2004 upon certain cumulative commercial milestones being achieved and will pay approximately \$29.1 million upon FDA approval of PERLANE. Payments and costs related to this acquisition are capitalized as an intangible asset and are amortized over 15 years beginning in March 2003.

8. MERGER OF ASCENT PEDIATRICS, INC.

As part of its merger with Ascent completed in November 2001, the Company may be required to make contingent purchase price payments (Contingent Payments) for each of the first five years following closing based upon reaching certain sales threshold milestones on the Ascent products for each twelve month period through November 15, 2006, subject to certain deductions and set-offs. From time to time the Company assesses the probability and likelihood of payment in the coming respective November period based on current sales trends. There can be no assurance that such payment will ultimately be made nor is the accrual of a liability an indication of current sales levels. A total of approximately \$27.4 million is included in short-term contract obligation in the Company's condensed consolidated balance sheets as of September 30, 2005, representing the first three years' Contingent Payments. Pursuant to the merger agreement, payment of the contingent portion of the purchase price will be withheld pending the final outcome of the litigation discussed in Part II of this Form 10-Q.

9. SEGMENT AND PRODUCT INFORMATION

The Company operates in one significant business segment: Pharmaceuticals. The Company's current pharmaceutical franchises are divided between the Dermatological and Non-dermatological fields. The Dermatological field represents products for the treatment of Acne and Acne-related dermatological conditions and Non-acne dermatological conditions. The Non-dermatological field represents products for the treatment of Urea Cycle Disorder and contract revenue. The Acne and Acne-related dermatological product lines include core brands DYNACIN®, PLEXION® and TRIAZ®. The Non-acne dermatological product lines include core brands LOPROX®, OMNICEF®, RESTYLANE® and VANOS. The Non-dermatological product lines include AMMONUL® and BUPHENYL®. The Non-dermatological field also includes contract revenues associated with licensing agreements and authorized generics.

The Company's pharmaceutical products, with the exception of AMMONUL® and BUPHENYL®, are promoted to dermatologists, podiatrists and plastic surgeons. Such products are often prescribed by physicians outside these three specialties; including family practitioners, general practitioners, primary-care physicians and OB/GYNs, as well as hospitals, government agencies and others. All products, with the exception of BUPHENYL®, are sold primarily to wholesalers and retail chain drug stores. BUPHENYL® is primarily sold directly to hospitals and pharmacies.

The percentage of net revenues for each of the product categories is as follows:

	THREE MONTHS ENDED SEPTEMBER 30, 2005		2004
Acne and acne-related dermatological products	33%		31%
Non-acne dermatological products	56		45
Non-dermatological products	11		24

Total net revenues

100%

100%

14

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The Company utilizes third parties to manufacture and package inventories held for sale, takes title to certain inventories once manufactured, and warehouses such goods until packaged for final distribution and sale. Inventories consist of salable products held at the Company's warehouses, as well as raw materials and components at the manufacturers' facilities, and are valued at the lower of cost or market using the first-in, first-out method. The Company provides valuation reserves for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions.

Inventories at September 30, 2005 and June 30, 2005 are as follows (amounts in thousands):

	September 30, 2005	June 30, 2005
Raw materials	\$ 4,829	\$ 5,283
Finished goods	15,867	16,518
Valuation reserve	(996)	(1,100)
Total inventories	\$ 19,700	\$ 20,701

11. CONTINGENT CONVERTIBLE SENIOR NOTES

In June 2002, the Company sold \$400.0 million aggregate principal amount of its 2.5% Contingent Convertible Notes Due 2032 (the "Old Notes") in private transactions. As discussed below, approximately \$230.8 million in principal amount of the Old Notes was exchanged for New Notes on August 14, 2003. The Old Notes bear interest at a rate of 2.5% per annum, which is payable on June 4 and December 4 of each year, beginning on December 4, 2002. The Company also agreed to pay contingent interest at a rate equal to 0.5% per annum during any six-month period, with the initial six-month period commencing June 4, 2007, if the average trading price of the Old Notes reaches certain thresholds. The Old Notes will mature on June 4, 2032.

The Company may redeem some or all of the Old Notes at any time on or after June 11, 2007, at a redemption price, payable in cash, of 100% of the principal amount of the Old Notes, plus accrued and unpaid interest, including contingent interest, if any. Holders of the Old Notes may require the Company to repurchase all or a portion of their Old Notes on June 4, 2007, 2012 and 2017; and upon a change in control, as defined in the indenture governing the Old Notes, at 100% of the principal amount of the Old Notes, plus accrued and unpaid interest to the date of the repurchase, payable in cash.

The Old Notes are convertible, at the holders' option, prior to the maturity date into shares of the Company's Class A common stock in the following circumstances:

during any quarter commencing after June 30, 2002, if the closing price of the Company's Class A common stock over a specified number of trading days during the previous quarter, including the last trading day of such quarter, is more than 110% of the conversion price of the Old Notes, or \$31.96. The Old Notes are initially convertible at a conversion price of \$29.05 per share, which is equal to a conversion rate of approximately 34.4234 shares per \$1,000 principal amount of Old Notes, subject to adjustment;

if the Company has called the Old Notes for redemption;

during the five trading day period immediately following any nine consecutive day trading period in which the trading price of the Old Notes per \$1,000 principal amount for each day of such period was less than 95% of the product of the closing sale price of the Company's Class A common stock on that day multiplied by the number of shares of the Company's Class A common stock issuable upon conversion of \$1,000 principal amount of the Old Notes; or

upon the occurrence of specified corporate transactions.

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The Old Notes, which are unsecured, do not contain any restrictions on the payment of dividends, the incurrence of additional indebtedness or the repurchase of the Company's securities and do not contain any financial covenants.

The Company incurred \$12.6 million of fees and other origination costs related to the issuance of the Old Notes. The Company is amortizing these costs over the five-year Put period, which runs through May 2007. The Put period runs from the date the Old Notes were issued to the date the Company may redeem some or all of the Old Notes.

On August 14, 2003, the Company exchanged approximately \$230.8 million in principal amount of its Old Notes for approximately \$283.9 million in principal amount of its 1.5% Contingent Convertible Senior Notes Due 2033 (the New Notes). Holders of Old Notes that accepted the Company's exchange offer received \$1,230 in principal amount of New Notes for each \$1,000 in principal amount of Old Notes. The terms of the New Notes are similar to the terms of the Old Notes, but have a different interest rate, conversion rate and maturity date. Holders of Old Notes that chose not to exchange continue to be subject to the terms of the Old Notes.

The New Notes bear interest at a rate of 1.5% per annum, which is payable on June 4 and December 4 of each year, beginning December 4, 2003. The Company will also pay contingent interest at a rate of 0.5% per annum during any six-month period, with the initial six-month period commencing June 4, 2008, if the average trading price of the New Notes reaches certain thresholds. The New Notes mature on June 4, 2033.

The Company may redeem some or all of the New Notes at any time on or after June 11, 2008, at a redemption price, payable in cash, of 100% of the principal amount of the New Notes, plus accrued and unpaid interest, including contingent interest, if any. Holders of the New Notes may require the Company to repurchase all or a portion of their New Notes on June 4, 2008, 2013 and 2018, and upon a change in control, as defined in the indenture governing the New Notes, at 100% of the principal amount of the New Notes, plus accrued and unpaid interest to the date of the repurchase, payable in cash.

The New Notes are convertible, at the holders' option, prior to the maturity date into shares of the Company's Class A common stock in the following circumstances:

during any quarter commencing after September 30, 2003, if the closing price of the Company's Class A common stock over a specified number of trading days during the previous quarter, including the last trading day of such quarter, is more than 120% of the conversion price of the New Notes, or \$46.51. The Notes are initially convertible at a conversion price of \$38.76 per share, which is equal to a conversion rate of approximately 25.7998 shares per \$1,000 principal amount of New Notes, subject to adjustment;

if the Company has called the New Notes for redemption;

during the five trading day period immediately following any nine consecutive day trading period in which the trading price of the New Notes per \$1,000 principal amount for each day of such period was less than 95% of the product of the closing sale price of the Company's Class A common stock on that day multiplied by the number of shares of the Company's Class A common stock issuable upon conversion of \$1,000 principal amount of the New Notes; or

upon the occurrence of specified corporate transactions.

The New Notes, which are unsecured, do not contain any restrictions on the incurrence of additional indebtedness or the repurchase of the Company's securities and do not contain any financial covenants. The New Notes require an adjustment to the conversion price if the cumulative aggregate of all current and prior dividend increases above \$0.025 per share would result in at least a one percent (1%) increase in the conversion price. This threshold has not been reached and no adjustment to the conversion price has been made.

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As a result of the exchange, the outstanding principal amounts of the Old Notes and the New Notes were \$169.2 million and \$283.9 million, respectively. Both the New Notes and Old Notes are reported in aggregate on the Company's condensed consolidated balance sheets. The Company incurred approximately \$5.1 million of fees and other origination costs related to the issuance of the New Notes. The Company is amortizing these costs over the five-year Put period, which runs through August 2008. The Put period runs from the date the New Notes were issued to the date the Company may redeem some or all of the New Notes.

During the quarters ended September 30, 2005, December 31, 2004, September 30, 2004, June 30, 2004, March 31, 2004 and December 31, 2003, the Old Notes met the criteria for the right of conversion into shares of the Company's Class A common stock. This right of conversion of the holders of Old Notes was triggered by the stock closing above \$31.96 on 20 of the last 30 trading days and the last trading day of the quarters ended September 30, 2005, December 31, 2004, September 30, 2004, June 30, 2004, March 31, 2004 and December 31, 2003. The holders of Old Notes have this conversion right only until December 31, 2005. During the quarters ended June 30, 2005 and March 31, 2005, the Old Notes did not meet the criteria for the right of conversion. At the end of all future quarters, the conversion rights will be reassessed in accordance with the bond indenture agreement to determine if the conversion trigger rights have been achieved. During the three months ended September 30, 2004 and March 31, 2004, outstanding principal amounts of \$2,000 and \$6,000 of Old Notes, respectively, were converted into shares of the Company's Class A common stock. As of November 8, 2005, no other Old Notes had been converted.

12. INCOME TAXES

Income taxes have been provided for using the liability method in accordance with Statement of Financial Accounting Standard No. 109, Accounting for Income Taxes. The provision for income taxes reflects management's estimate of the effective tax rate expected to be applicable for the full fiscal year. This estimate is re-evaluated by management each quarter based on the Company's estimated tax expense for the year.

At September 30, 2005, the Company has a federal net operating loss carryforward of approximately \$62.9 million that begins expiring in varying amounts in the years 2008 through 2021 if not previously utilized. The net operating loss carryforward was acquired in connection with the Company's merger with Ascent during fiscal 2002. As a result of the merger and related ownership change for Ascent, the annual utilization of the net operating loss carryforward is limited under Internal Revenue Code Section 382. Based upon this limitation, the Company estimates that approximately \$16.7 million of the \$62.9 million net operating loss carryforward will be realized. Accordingly, a valuation reserve has been recorded for the remaining net operating loss carryforward that is not expected to be realized.

At September 30, 2005, the Company had a research and experimentation credit carryforward of approximately \$1.3 million that begins expiring in varying amounts in the years 2008 through 2021 if not previously utilized. All of the research and experimentation credit carryforward was acquired in connection with the Company's merger with Ascent during fiscal 2002 and is subject to the limitation under Internal Revenue Code Section 383. As a result of this limitation, the Company does not expect to realize any of the research and experimentation credits acquired from Ascent. Accordingly, a valuation reserve of \$1.3 million has been established for the acquired research and experimentation credits.

As a result of the limitations described above, the Company recorded a deferred tax asset valuation allowance of \$17.5 million related to the net operating loss and research and experimentation credit carryforwards acquired in the merger with Ascent. Subsequent realization of loss and credit carryforwards in excess of the amounts estimated to be realized as of September 30, 2005 will be applied to reduce the valuation allowance and goodwill recorded in connection with the merger with Ascent.

The Company benefited from additional tax deductions available relating to the vesting of restricted stock and the exercise of employee stock options. Accordingly, the Company recorded a \$0.1 million increase to equity with a corresponding \$0.1 million reduction in taxes payable for the three months ended September 30, 2005. Quarterly adjustments for the tax deductions relating to share-based payments may vary as they relate to the actions of the option holder or shareholder.

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13. STOCK TRANSACTIONS

During September 2004, all 758,032 shares of the Company's Class B common stock were exchanged for 758,032 shares of the Company's Class A common stock. As of September 30, 2005, there were no shares of Class B common stock outstanding.

During the three months ended September 30, 2004, Medicis purchased 1,743,800 shares of its Class A common stock in the open market at an average price of \$37.76 per share. These stock purchases were made in accordance with a stock repurchase program that was approved by the Company's Board of Directors in August 2004. This program provided for the repurchase of up to \$150 million of Class A common stock at such times as management determined. As of September 30, 2005, the Company had repurchased a total of approximately \$150.0 million of Class A common stock pursuant to this program, all during the six months ended December 31, 2004. As the purchase limit had been reached, the plan was terminated. During the three months ended September 30, 2005, Medicis did not purchase any of its shares of Class A common stock. The timing and amount of any future repurchases will depend on market conditions and corporate considerations.

14. DIVIDENDS DECLARED ON COMMON STOCK

On September 14, 2005, the Company declared a cash dividend of \$0.03 per issued and outstanding share of its Class A common stock payable on October 31, 2005 to stockholders of record at the close of business on October 3, 2005. The \$1.7 million dividend was recorded as a reduction of accumulated earnings and is included in other current liabilities in the accompanying condensed consolidated balance sheets as of September 30, 2005.

15. COMPREHENSIVE INCOME

Total comprehensive income includes net income and other comprehensive income, which consists of foreign currency translation adjustments and unrealized gains and losses on available-for-sale investments. Total comprehensive income for the three months ended September 30, 2005 was \$13.2 million. Total comprehensive income for the three months ended September 30, 2004 was \$2.2 million.

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The following table sets forth the computation of basic and diluted net income per common share (in thousands, except per share amounts):

	Three Months Ended September 30,	
	2005	2004
BASIC		
Net income	\$ 12,460	\$ 1,023
Weighted average number of common shares outstanding	54,310	57,228
Basic net income per common share	\$ 0.23	\$ 0.02
DILUTED		
Net income	\$ 12,460	\$ 1,023
Add:		
Tax-effected interest expense and issue costs related to Old Notes	841	839
Tax-effected interest expense and issue costs related to New Notes	839	838
Net income assuming dilution	\$ 14,140	\$ 2,700
Weighted average number of common shares	54,310	57,228
Effect of dilutive securities:		
Old Notes	5,823	
New Notes	7,325	
Stock options and restricted stock	2,392	3,040
Weighted average number of common Shares assuming dilution	69,850	60,268
Diluted net income per common share	\$ 0.20	\$ 0.02

Diluted net income per common share must be calculated using the if-converted method in accordance with EITF 04-8, Effect of Contingently Convertible Debt on Earnings per Share. Diluted net income per share is calculated by adjusting net income for tax-effected net interest and issue costs on the Old Notes and New Notes, divided by the weighted average number of common shares outstanding assuming conversion. Prior year results have been restated to conform to EITF 04-8.

The diluted net income per common share computation for the three months ended September 30, 2005 excludes 5,501,851 shares of stock that represented outstanding stock options that were anti-dilutive.

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The diluted net income per common share computation for the three months ended September 30, 2004 excludes 2,183,362 shares of stock that represented outstanding stock options that were anti-dilutive. Diluted net income per common share for the three months ended September 30, 2004 also excludes 5,822,960 and 7,324,820 shares of Class A common stock, respectively, issuable upon conversion of the Old Notes and New Notes, as they were anti-dilutive.

17. SUBSEQUENT EVENT

On October 31, 2005, the Company made a development milestone payment of approximately \$8.0 million to Dow Pharmaceutical Sciences, Inc. (Dow) under an amended development and license agreement for the development and commercialization of a patented dermatologic product. This payment will be recorded as a charge to research and development expense during the three months ended December 31, 2005.

18. CONTINGENCIES

The Company and certain of its subsidiaries are parties to actions and proceedings incident to their businesses, including litigation regarding its intellectual property, challenges to the enforceability or validity of its intellectual property and claims that its products infringe on the intellectual property rights of others. Although the outcome of these actions is not presently determinable, it is the opinion of the Company's management, based upon the information available at this time, the litigation is either covered by insurance and/or established reserves, or in some cases rights of offset and/or indemnification, and that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the results of operations or financial condition of the Company.

19. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In October 2004, the FASB ratified the consensus reached by the EITF on Issue 04-1, *Accounting for Preexisting Relationships between the Parties to a Business Combination*, EITF No. 04-1 requires that a business combination between two parties that have a preexisting relationship be evaluated to determine if a settlement of a preexisting relationship exists. EITF No. 04-1 also requires that certain reacquired rights (including the rights to the acquirer's trade name under a franchise agreement) be recognized as intangible assets apart from goodwill. However, if a contract giving rise to the reacquired rights includes terms that are favorable or unfavorable when compared to pricing for current market transactions for the same or similar items, EITF No. 04-1 requires that a settlement gain or loss should be measured as the lesser of a) the amount by which the contract is favorable or unfavorable under market terms from the perspective of the acquirer or b) the stated settlement provisions of the contract available to the counterparty to which the contract is unfavorable.

EITF No. 04-1 is effective prospectively for business combinations consummated in reporting periods beginning after October 13, 2004. EITF No. 04-1 will apply to the merger with Inamed. The amount and timing of any such gains or losses the Company might record is dependent upon what the Company acquires and when the merger is consummated. The Company currently expects to record a charge of \$16.5 million related to the settlement of certain litigation with Inamed.

In October 2005, the FASB issued FASB Staff Position (FSP) No. 123R-2, *Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123R*, to provide guidance on determining the grant date for an award as defined in SFAS No. 123R. This FSP stipulates that assuming all other criteria in the grant date definition are met, a mutual understanding of the key terms and conditions of an award to an individual employee is presumed to exist upon the award's approval in accordance with the relevant corporate governance requirements, provided that the key terms and conditions of an award (a) cannot be negotiated by the recipient with the employer because the award is a unilateral grant, and (b) are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. The Company has applied the principles set forth in this FSP upon its adoption of SFAS No. 123R.

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

EXECUTIVE SUMMARY

We are a leading specialty pharmaceutical company focusing primarily on helping patients attain a healthy and youthful appearance and self-image through the development and marketing of products in the U.S. for the treatment of dermatological, aesthetic and podiatric conditions. We also market products in Canada for the treatment of dermatological and aesthetic conditions. We offer a broad range of products addressing various conditions or aesthetics improvements, including dermal fillers, acne, fungal infections, rosacea, hyperpigmentation, photoaging, psoriasis, eczema, skin and skin-structure infections, seborrheic dermatitis and cosmesis (improvement in the texture and appearance of skin).

Our current product lines are divided between the Dermatological and Non-dermatological fields. The Dermatological field represents products for the treatment of Acne and Acne-related dermatological conditions and Non-acne dermatological conditions. The Non-dermatological field represents products for the treatment of Urea Cycle Disorder and contract revenue. Our Acne and Acne-related dermatological product lines include core brands DYNACIN[®], PLEXION[®] and TRIAZ[®]. Our Non-acne dermatological product lines include core brands LOPROX[®], OMNICEF[®], RESTYLANE[®] and VANOS. The Non-dermatological product lines include AMMONUL[®] and BUPHENYL[®]. Our Non-dermatological field also includes contract revenues associated with licensing agreements and authorized generic agreements.

Key Aspects of Our Business

We derive a majority of our prescription volume from our core prescription products. We believe that sales of our core prescription products and sales of our dermal aesthetic product, RESTYLANE[®], which we began selling in the U.S. on January 6, 2004, will continue to constitute a significant portion of our sales for the foreseeable future.

We have built our business by executing a four-part growth strategy. This strategy consists of promoting existing core brands, developing new products and important product line extensions, entering into strategic collaborations and acquiring complementary products, technologies and businesses.

As a result of customer buying patterns, a substantial portion of our revenues has been recognized in the last month of each quarter. We schedule our inventory purchases to meet anticipated customer demand. As a result, relatively small delays in the receipt of manufactured products by us could result in revenues being deferred or lost. Our operating expenses are based upon anticipated sales levels, and a high percentage of our operating expenses are relatively fixed in the short term. Consequently, variations in the timing of revenue recognition could cause significant fluctuations in operating results from period to period and may result in unanticipated periodic earnings shortfalls or losses.

We estimate customer demand for our prescription products primarily through use of third party syndicated data sources which track prescriptions written by health care providers and dispensed by licensed pharmacies. The data represents extrapolations from information provided only by certain pharmacies and are estimates of historical demand levels. We estimate customer demand for our non-prescription products primarily through internal data that we compile. We observe trends from these data, and, coupled with certain proprietary information, prepare demand forecasts that are the basis for purchase orders for finished and component inventory from our third party manufacturers and suppliers. Our forecasts may fail to accurately anticipate ultimate customer demand for products. Overestimates of demand may result in excessive inventory production; underestimates may result in inadequate supply of our products in channels of distribution.

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We sell our products primarily to major wholesalers and retail pharmacy chains. Consistent with pharmaceutical industry patterns, approximately 80% of our revenues are derived from three major drug wholesale concerns. While we attempt to estimate inventory levels of our products at our major wholesale customers, using historical prescription information and historical purchase patterns, this process is inherently imprecise. Rarely do wholesale customers provide us complete inventory levels at regional distribution centers, or within their national distribution systems. We rely wholly upon our wholesale and drug chain customers to effect the distribution allocation of our products. Based upon historically consistent purchasing patterns of our major wholesale customers, we believe our estimates of trade inventory levels of our products are reasonable. We further believe that inventories of our products among wholesale customers, taken as a whole, are similar to those of other specialty pharmaceutical companies, and that our trade practices, which periodically involve volume discounts and early payment discounts, are typical of the industry.

We periodically offer promotions to wholesale and chain drugstore customers to encourage dispensing of our products, consistent with prescriptions written by licensed health care providers. Because many of our products compete in multi-source markets, it is important for us to ensure the licensed health care providers' dispensing instructions are fulfilled with our branded products and are not substituted with a generic product or another therapeutic alternative product which may be contrary to the licensed health care providers' recommended and prescribed Medicis brand. We believe that a critical component of our brand protection program is maintenance of full product availability at drugstore and wholesale customers. We believe such availability reduces the probability of local and regional product substitutions, shortages and backorders, which could result in lost sales. We expect to continue providing favorable terms to wholesale and retail drug chain customers as may be necessary to ensure the fullest possible distribution of our branded products within the pharmaceutical chain of commerce.

We cannot control or significantly influence the purchasing patterns of our wholesale and retail drug chain customers. They are highly sophisticated customers that purchase products in a manner consistent with their industry practices and, presumably, based upon their projected demand levels. Purchases by any given customer, during any given period, may be above or below actual prescription volumes of any of our products during the same period, resulting in fluctuations of product inventory in the distribution channel.

As described in more detail below, the following significant events and transactions occurred during the three months ended September 30, 2005 and affected our results of operations, our cash flows and our financial condition: costs incurred related to the pending merger with Inamed; and

adoption of SFAS No. 123R.

Costs Incurred Related to the Pending Merger with Inamed

On March 20, 2005, Medicis, Masterpiece Acquisition Corp. (a wholly-owned subsidiary of Medicis), and Inamed entered into an Agreement and Plan of Merger. Inamed is a global healthcare company that develops, manufactures, and markets a diverse line of products that enhance the quality of people's lives. These products include breast implants for aesthetic augmentation and reconstructive surgery following a mastectomy, a range of dermal products to correct facial wrinkles, the BioEnterics® LAP-BAND® System designed to treat severe and morbid obesity, and the BioEnterics® IntraGastric Balloon (BIB®) system for the treatment of obesity. Inamed's common stock trades on the NASDAQ National Market under the symbol IMDC.

Under the terms of the Agreement and Plan of Merger, Inamed will merge with and into Masterpiece Acquisition Corp. and each share of Inamed common stock will be converted into the right to receive 1.4205 shares of Medicis common stock and \$30.00 in cash. The completion of the transaction is subject to several customary conditions, including the receipt of applicable approvals from Medicis' and Inamed's stockholders, the absence of any material adverse effect on either party's business and the receipt of regulatory approvals. The Agreement and Plan of Merger was filed with the Securities and Exchange Commission (SEC) by the Company as part of an 8-K filed on March 21, 2005.

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We have incurred approximately \$11.4 million of professional and other costs related to the transaction, including approximately \$2.8 million of such costs during the three months ended September 30, 2005. The costs are included in other long-term assets in the accompanying condensed consolidated balance sheets. Business integration costs related to the transaction, including the planning for and implementation of integration activities are being expensed as incurred. During the first quarter of fiscal 2006, we incurred approximately \$0.7 million of business integration planning costs, which are included in selling, general and administrative expenses in the accompanying condensed consolidated statements of income. We anticipate that we will continue to incur significant costs related to this transaction prior to and after closing.

The discussions in this report relate to Medicis as a stand-alone entity and do not include or reflect the operating results of Inamed or the impact of the proposed merger with Inamed following the closing of the transaction.

Adoption of SFAS No. 123R

During December 2004, the FASB issued SFAS No. 123R, which requires companies to measure and recognize compensation expense for all share-based payments at fair value. Share-based payments include stock option and nonvested share grants. We grant options to purchase common stock to some of our employees and directors under various plans at prices equal to the market value of the stock on the dates the options were granted. We historically have accounted for stock options using the method prescribed in Accounting Principals Board Opinion No. 25,

Accounting for Stock Issued to Employees, (APB Opinion No. 25) whereby stock options are granted at market price and no compensation cost is recognized, and disclosed the pro forma effect on net earnings assuming compensation cost had been recognized in accordance with SFAS No. 123. SFAS No. 123R, which was effective for us beginning in the first quarter of fiscal year 2006, eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, and generally requires that such transactions be accounted for using prescribed fair-value-based methods. SFAS No. 123R permits public companies to adopt its requirements using one of two methods: (a) a modified prospective method in which compensation costs are recognized beginning with the effective date based on the requirements of SFAS No. 123R for all share-based payments granted or modified after the effective date, and based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date or (b) a modified retrospective method which includes the requirements of the modified prospective method described above, but also permits companies to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either for all periods presented or prior interim periods of the year of adoption. We have decided to adopt SFAS No. 123R using the modified prospective method. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under historical literature.

During the three months ended September 30, 2005, we recognized approximately \$7.7 million of compensation expense related to the expensing of stock options and restricted stock in accordance with SFAS No. 123R. Approximately \$7.2 million and \$0.5 million of this amount is included in selling, general and administrative expenses and research and development expenses, respectively, in the accompanying condensed consolidated statements of income.

Table of Contents**RESULTS OF OPERATIONS**

The following table sets forth certain data as a percentage of net revenues for the periods indicated.

	THREE MONTHS ENDED	
	SEPTEMBER	SEPTEMBER
	30,	30,
	2005	2004
Net revenues	100.0%	100.0%
Gross profit	85.6	84.4
Operating expenses	63.5**	83.0*
Operating income	22.1	1.4
Interest income (expense), net	1.7	(0.1)
Income before income tax expense	23.8	1.3
Income tax expense	(8.8)	(0.1)
Net income	15.0%	1.2%

* Included in operating expenses is \$30.7 million (34.6% of net revenues) related to our exclusive license agreement with Q-Med for the development of SubQ™ and \$0.1 million (0.1% of net revenues) of compensation expense related to restricted stock.

** Included in operating expenses is \$7.7 million (9.2% of net revenues) of compensation expense related to stock options and restricted stock, and \$0.7 million (0.8% of net revenues) of business integration planning costs related to the proposed merger with Inamed.

Three Months Ended September 30, 2005 Compared to the Three Months Ended September 30, 2004**Net Revenues**

The following table sets forth the net revenues for the three months ended September 30, 2005 (the first quarter of fiscal 2006) and September 30, 2004 (the first quarter of fiscal 2005), along with the percentage of net revenues for each of our product categories (dollar amounts in millions):

	First Quarter	First Quarter	\$	%
	Fiscal 2006	Fiscal 2005	Change	Change
Net product revenues	\$ 79.4	\$ 72.1	\$ 7.3	10.1%
Net contract revenues	\$ 3.9	\$ 16.7	\$ (12.8)	(76.9)%
Net revenues	\$ 83.3	\$ 88.8	\$ (5.5)	(6.3)%

	First Quarter	First Quarter	Change
	Fiscal 2006	Fiscal 2005	
Acne and acne-related dermatological products	32.6%	31.3%	1.3%
Non-acne dermatological products	56.2%	44.7%	11.5%
Non-dermatological products	11.2%	24.0%	(12.8)%
Total net revenues	100.0%	100.0%	

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Our total net revenues decreased during the first quarter of fiscal 2006 primarily as a result of a decrease in net contract revenues associated with licensing agreements and authorized generic agreements. Net contract revenues decreased primarily due to a decrease in contract revenues during the first quarter of fiscal 2006 related to our outlicensing of the ORAPRED® brand pursuant to the terms of our license agreement with BioMarin. Core brand revenues, which are included in net product revenues and includes revenues associated with RESTYLANE®, DYNACIN®, LOPROX®, OMNICEF®, PLEXION®, TRIAZ® and VANOS, represented approximately \$71.8 million, or approximately 86.2% of net revenues, during the first quarter of fiscal 2006, an increase of approximately 7.2%, compared to core brand revenues of approximately \$67.0 million, or approximately 75.4% of net revenues, for the first quarter of fiscal 2005. Net revenues associated with our acne and acne-related dermatological products increased slightly as a percentage of net revenues during the first quarter of fiscal 2006, and was consistent in net dollars with the net revenues recognized during the first quarter of fiscal 2005. Net revenues associated with our non-acne dermatological products increased as a percentage of net revenues, and increased in net dollars by 18.0% during the first quarter of fiscal 2006, primarily due to an increase in sales of RESTYLANE®. Net revenues associated with our non-dermatological products decreased as a percentage of net revenues primarily due to the decrease in contract revenues discussed above.

Gross Profit

Gross profit represents our net revenues less our cost of product revenue. Our cost of product revenue includes our acquisition cost for the products we purchase from our third party manufacturers and royalty payments made to third parties. Amortization of intangible assets related to acquired products is not included in gross profit. Amortization expense related to these intangible assets for the first quarter of fiscal 2006 and 2005 was approximately \$5.6 million and \$4.4 million, respectively. Product sales mix plays a significant role in our quarterly and annual gross profit as a percentage of net revenues. Different products generate different gross profit margins, and the relative sales mix of higher gross profit products and lower gross profit products can affect our total gross profit.

The following table sets forth our gross profit for the first quarter of fiscal 2006 and 2005, along with the percentage of net revenues represented by such gross profit (dollar amounts in millions):

	First Quarter	First Quarter		%
	Fiscal 2006	Fiscal 2005	\$Change	Change
Gross profit	\$ 71.2	\$ 75.0	\$ (3.8)	(5.0)%
% of net revenues	85.6%	84.4%		

The decrease in gross profit during the first quarter of fiscal 2006, compared to the first quarter of fiscal 2005 was due to the decrease in our net revenues. The increase in gross profit as a percentage of net revenues was primarily due to the different sales mix of products sold during the first quarter of fiscal 2006, compared to during the first quarter of fiscal 2005.

Selling, General and Administrative Expenses

The following table sets forth our selling, general and administrative expenses for the first quarter of fiscal 2006 and 2005, along with the percentage of net revenues represented by selling, general and administrative expenses (dollar amounts in millions):

	First Quarter	First Quarter	\$	%
	Fiscal 2006	Fiscal 2005	Change	Change
Selling, general and administrative	\$ 41.5	\$ 32.9	\$ 8.6	26.0%
% of net revenues	49.8%	37.1%		
Share-based compensation expense included in selling, general and administrative	\$ 7.2	\$ 0.1	\$ 7.1	5,479.7%

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The increase in selling, general and administrative expenses from the first quarter of fiscal 2005 to the first quarter of fiscal 2006 was attributable to approximately \$7.1 million of additional share-based compensation expense recognized upon our adoption of SFAS No. 123R, approximately \$0.7 million of business integration planning costs related to the proposed merger with Inamed, and \$1.5 million of additional selling, general and administrative expenses incurred during the first quarter of fiscal 2006, partially offset by approximately \$0.7 million of professional fees related to a research and development collaboration with Q-Med for the development of SubQ™ incurred during the first quarter of fiscal 2005.

Research and Development Expenses

The following table sets forth our research and development expenses for the first quarter of fiscal 2006 and 2005 (dollars amounts in millions):

	First Quarter Fiscal 2006	First Quarter Fiscal 2005	\$ Change	% Change
Research and development	\$ 5.1	\$ 35.8	\$ (30.7)	(85.9)%
Charges included in research and development		30.0	(30.0)	(100.0)%
Share-based compensation expense included in research and development	\$ 0.5		\$ 0.5	100.0%

The decrease in research and development expenses from the first quarter of fiscal 2005 to the first quarter of fiscal 2006 was attributable to a \$30.0 million research and development payment related to a license agreement with Q-Med for the development of SubQ™ incurred during the first quarter of fiscal 2005, \$0.5 million of compensation expense for stock options and restricted stock recognized upon our adoption of SFAS No. 123R incurred during the first quarter of fiscal 2006, and \$1.2 million related to the timing of various research and development projects. We expect research and development expenses to fluctuate from quarter to quarter based on the timing of the achievement of development milestones under license and development agreements, as well as the timing of other development projects and the funds available to support these projects.

Depreciation and Amortization Expenses

Depreciation and amortization expenses during the first quarter of fiscal 2006 increased \$1.3 million, or 25.3%, to \$6.3 million from \$5.0 million during the first quarter of fiscal 2005. This increase was primarily due to increased amortization that began during the third quarter of fiscal 2005 related to certain intangible assets whose useful lives were determined to be shorter than originally estimated.

Interest Income

Interest income during the first quarter of fiscal 2006 increased \$1.6 million, or 63.3%, to \$4.1 million from \$2.5 million during the first quarter of fiscal 2005, primarily due to an increase in the interest rates achieved by our invested funds during the first quarter of fiscal 2006.

Interest Expense

Interest expense during the first quarter of fiscal 2006 remained consistent with the first quarter of fiscal 2005, at \$2.7 million. Our interest expense during the first quarter of fiscal 2006 and 2005 consisted of interest expense on our Old Notes, which accrue interest at 2.5% per annum, our New Notes, which accrue interest at 1.5% per annum, and amortization of fees and other origination costs related to the issuance of the Old Notes and New Notes. See Note 11 in our accompanying condensed consolidated financial statements for further discussion on the Old Notes and New Notes.

Table of Contents**Income Tax Expense**

The following table sets forth our income tax expense and the resulting effective tax rate stated as a percentage of pre-tax income for the first quarters of fiscal 2006 and 2005 (dollar amounts in millions):

	First Quarter Fiscal 2006	First Quarter Fiscal 2005	\$ Change	% Change
Income tax expense	\$ 7.4	\$ 0.1	\$ 7.3	7,676.9%
Effective tax rate	37.2%	8.5%		

Income taxes are determined using an annual effective tax rate, which generally differs from the U.S. Federal statutory rate, primarily because of state and local income taxes, tax-exempt interest, charitable contribution deductions and research and development tax credits available in the U.S.. Our effective tax rate may be subject to fluctuations during the fiscal year as new information is obtained which may affect the assumptions we use to estimate our annual effective tax rate, including factors such as our mix of pre-tax earnings in the various tax jurisdictions in which we operate, valuation allowances against deferred tax assets, reserves for tax audit issues and settlements, utilization of research and development tax credits and changes in tax laws in jurisdictions where we conduct operations. We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities. We record valuation allowances against our deferred tax assets to reduce the net carrying value to an amount that management believes is more likely than not to be realized.

Income tax expense during the first quarter of fiscal 2006 increased 7,676.9%, or \$7.3 million, to \$7.4 million, from income tax expense of \$0.1 million in the first quarter of fiscal 2005. The increase in income tax expense was primarily due to the increase in our pre-tax income for the same period. The provision for income taxes reflects management's estimate of the effective tax rate expected to be applicable for the full fiscal year. Based on information currently available, we believe that our fiscal 2006 rate will be approximately 37%. The estimate of our fiscal 2006 effective tax rate is higher than our fiscal 2005 effective tax rate of 34.4% primarily due to: (i) the statutory expiration of the U.S. research and development tax credit on December 31, 2005, (ii) higher income taxes in foreign jurisdictions in which we operate, (iii) an increase in the relative weighting of taxable interest income in our mix of taxable and tax-exempt interest income and (iv) the adoption of SFAS No. 123R which precludes the recognition of tax benefits relating to the expensing of share based awards that are not ordinarily designed to result in a tax deduction.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES****Overview**

The following table highlights selected cash flow components for the first quarters of fiscal 2006 and 2005, and selected balance sheet components as of September 30, 2005 and June 30, 2005 (dollar amounts in millions):

	First Quarter	First Quarter	\$	%
	Fiscal 2006	Fiscal 2005	Change	Change
Cash provided by (used in):				
Operating activities	\$ 28.1	\$ 13.9	\$ 14.2	101.8%
Investing activities	45.7	96.5	(50.8)	(52.6)%
Financing activities	(1.5)	(59.1)	57.6	97.5%
	Sept. 30, 2005	June 30, 2005	\$	%
			Change	Change
Cash, cash equivalents and short-term investments	\$ 628.4	\$ 603.6	\$ 24.8	4.1%
Working capital	625.4	600.1	25.3	4.2%
2.5% contingent convertible senior notes due 2032	169.2	169.2		
1.5% contingent convertible senior notes due 2033	283.9	283.9		

Working Capital

Working capital as of September 30, 2005 and June 30, 2005 consisted of the following (dollar amounts in millions):

	Sept. 30, 2005	June 30, 2005	\$	%
			Change	Change
Cash, cash equivalents and short-term investments	\$ 628.4	\$ 603.6	\$ 24.8	4.1%
Accounts receivable, net	43.3	47.2	(3.9)	(8.2)%
Inventories, net	19.7	20.7		