PharMerica CORP
Form 10-Q
October 30, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2008

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______.

Commission File Number: 001-33380

PHARMERICA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**87-0792558**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
1901 Campus Place	
Louisville, KY	**40299**

(Address of principal executive offices) **(Zip Code)**

(502) 627-7000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer ¨ Accelerated filer ¨

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

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

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

Class of Common Stock	Outstanding at October 24, 2008
Common stock, $0.01 par value	30,465,451 shares

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PHARMERICA CORPORATION

FORM 10-Q

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three and Nine months Ended September 30, 2007 and 2008

(Unaudited)

(In millions, except share and per share amounts)

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2008
Revenues	$ 377.5	$ 486.2	$ 725.6	$ 1,467.6
Cost of goods sold	321.1	415.9	626.9	1,254.0
Gross profit	56.4	70.3	98.7	213.6
Selling, general and administrative expenses	46.8	50.5	81.2	161.8
Amortization expense	1.4	1.6	3.4	4.8
Integration, merger related costs and other charges (See Note 8)	46.8	7.1	52.5	17.8
Operating income (loss)	(38.6)	11.1	(38.4)	29.2
Interest expense, net	3.1	3.4	3.1	10.6
Income (loss) before income taxes	(41.7)	7.7	(41.5)	18.6
Provision (benefit) for income taxes	(14.7)	3.4	(14.6)	8.1
Net income (loss)	$ (27.0)	$ 4.3	$ (26.9)	$ 10.5
Earnings (loss) per common share:				
Basic	$ (1.07)	$ 0.14	$ (1.46)	$ 0.35
Diluted	$ (1.07)	$ 0.14	$ (1.46)	$ 0.35
Shares used in computing earnings per common share:				
Basic	25,112,843	30,105,157	18,407,991	30,081,596
Diluted	25,112,843	30,391,484	18,407,991	30,195,009

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

As of December 31, 2007 and September 30, 2008

(Unaudited)

(In millions, except share and per share amounts)

	December 31, 2007	September 30, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 32.0	$ 42.6
Accounts receivable, net	213.0	220.8
Inventories	77.9	77.9
Deferred tax assets	27.1	28.2
Prepaids and other assets	19.5	14.6
	369.5	384.1
Equipment and leasehold improvements	87.4	99.9
Accumulated depreciation	(30.0)	(42.1)
	57.4	57.8
Deferred tax assets	58.8	51.9
Goodwill	111.3	110.7
Intangible assets, net	77.5	72.7
Other	5.6	6.9
	$ 680.1	$ 684.1
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 51.5	$ 54.2
Salaries, wages and other compensation	40.5	37.3
Other accrued liabilities	8.9	11.5
	100.9	103.0
Long-term debt	250.0	240.0
Other long term liabilities	15.6	16.8
Commitments and contingencies (See Note 6)		
Minority interest	4.4	-
Stockholders equity:		
Preferred stock, $0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2007 and September 30, 2008	-	-
Common stock, $0.01 par value per share; 175,000,000 shares authorized; 30,360,612 shares issued and outstanding, December 31, 2007 and 30,462,251 shares issued and outstanding, September 30, 2008	0.3	0.3
Capital in excess of par value	332.9	337.1
Accumulated other comprehensive loss	(2.6)	(2.2)
Retained deficit	(21.4)	(10.9)
	309.2	324.3

	$	680.1	$	684.1

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three and Nine Months Ended September 30, 2007 and 2008

(Unaudited)

(In millions)

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2008
Cash flows provided by operating activities:				
Net income (loss)	$ (27.0)	$ 4.3	$ (26.9)	$ 10.5
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation	4.5	5.3	8.0	16.8
Amortization	1.4	1.6	3.4	4.8
Provision for bad debt	6.3	7.2	10.7	17.9
Integration, merger related costs and other charges	34.7	0.6	34.7	1.5
Stock-based compensation	0.4	1.4	0.6	3.5
Amortization of deferred financing fees	0.1	0.1	0.1	0.3
Deferred income taxes	(19.6)	2.8	(22.7)	6.9
Loss on disposition of equipment	0.8	0.2	0.9	0.8
Other	0.4	(0.3)	(0.4)	(0.3)
Change in operating assets and liabilities:				
Accounts receivable	(7.5)	(12.0)	(28.3)	(26.6)
Inventories and other assets	(1.8)	(1.6)	(0.4)	-
Prepaids and other assets	(7.1)	0.1	(8.2)	4.5
Accounts payable	21.7	8.1	27.3	1.9
Salaries, wages and other compensation	6.4	0.9	7.5	(1.6)
Other accrued liabilities	6.4	(1.2)	6.8	0.8
Net cash provided by operating activities	20.1	17.5	13.1	41.7
Cash flows used in investing activities:				
Purchase of equipment and leasehold improvements	(11.2)	(6.0)	(14.5)	(17.8)
Acquisitions	(3.9)	(4.4)	(4.8)	(4.4)
Cash proceeds from sale of assets	-	0.1	-	0.3
Other	-	-	0.3	-
Net cash used in investing activities	(15.1)	(10.3)	(19.0)	(21.9)
Cash flows provided by (used in) financing activities:				
Proceeds from long-term revolving credit facility	20.0	-	20.0	-
Repayments of long-term revolving credit facility	(20.0)	-	(20.0)	-
Proceeds from long-term debt	275.0	-	275.0	-
Repayments of long-term debt	(10.0)	-	(10.0)	(10.0)
Proceeds from spin-co loan	125.0	-	125.0	-
Repayment of spin-co loan	(250.0)	-	(250.0)	-
Payment of debt issuance costs	(2.0)	-	(2.0)	-
Dividends	(125.0)	-	(125.0)	-
Net contributions from Former Parent	8.0	-	17.3	-
Cash contributions received from minority shareholders	0.5	-	1.6	0.1
Issuance of common stock	-	0.5	-	0.7
Net cash provided by (used in) financing activities	21.5	0.5	31.9	(9.2)

Change in cash and cash equivalents	26.5	7.7	26.0	10.6
Cash and cash equivalents at beginning of period	3.2	34.9	3.7	32.0
Cash and cash equivalents at end of period	$ 29.7	$ 42.6	$ 29.7	$ 42.6
Supplemental information:				
Transfers of property and equipment from Former Parent	$ 4.9	$ -	$ 10.4	$ -
Cash paid for interest	$ 0.9	$ 3.6	$ 0.9	$ 11.1
Cash paid for taxes	$ -	$ 0.5	$ 0.7	$ 1.4
Supplemental schedule of non-cash activities:				
Fair value of assets acquired	$ 320.9	$ -	$ 320.9	$ (1.4)
Fair value of liabilities assumed or incurred	$ 174.1	$ -	$ 174.1	$ (1.4)
Stock issued and cash paid	$ 251.4	$ -	$ 251.4	$ -

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the Period Ended September 30, 2008

(Unaudited)

(In millions, except share amounts)

	Common Stock		Capital in Excess of Par Value	Accumulated Other Comprehensive Loss	Retained Deficit	Total
	Shares	Amount				
Balance at December 31, 2007	30,360,612	$ 0.3	$ 332.9	$ (2.6)	$ (21.4)	$ 309.2
Comprehensive income:						
Net income	-	-	-	-	10.5	10.5
Change in fair value of interest rate swap, net	-	-	-	0.4	-	0.4
Total comprehensive income	-	-	-	0.4	10.5	10.9
Grant and forfeiture of non-vested restricted stock	49,190	-	0.1	-	-	0.1
Exercise of stock options	52,449	-	0.6	-	-	0.6
Stock-based compensation - restricted stock	-	-	1.8	-	-	1.8
Stock-based compensation - stock options	-	-	1.7	-	-	1.7
Balance at September 30, 2008	30,462,251	$ 0.3	$ 337.1	$ (2.2)	$ (10.9)	$ 324.3

See accompanying Notes to Condensed Consolidated Financial Statements

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

PharMerica Corporation (the Corporation) is an institutional pharmacy services company, which services healthcare facilities and provides management pharmacy services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States. The Corporation operates over 100 institutional pharmacies in 40 states. The Corporation s customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 85 hospitals in the United States.

Pharmacy Transaction

The Corporation, formerly known as Safari Holding Corporation, was formed on October 23, 2006 by Kindred Healthcare, Inc. (Kindred or Former Parent) and AmerisourceBergen Corporation (AmerisourceBergen) for the purpose of consummating the transactions contemplated by the Master Transaction Agreement dated October 25, 2006, as amended (the Master Agreement). Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through a series of transactions (collectively, the Pharmacy Transaction), spun-off and combined their respective institutional pharmacy businesses, Kindred Pharmacy Services (KPS) and PharMerica Long-Term Care (PharMerica LTC), into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007 (the Closing Date).

The shares of common stock of the Corporation were registered with the Securities and Exchange Commission (the Commission) on Form S-4/S-1, which was declared effective by the Commission on July 17, 2007 (the Form S-4/S-1).

On August 1, 2007, the Corporation s common stock began trading on the New York Stock Exchange under the symbol PMC. Under the terms of the Pharmacy Transaction, on the Closing Date, each of KPS and PharMerica LTC borrowed $125.0 million as mutually agreed upon by Kindred and AmerisourceBergen and used such proceeds to fund a one-time, tax-free cash distribution in that amount to their respective parent companies. Following the cash distributions, Kindred spun off to its stockholders all of the outstanding stock of KPS and AmerisourceBergen spun off to its stockholders all of the outstanding stock of PharMerica LTC. Immediately thereafter, separate wholly owned subsidiaries of the Corporation were merged with and into KPS and PharMerica LTC with KPS and PharMerica LTC as the surviving entities of the mergers, and, as a result, KPS and PharMerica LTC became wholly owned subsidiaries of the Corporation. In the mergers, each Kindred stockholder received approximately 0.366 shares of the Corporation s common stock in respect of each share of Kindred common stock held on the record date and each AmerisourceBergen stockholder received approximately 0.083 shares of the Corporation s common stock in respect of each share of AmerisourceBergen common stock held on the record date. Immediately following such spin-offs and mergers, the stockholders of Kindred and AmerisourceBergen each owned 50% of the outstanding common stock of the Corporation. The shares of the Corporation s common stock held by Kindred and AmerisourceBergen prior to the Pharmacy Transaction were cancelled, and neither retained any ownership of the outstanding shares of common stock of the Corporation.

For accounting purposes, the Pharmacy Transaction was treated as an acquisition by KPS of PharMerica LTC with KPS being considered the accounting acquirer based on the application of criteria specified in Statement of Financial Accounting Standards (SFAS) No. 141 (SFAS 141), *Business Combinations*. As a result, the accompanying condensed consolidated financial statements include only certain accounts and results of operations representing the institutional pharmacy business of Kindred on a carve-out basis. Because KPS was determined to be the acquirer for accounting purposes, the historical financial statements of KPS became the historical financial statements of the Corporation. Accordingly, the financial statements of the Corporation prior to the Pharmacy Transaction reflect the financial position, results of operations and cash flows of KPS, which during the historical periods presented in the accompanying condensed consolidated financial statements, was a wholly owned subsidiary of Kindred. Following the Pharmacy Transaction, the accompanying condensed consolidated financial statements of the current period reflect the financial position, results of operation and cash flows of the Corporation. For accounting purposes, the results of operations of PharMerica LTC are included in the results of operations of the Corporation beginning August 1, 2007.

Prior to the closing of the Pharmacy Transaction, the Corporation had no assets or liabilities and conducted no business activity. Prior to the closing of the Pharmacy Transaction, the Corporation s business was operated as two separate businesses within two different public companies, Kindred and AmerisourceBergen.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Principles of Consolidation; Parent Allocations

For all periods prior to the Pharmacy Transaction, the accompanying condensed consolidated financial statements present the historical results of KPS s operations during each respective period. Accordingly, the accompanying condensed consolidated financial statements include allocations of certain expenses, as well as assets and liabilities, historically maintained by Kindred and not recorded in the accounts of KPS. Prior to the Pharmacy Transaction, Kindred corporate expenses were allocated based upon either the identification of specific costs or as a percentage of KPS revenues, where applicable. Allocated costs may not necessarily be indicative of the costs that would have been incurred by KPS if it had operated as a separate entity.

The accompanying condensed consolidated financial statements include the accounts of the Corporation and its subsidiaries including certain accounts of KPS prior to the Pharmacy Transaction. Significant intercompany transactions have been eliminated. Investments in affiliates in which the Corporation had a less than 100% interest were accounted for by the equity method. As of September 30, 2008, there were no minority interests.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Corporation and related footnotes for the year ended December 31, 2007, included in the Corporation s Annual Report on Form 10-K. The balance sheet as of December 31, 2007 has been derived from the audited consolidated financial statements as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

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

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications have no impact on the Corporation s total assets, liabilities, stockholders equity, net income (loss) or cash flows.

Use of Estimates

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

Potential risks and uncertainties, many of which are beyond the control of the Corporation, include, but are not necessarily limited to, such factors as overall economic, financial and business conditions; delays and reductions in reimbursement by the government and other payors to the Corporation and/or its customers; the overall financial condition of the Corporation s customers; the effect of new government regulations, executive orders and/or legislative initiatives, including those relating to reimbursement and drug pricing policies and changes in the interpretation and application of such policies; efforts by payors to control costs; the outcome of litigation; the outcome of audit, compliance, administrative or investigatory reviews, including governmental/regulatory inquiries; other contingent liabilities; changes in economic and political conditions; changes in interest rates; changes in the valuation of the Corporation s financial instruments, including the swap agreement and other derivative instruments; changes in tax laws and regulations; access to capital and financing; the demand for the Corporation s products and services; pricing and other competitive factors in the industry; changes in insurance claims experience and related assumptions; variations in costs or expenses; and changes in accounting rules and standards.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Minority Interests in Consolidated Entities

The accompanying condensed consolidated financial statements include all assets, liabilities, revenues, and expenses of less- than-100%-owned entities that the Corporation controls. Accordingly, the Corporation recorded minority interests in the earnings or losses and equity of such entities. The Corporation records adjustments to minority interest for the allocable portion of income or loss to which the minority interest holders are entitled based upon their portion of certain subsidiaries that they own.

On July 9, 2008, the Corporation purchased the 49.0% minority interest held by a third-party in the Corporation s joint ventures. The Corporation paid approximately $4.4 million in cash for the minority interest share of the joint ventures. The amount paid for the minority interest share of the joint ventures approximated fair value and resulted in the recognition of $0.2 million in goodwill as a result of the transaction, of which approximately $0.1 million included professional fees capitalized as part of the purchase price.

As of September 30, 2008, the Corporation no longer held a minority interest in any joint ventures. For the three and nine months ended September 30, 2007 minority interest income was $0.1 million and $0.9 million, respectively, and approximately $0.5 million for the nine months ended September 30, 2008. The Corporation had no minority interest income for the three months ended September 30, 2008. These amounts are recorded in cost of goods sold in the accompanying condensed consolidated statement of operations.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and cash equivalents with original maturities of three months or less. The Corporation places its cash in financial institutions that are federally insured. As of September 30, 2008, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets given current economic conditions.

Derivative Instruments

The Corporation uses derivative instruments to protect against the risk of interest rate movements on future cash flows under the Corporation s credit agreement. In accordance with SFAS No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities* derivative instruments are reported at fair value on the accompanying condensed consolidated balance sheets. For interest rate exposures, derivatives are used primarily to fix the rate on debt based on floating-rate indices and to manage the cost of borrowing obligations. The Corporation prohibits the use of derivative instruments for trading or speculative purposes. Changes in the fair value of derivatives deemed to be eligible for hedge accounting are reported in accumulated other comprehensive loss exclusive of ineffective amounts which are reported in interest expense. The fair value of the Corporation s interest rate swap agreement is the amount at which it could be settled, based on estimates obtained from the counterparty. The Corporation s interest rate swap is further described in Note 5.

Fair Value of Financial Instruments

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157 (SFAS 157), *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value and enhances disclosure about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. On February 2, 2008, the FASB issued FASB Staff Position No. FAS 157-2 which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Where the measurement objective specifically requires the use of fair value , the Corporation has adopted the provisions of SFAS 157 related to financial assets and financial liabilities as of January 1, 2008.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based upon assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1: Observable inputs such as quoted prices in active markets;

Level 2: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly; and

Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Assets and liabilities measured at fair value are based on one or more of the following three valuation techniques noted in SFAS 157:

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

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

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

Financial assets and liabilities disclosed at fair value at September 30, 2008 are set forth in the table below (in millions):

	Asset/ (Liability)	Level 1	Level 2	Level 3	Valuation Technique
Derivative financial instrument	$ (3.9)	$ -	$ (3.9)	$ -	C
Deferred compensation plan	$ (1.6)	$ -	$ (1.6)	$ -	A

The Corporation s Level 2 liabilities represent a derivative financial instrument (interest rate swap) and an unfunded obligation associated with a deferred compensation plan offered to eligible employees of the Corporation. The interest rate swap s fair value is derived using a pricing model predicated upon observable market inputs. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for similar assets or liabilities generated by market transactions.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable and debt approximate fair value because of the nature or short-term maturity of these instruments.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Accounts Receivable and Allowance for Doubtful Accounts

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

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

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

	December 31, 2007	September 30, 2008
Institutional healthcare providers	$ 134.7	$ 147.4
Medicare Part D	60.5	59.1
Private payor and other	35.0	38.1
Insured	11.9	10.7
Medicaid	11.5	8.1
Medicare	2.8	3.2
Allowance for doubtful accounts	(43.4)	(45.8)
	$ 213.0	$ 220.8
0 to 60 days	64.8 %	62.0 %
61 to 120 days	17.4	19.1
Over 120 days	17.8	18.9
	100.0 %	100.0 %

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

	Beginning Balance	Acquisitions	Charges to Costs	Write-offs	Ending Balance

			and Expenses		
Allowance for doubtful accounts:					
Year Ended December 31, 2007	$ 16.6	$ 25.7	$ 44.1	$ (43.0)	$ 43.4
Nine Months Ended September 30, 2008	$ 43.4	$ -	$ 17.9	$ (15.5)	$ 45.8

During the year ended December 31, 2007, the Corporation performed a comprehensive assessment of allowance for doubtful accounts estimation methodologies and reserve levels in light of its expectations around the ultimate collection of its accounts receivable balances. As part of this comprehensive assessment, the Corporation considered industry trends, changes in reimbursement sources and procedures, age of receivables and collection history. In connection with that comprehensive assessment of the allowance for doubtful accounts, included in amounts charged to costs and expenses in the third quarter of 2007 is a change in accounting estimate to increase the allowance for doubtful accounts by $27.9 million.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Deferred Financing Fees

The Corporation capitalizes financing fees related to acquiring or issuing new debt instruments. These expenditures include bank fees and premiums, legal costs and filing fees. The Corporation amortizes these deferred financing fees over the life of the respective debt instrument using the straight-line method.

Inventory

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

Equipment and Leasehold Improvements

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

	Estimated Useful Lives
Leasehold improvements	1-5
Equipment and software	3-10
Leased equipment	1-5

Expenditures for maintenance, repairs and renewals of minor items are expensed as incurred and included in selling, general and administrative expenses. Major rebuilds and improvements are capitalized. For the three and nine months ended September 30, 2007 maintenance and repairs were approximately $1.8 million and $3.1 million, respectively, and approximately $1.7 million and $5.5 million for the three and nine months ended September 30, 2008, respectively.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset to the estimated future undiscounted net cash flows expected to be generated by the asset. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset to its then fair value. The Corporation did not record impairment charges on equipment and leasehold improvements for the three and nine months ended September 30, 2007 or 2008.

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

Capitalization of Internal Software Costs

Costs incurred by the Corporation in the development or obtaining of internal software are capitalized. Certain costs, such as maintenance and training, are expensed as incurred. Capitalized costs are amortized over a period of not more than seven years and are subject to impairment evaluations in accordance with SFAS 144. Amounts capitalized in equipment and leasehold improvements for internal software costs were $3.4 million and $5.0 million as of December 31, 2007 and September 30, 2008, respectively.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Goodwill and Other Intangibles

The Corporation accounts for its acquisitions in accordance with SFAS No. 141 using the purchase method of accounting. Goodwill represents the excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. Under SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill and intangible assets with indefinite lives are reviewed by the Corporation at least annually for impairment. The Corporation s business is comprised of two reporting units for impairment test purposes, institutional pharmacy and hospital management. The Corporation performed its annual impairment tests as of December 31, 2007, and did not incur an impairment charge.

The Corporation s finite lived intangible assets are comprised primarily of trade names, customer relationship assets and non-compete agreements originating from business acquisitions. Finite lived intangible assets are amortized on a straight-line basis over the terms of the agreements ranging from 5 to 20 years. The Corporation s goodwill and intangible assets are further described in Note 4.

Self-Insured Employee Health Benefits

The Corporation is self-insured for substantially all employee health benefits. The Corporation s self-insurance for employee health benefits includes a stop-loss policy to limit the maximum potential liability of the Corporation for both individual and aggregate claims per year. The Corporation records a monthly expense for self-insurance based on historical claims data and inputs from third-party administrators. As of December 31, 2007 and September 30, 2008, the Corporation had approximately $8.8 million and $3.0 million, respectively, recorded as a liability for self-insured employee health benefits. For the three and nine months ended September 30, 2007 self-insured employee health benefits expenses were $1.6 million and $4.5 million, respectively, and $0.3 million and $10.4 million for the three and nine months ended September 30, 2008, respectively.

On September 5, 2008, the Corporation received a $2.1 million refund as a result of over charges on self-insured employee health benefits. Approximately $1.2 million of the refund related to charges from August 2007 through December 2007. For the three months ended September 30, 2008, employee benefits classified in cost of goods sold and selling, general and administrative expenses were reduced by $1.5 million and $0.6 million, respectively.

Supplier Rebates

The Corporation receives rebates on purchases from its various vendors and suppliers. The Corporation generally accounts for these rebates and other incentives received from its vendors and suppliers, relating to the purchase or distribution of inventory, as a reduction to cost of goods sold and inventory, in accordance with Emerging Issues Task Force Issue No. 02-16, Accounting by a Customer for Certain Consideration Received from a Vendor. The Corporation considers these rebates to represent product discounts, and as a result, the rebates are capitalized as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory. For the three and nine months ended September 30, 2007 rebates were $11.5 million and $19.3 million, respectively, and $12.1 million and $38.7 million for the three and nine months ended September 30, 2008, respectively. The Corporation had approximately $2.9 million and $3.0 million of rebates capitalized in inventory as of December 31, 2007 and September 30, 2008, respectively.

Delivery Expenses

The Corporation incurred expenses totaling approximately $11.6 million and $24.6 million for the three and nine months ended September 30, 2007, respectively, and $15.9 million and $47.3 million for the three and nine months ended September 30, 2008, respectively, to deliver products sold to its customers. Delivery expenses are reported as a component of cost of goods sold in the accompanying condensed consolidated statements of operations.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Comprehensive Income (Loss)

The Corporation entered into an interest rate swap agreement, which the Corporation has designated as a cash flow hedge in accordance with SFAS No. 133. The Corporation recognizes all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through the statement of operations. If the derivative meets the hedge criteria as defined by SFAS 133, depending on the nature of the hedge, changes in the fair value of the derivative are either offset against the change in fair value of assets and liabilities through earnings or recognized in accumulated other comprehensive income (loss) until the hedged item is recognized in earnings. The ineffective portion of a derivative s change in fair value, if any, is immediately recognized in earnings.

The changes in the fair value of the interest rate swap for the nine months ended September 30, 2007 and 2008 resulted in a comprehensive loss of $1.9 million and $0.6 million, respectively, or $1.2 million and $0.4 million net of income taxes, respectively. Accumulated other comprehensive loss at December 31, 2007 and September 30, 2008 was $2.6 million and $2.2 million, respectively. The interest rate swap is described more fully in Note 5.

Stock Based Compensation

The Corporation accounts for its stock-based awards in accordance with the provisions of SFAS No. 123(R) (SFAS 123(R)), *Share-Based Payment*. Under SFAS 123(R), the Corporation recognizes compensation expense based on the grant date fair value estimated in accordance with the standard.

The following table summarizes stock compensation of the Corporation for the periods presented (in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Nonvested stock and stock option expense	$ 0.4	$ 1.4	$ 0.6	$ 3.5
Income tax benefit	$ 0.2	$ 0.6	$ 0.3	$ 1.5
Effect of stock based compensation expense per share	$ 0.01	$ 0.03	$ 0.02	$ 0.07

Stock based compensation is more fully described in Note 9.

Income Taxes

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

Concentration of Credit Risk

For the three and nine months ended September 30, 2008, the Corporation derived approximately 13.0% of its revenues from a single customer, including all payor sources associated with the residents of its long-term care facilities. If the Corporation were to no longer attain revenues from this customer, it would have a material impact on the Corporation s results of operations.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

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

Impact of Recent Accounting Pronouncements

On March 19, 2008, the FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an Amendment of FASB Statement No. 133. Statement No. 161 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how: (a) an entity uses derivative instruments; (b) derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and (c) derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. Specifically, Statement No. 161 requires:

Disclosure of the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation;

Disclosure of the fair values of derivative instruments and their gains and losses in a tabular format;

Disclosure of information about credit-risk-related contingent features; and

Cross-reference from the derivative footnote to other footnotes in which derivative-related information is disclosed.

Statement No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged, however, at the current time the Corporation does not plan to early adopt the standard. The adoption of SFAS No. 161 is not expected to have a material impact on the Corporation s financial position, results of operations or liquidity.

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations.* This statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as true mergers or mergers of equals and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to: 1) the formation of a joint venture; 2) the acquisition of an asset or a group of assets that does not constitute a business; 3) a combination between entities or businesses under common control; 4) a combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The adoption of SFAS No. 141(R), prospectively, will have a material effect on the Corporation s results of operations and financial position, to the extent the Corporation has acquisitions, as costs that have historically been capitalized as part of the purchase price will now be expensed, such as accounting, legal and other professional fees.

In December 2007, the FASB issued SFAS No. 160. *Non-controlling Interests in Consolidated Financial Statements, an Amendment to ARB No. 51*. This statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. The effective date of this statement is the same as that of the related Statement No. 141(R). The adoption of SFAS No. 160 will not have a material effect on the Corporation s results of operations, cash flows or financial position.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP FAS 142-3), which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The intent of FSP FAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other U.S. generally accepted accounting principles. FSP FAS 142-3 requires an entity to disclose information for a recognized intangible asset that enables users of the financial statements to assess the extent to which the expected future cash flows associated with the asset are affected by the entity s intent and/or ability to renew or extend the arrangement. FSP FAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The requirements for determining the useful life of intangible assets apply to intangible assets acquired after January 1, 2009. The disclosure requirements will be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 2 ACQUISITIONS

2007 Acquisitions

On the Closing Date, the Corporation completed the Pharmacy Transaction. As discussed in Note 1, the Pharmacy Transaction was accounted for as an acquisition by KPS of PharMerica LTC. In the Pharmacy Transaction, the Corporation issued 30.0 million shares of common stock, of which Kindred and AmerisourceBergen stockholders each received 15.0 million shares. The aggregate purchase price was $436.7 million, comprised primarily of the 15.0 million shares of common stock of the Corporation issued to AmerisourceBergen stockholders, with a fair value of $251.4 million, and the assumption of long-term debt related to the dividend payment to AmerisourceBergen of $125.0 million before the Pharmacy Transaction. The fair value of the common stock issued by the Corporation was calculated using the opening stock price on August 1, 2007. The total purchase price of PharMerica LTC was allocated to the net tangible and identifiable intangible assets based upon their estimated fair values as of the Closing Date. The excess of the purchase price over the estimated fair values of the net tangible and identifiable intangible assets was recorded as goodwill. For tax purposes, the assets acquired were recorded by the Corporation under the provisions of the Internal Revenue Code at the respective assets carryover basis. The results of operations of PharMerica LTC were included in the results of operations of the Corporation beginning August 1, 2007.

The following are the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition (in millions):

Fair value of 15.0 million shares at $16.76 per share issued to PharMerica LTC	$ 251.4
Fair value of the liabilities assumed:	
Current liabilities	32.9
Capital lease obligations	0.1
Deferred tax liabilities	12.3
Long-term liabilities	7.1
PharMerica LTC debt borrowing to fund cash distribution to parent in connection with the Pharmacy Transaction	125.0
Total fair value of liabilities assumed	177.4
Total fair value of liabilities assumed and shares issued	428.8
Legal, advisory and other acquisition costs incurred by KPS	7.9
Total purchase price	$ 436.7
The allocation of the purchase price was as follows:	
Current assets	$ 243.6
Equipment and leasehold improvements	32.8
Identifiable intangible assets	44.5
Other assets	52.8
Goodwill	63.0
	$ 436.7

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 2 ACQUISITIONS (Continued)

The following are the estimated fair values of the equipment and leasehold improvements of PharMerica LTC acquired at the date of acquisition (in millions, except weighted average useful lives):

	Fair Value	Weighted Average Useful Lives
Leasehold improvements	$ 4.1	0.8
Equipment and software	28.0	3.7
Leased equipment	0.7	1.3
Total equipment and leasehold improvements	$ 32.8	2.5

The following are the estimated fair values of the identifiable intangible assets of PharMerica LTC acquired at the date of acquisition (in millions, except weighted average useful lives):

	Fair Value	Weighted Average Useful Lives
Trade name - PharMerica	$ 27.6	20.0
Trade name - MedMate	0.3	20.0
Non-competition agreement	0.2	5.0
Customer relationships	16.4	15.0
Total identifiable intangible assets acquired	$ 44.5	17.6

Other

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

The pro forma effect of the PharMerica LTC acquisition assuming the Pharmacy Transaction occurred on January 1, 2007 excluding integration, merger related costs and other charges would be as follows (in millions, except per share amounts):

	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2007
Revenues	$ 481.8	$ 1,449.0
Net income	$ 1.9	$ 4.4

Earnings per common share:				
Basic	$	0.06	$	0.15
Diluted	$	0.06	$	0.15

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS

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

	December 31, 2007	September 30, 2008
Leasehold improvements	$ 9.0	$ 9.2
Equipment	76.5	84.9
Leased equipment	0.7	0.7
Construction in progress	1.2	5.1
	87.4	99.9
Accumulated depreciation	(30.0)	(42.1)
	$ 57.4	$ 57.8

The following represents a progression of the Corporation s activity in equipment and leasehold improvements for the nine months ended September 30, 2008 (in millions):

	Balance at December 31, 2007	Additions	Disposals	Balance at September 30, 2008
Equipment and leasehold improvements:				
Leasehold improvements	$ 9.0	$ 1.7	$ (1.5)	$ 9.2
Equipment	76.5	13.7	(5.3)	84.9
Leased equipment	0.7	-	-	0.7
Construction in progress	1.2	4.0	(0.1)	5.1
SubTotal	87.4	19.4	(6.9)	99.9
Accumulated depreciation	(30.0)	(16.8)	4.7	(42.1)
Total	$ 57.4	$ 2.6	$ (2.2)	$ 57.8

Depreciation expense totaled approximately $4.9 million and $8.4 million for the three and nine months ended September 30, 2007, respectively, and $5.3 million and $16.8 million for the three and nine months ended September 30, 2008, respectively.

NOTE 4 GOODWILL AND INTANGIBLES

The following table presents the changes in the carrying amount of goodwill for the period presented (in millions):

Balance at December 31, 2007	$ 111.3
Purchase adjustments to Goodwill recorded from acquisitions	(0.6)

Balance at September 30, 2008	$ 110.7

The purchase adjustments in the period related to the acquisitions of PharmaSTAT, LLC (acquired August 1, 2006), the Pharmacy Transaction, and the buy-out of the minority interest held by a third-party in the Corporation s joint ventures in July 2008. Approximately $1.1 million of contingent payments were released from escrow to PharmaSTAT, LLC under the terms of the purchase agreement and $0.2 million as a result of the buy-out of the joint venture interests in July 2008. The remaining change related to a reduction in liabilities assumed of $1.9 million related to the Pharmacy Transaction based on subsequent facts and circumstances.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 4 GOODWILL AND INTANGIBLES (Continued)

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

Finite Lived Intangible Assets	Gross Carrying Amount	Accumulated Amortization	Net Total
Tradenames			
December 31, 2007	$ 27.9	$ (0.6)	$ 27.3
September 30, 2008	$ 27.9	$ (1.6)	$ 26.3
Non-competition agreements			
December 31, 2007	$ 2.4	$ (1.0)	$ 1.4
September 30, 2008	$ 2.4	$ (1.3)	$ 1.1
Customer relationships			
December 31, 2007	$ 57.4	$ (8.6)	$ 48.8
September 30, 2008	$ 57.4	$ (12.1)	$ 45.3
Total amortized intangible assets:			
December 31, 2007	$ 87.7	$ (10.2)	$ 77.5
September 30, 2008	$ 87.7	$ (15.0)	$ 72.7

Amortization expense relating to finite lived intangible assets was approximately $1.4 million and $3.4 million for the three and nine months ended September 30, 2007, respectively, and $1.6 million and $4.8 million for the three and nine months ended September 30, 2008, respectively.

NOTE 5 CREDIT AGREEMENT

On the Closing Date, the Corporation entered into a credit agreement among the Corporation, the Lenders named therein, and JPMorgan Chase Bank, N.A. (JPMorgan), as Administrative Agent (the Credit Agreement). The Credit Agreement consisted of a $275.0 million term loan facility and a $150.0 million revolving credit facility. The Corporation borrowed $275.0 million under the term loan portion of the Credit Agreement and an additional $20.0 million under the revolving credit portion of the Credit Agreement on the Closing Date to refinance the initial financings entered into by KPS and PharMerica LTC, to finance their respective cash distributions, to pay fees and expenses incurred in connection with the Pharmacy Transaction and for working capital and other general corporate purposes. Indebtedness under the Credit Agreement matures on July 31, 2012, at which time the commitment of the Lenders to make revolving loans also shall expire. There is no scheduled amortization under the term loan facility but the term loans are subject to certain prepayment obligations relating to asset sales, casualty losses and the incurrence by the Corporation of indebtedness.

Prior to the Pharmacy Transaction, KPS and PharMerica LTC each entered into a financing arrangement for daylight loans (Spin-Co Loans). The Spin-Co Loans were provided by a syndicate of lenders arranged by J.P. Morgan Securities Inc. (JPMorgan) pursuant to a commitment letter that KPS, PharMerica LTC, and the Corporation entered into with JPMorgan and JPMorgan Chase Bank, N.A. on May 31, 2007. On July 31, 2007, KPS and PharMerica LTC each obtained a $125.0 million loan under the Spin-Co Loans, for a total of $250.0 million, subject to certain adjustments for changes in working capital. The initial financings were funded immediately prior to closing of the Pharmacy Transaction.

The proceeds of the initial financings were used by KPS and PharMerica LTC to make the Kindred cash distribution and AmerisourceBergen cash distribution, respectively, prior to consummation of the Pharmacy Transaction. The amounts of the distributions to Kindred and AmerisourceBergen were in the amounts of the indebtedness incurred by KPS and PharMerica LTC, respectively. The Spin-Co Loans were paid by the Corporation on July 31, 2007 with proceeds from the Credit Agreement.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

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

	December 31, 2007	September 30, 2008
2007 Credit Agreement:		
Term Debt - payable to lenders at LIBOR plus applicable margin (4.0% as of September 30, 2008), matures July 31, 2012	$ 250.0	$ 240.0
Revolving Credit Facility payable to lenders, interest at LIBOR plus applicable margin, matures July 31, 2012	-	-
Long-term debt	$ 250.0	$ 240.0

Maturities of the Corporation s long-term debt are as follows for the years indicated (in millions):

Year Ending December 31,	
2008	$ -
2009	-
2010	-
2011	-
2012	240.0
	$ 240.0

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at our option, a base rate plus a margin between 0.00% and 0.75% per annum, or an adjusted LIBO rate plus a margin between 0.625% and 1.75% per annum, in each case depending on the leverage ratio of the Corporation. The base rate is the higher of the prime lending rate announced by JPMorgan in New York from time to time and the federal funds rate published by the Federal Reserve Bank of New York plus 0.50%. The Credit Agreement also provides for letter of credit participation fees between 0.625% and 1.75%, letter of credit fronting fees of 0.125%, and a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.125% to 0.250%, in each case depending on the leverage ratio of the Corporation.

The obligations of the Corporation under and related to the Credit Agreement are secured by substantially all of its assets. Those obligations are guaranteed by many of the Corporation s wholly owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of our direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries. The Credit Agreement also contains financial and non-financial affirmative and negative covenants, representations, warranties, and events of default that are customary to facilities of this nature.

The Corporation had a total of $250.0 million in term loans outstanding as of December 31, 2007, and $240.0 million as of September 30, 2008, under the Credit Agreement. The Corporation had no borrowings under the revolving credit facility as of December 31, 2007 or September 30, 2008. The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of September 30, 2008 was $2.7 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $147.3 million as of September 30, 2008. The total availability of the revolving credit facility is limited by the ability of the lenders in the Credit Agreement to fund any requested future borrowing.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

Covenants

The Credit Agreement requires the Corporation to satisfy a minimum fixed charge coverage ratio and a maximum leverage ratio. The fixed charge coverage ratio, which is tested quarterly on a trailing four quarter basis, can be no less than 2.00:1.00 during the period from the Closing Date through December 31, 2008; 2.25:1.00 during the period January 1, 2009 through December 31, 2009; and 2.50:1.00 thereafter. The maximum leverage ratio, which also is tested quarterly, cannot exceed 4.50:1.00 during the period July 1, 2008 through December 31, 2008; 3.50:1.00 during the period January 1, 2009 through December 31, 2009; and 3.00:1.00 thereafter. The leverage ratio is not tested when at any time it is less than 2.00:1.00 or both S&P and Moody s shall have in effect corporate credit ratings for the Corporation that are investment grade. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 3.0% of revenues, subject to certain carry over rights in regards to unused portions commencing with the fiscal year ending December 31, 2008.

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

	Requirement	Level at December 31, 2007	Level at September 30, 2008
Minimum Fixed Charge Coverage Ratio	> = 2.00 to 1.00	2.57	3.30
Maximum Total Leverage Coverage Ratio	< = 4.50 to 1.00	2.99	2.15
Capital Expenditure	< = 3.00	1.40%	**

*** Not applicable as Capital Expenditures Covenant is an annual requirement under the terms of the Credit Agreement.*

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

Interest Rate Swap

On the Closing Date, the Corporation entered into an interest rate swap agreement with JPMorgan as the counterparty. The interest rate swap agreement was effective as of the Closing Date and has a maturity date of July 31, 2009. The Corporation entered into the interest rate swap agreement to mitigate the floating interest rate risk on $200.0 million of its outstanding variable rate borrowings. The interest rate swap agreement requires the Corporation to make quarterly fixed rate payments to JPMorgan calculated on a notional amount set at an annual fixed rate of 5.123%, plus applicable margin (0.625% 1.75%). JPMorgan will be obligated to make quarterly floating payments to the Corporation based on the three-month LIBO rate, plus applicable margin (0.625% 1.75%) on the same referenced notional amount.

Notwithstanding the terms of the interest rate swap transaction, the Corporation is ultimately obligated for all amounts due and payable under the Credit Agreement. The notional value of the swap was $200.0 million as of December 31, 2007 and September 30, 2008.

The fair value of the interest rate swap agreement is the amount at which it could be settled, based on estimates. The Corporation has designated the interest rate swap as a cash flow hedge instrument, which is recorded in the Corporation s accompanying condensed consolidated balance sheet at its fair value. The fair value of the Corporation s interest rate swap at December 31, 2007 and September 30, 2008, and reflected as a liability of approximately $4.2 million and $3.9 million, respectively, is included in other long term liabilities in the Corporation s accompanying condensed consolidated balance sheets.

The Corporation assesses the effectiveness of its cash flow hedge instrument on a quarterly basis. The Corporation completed an assessment of the cash flow hedge instrument at December 31, 2007 and September 30, 2008, and determined the hedge to be highly effective in accordance with SFAS No. 133. The interest rate swap agreement exposes the Corporation to credit risk in the event of non-performance by JPMorgan and other participating financial institutions. However, the Corporation does not anticipate non-performance by JPMorgan. The Corporation prohibits the use of derivative instruments for trading or speculative purposes.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

Deferred Financing Fees

The Corporation capitalized a total of $2.0 million in deferred financing fees associated with the Credit Agreement and recorded them as other assets in the accompanying condensed consolidated balance sheets. The Corporation amortizes the financing fees under the straight-line method over the term of the Credit Agreement. Amortization expense relating to deferred financing fees was approximately $0.1 million for the three and nine months ended September 30, 2007, and $0.1 million and $0.3 million for the three and nine months ended September 30, 2008, respectively. Amortization expense relating to deferred financing fees is included in interest expenses, net in the accompanying condensed consolidated statement of operations. As of December 31, 2007 and September 30, 2008, the Corporation had approximately $1.8 million and $1.5 million, respectively, in unamortized deferred financing fees.

NOTE 6 COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

The Corporation is involved in certain legal actions and regulatory investigations arising in the ordinary course of business. None of such legal proceedings are, in the opinion of management, expected to have a material adverse effect on the condensed consolidated financial position, results of operations or liquidity of the Corporation.

Effective October 1, 2007, Centers for Medicare & Medicaid Services (CMS) promulgated new rules under the Deficit Reduction Act of 2005 (DRA) changing the federal upper payment limit for Medicaid reimbursement from 150% of the lowest published price for a drug (which is usually the average wholesale price) to 250% of the lowest average manufacturer price (AMP). Although the use of an AMP benchmark would have reduced Medicaid reimbursement rates for certain generic pharmaceuticals, it did not take effect due to a December 19, 2007 federal district court injunction against CMS prohibiting the agency from implementing the rule to the extent that such action would affect Medicaid reimbursement rates for pharmacies under the Medicaid program. The Medicare Improvements for Patients and Providers Act of 2008 delays the use of AMP in setting the payment limit for generic drugs under Medicaid until October 1, 2009. This legislation also delays the public disclosure of AMP data until October 1, 2009. The outcome of the AMP litigation is uncertain, and there can be no assurance that changes in reimbursement formula under the DRA or future legislation or regulation will not have a material adverse impact on our business and results of operations.

Average wholesale price or AWP, is a pricing benchmark published by First DataBank, Inc. (First Data Bank), which provides drug databases, content integration software and drug reference products. AWP is widely used to calculate a portion of the Medicaid and Medicare Part D drug reimbursements payable to pharmacy providers. In 2005, several pension funds brought an action against First DataBank and another healthcare provider alleging collusion to set AWPs for branded drugs. In October 2006, First DataBank agreed to a proposed settlement that would require it to stop publishing AWP two years after the settlement becomes effective unless a competitor is publishing AWP at that time. First DataBank would also be required to change the way it calculates AWP during the two-year interim period.

In May 2008, First DataBank, Inc. filed amendments with the courts to the proposed settlement. If the terms of the amended settlement are approved by the court, First DataBank will be required to (1) adjust its reporting of Blue Book AWP for those prescription drugs identified in the plaintiffs' previously filed complaint by reducing the mark-up factor utilized in connection with the calculation of the Blue Book AWP data field to 1.20 times the WAC or Direct Price for those prescription drugs that are on a mark-up basis; (2) establish a centralized data repository to facilitate reasonable access to discoverable material from First DataBank concerning its drug price reporting practices, (3) make a $1.0 million contribution into a court-supervised fund for the benefit of the settlement class members, and (4) pay certain settlement-related notice and other expenses and fees. The adjustments to Blue Book AWP will become effective on or about ninety days after final court approval of the amended settlement agreement. The approval process will, again, require a preliminary approval by the court, notification to the class, and final approval by the court. The adjustments will be effective on or about 90 days from the final approval of the court of the amended settlement agreement. The Court granted preliminary approval of the amended settlement on July 14, 2008. The order also gave preliminary certification to the settlement class. Further the court scheduled a final fairness hearing for December 17, 2008 to consider (1) whether to certify the class and (2) the fairness, reasonableness, and adequacy of the settlement.

Currently, we are unable to fully evaluate the potential impact until a final action is ultimately determined. There can be no assurance that changes in the calculation of AWP will not have an adverse impact on our business and results of operations.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Acquisitions

The Corporation has historically acquired the assets of businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, medical and general professional liabilities, workers compensation liabilities, previous tax liabilities and unacceptable business practices. Although the Corporation institutes policies designed to conform practices to its standards following completion of acquisitions, there can be no assurance the Corporation will not become liable for past activities that may later be asserted to be improper by private plaintiffs or government agencies.

Although the Corporation generally seeks to obtain indemnification from prospective sellers covering such matters, there can be no assurance that any such matter will be covered by indemnification, or if covered, that such indemnification will be adequate to cover potential losses and fines. In the ordinary course of business, the Corporation enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction such as business acquisitions and disposals of an operating facility. These indemnifications may cover claims against employment-related matters, governmental regulations, environmental issues, tax matters, as well as customer, third party payor, supplier and contractual relationships. Obligations under these indemnities generally would be initiated by a breach of the terms of the contract or by a third party claim or event.

Prime Vendor Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the Prime Vendor Agreement), with AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen, the Corporation s former 50% stockholder and former parent of PharMerica LTC. Pursuant to this agreement, the Corporation has agreed to purchase at least 95% of the Corporation s prescription pharmaceutical drugs from ABDC and to participate in its generic formulary purchase program for a period of five years following the Closing Date. In addition, ABDC will support the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provide inventory management support and packaging services. Unless either party provides certain notice of termination, the agreement will continue on a month-to-month basis upon expiration of the initial five year term. The agreement may be terminated by either party for cause during the initial five year term, and by either party with or without cause thereafter upon 90 days notice.

Information Technology Services Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (KHOI), a wholly owned subsidiary of Kindred, the Corporation s former 50% stockholder (the IT Services Agreement). Pursuant to this agreement, KHOI will be the Corporation s exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years following the Closing Date. The services provided by KHOI will include business services necessary to operate, manage, and support certain financial applications the Corporation uses, including enabling and/or supporting technology infrastructure and technology procurement services to support certain business functions. Such services will include, among other matters, functions for financial management, systems and payroll. The Corporation will support internally all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records management, human resources, internal and external customer call center support and general business systems.

Except for certain services which will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The initial term of the agreement is five years. The agreement shall automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior notice of termination as provided for in the agreement.

The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation s competitors. Following termination of the agreement, KHOI must provide termination and expiration assistance for up to 180 days.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Transition Services Agreements

At the consummation of the Pharmacy Transaction, the Corporation entered into a Transition Services Agreement with Kindred (the Kindred TSA). Pursuant to this agreement, Kindred will provide the Corporation with certain corporate administrative services, such as payroll and employee benefit administration, human resources, risk management, treasury, tax, accounting and financial reporting services, for a period of up to twelve months following the Closing Date. In addition, the Kindred TSA may be extended for a period not to exceed 90 days, upon mutual agreement by the parties. The Corporation and Kindred have extended the Kindred TSA for a period of 90 days pursuant to the agreement. Kindred will provide such services at its cost, which were actual costs and expenses incurred by Kindred in providing these services, including overhead costs and per hour costs of the Kindred employees providing the services. The Kindred TSA will expire on October 31, 2008. As of September 30, 2008, the Corporation has substantially transitioned all services covered by the Kindred TSA.

At the consummation of the Pharmacy Transaction, the Corporation entered into a Transition Services Agreement with AmerisourceBergen (the AmerisourceBergen TSA). Pursuant to this agreement, AmerisourceBergen provided the Corporation with certain transition services, such as payroll and employee benefit administration services for a period of twelve months following the Closing Date. AmerisourceBergen provided such services at its cost, which were the actual costs and expenses incurred by AmerisourceBergen in providing these services, including overhead costs and per hour costs of the AmerisourceBergen employees providing the services. The AmerisourceBergen TSA expired on July 31, 2008.

Employment Agreements

The Corporation has entered into employment agreements with certain of its executive officers. During the employment period, each of the executive officers will be eligible to (i) participate in any short-term and long-term incentive programs established or maintained by the Corporation, (ii) participate in all incentive, savings and retirement plans and programs of the Corporation, (iii) participate, along with their dependents, in all welfare benefit plans and programs provided by the Corporation and (iv) receive four weeks of paid vacation per calendar year.

The type of compensation due to each of the executive officers in the event of the termination of their employment period varies depending on the nature of the termination.

Leases

The Corporation leases real estate properties, buildings, vehicles and equipment under cancelable and non-cancelable leases. The leases expire at various times and have various renewal options. Certain leases that meet the lease capitalization criteria in accordance with SFAS No. 13, *Accounting for Leases*, as amended, have been recorded as an asset and liability at the net present value of the minimum lease payments at the inception of the lease. Interest rates used in computing the net present value of the lease payments are based on the Corporation s incremental borrowing rate at the inception of the lease.

The following is a summary of lease expense incurred by the Corporation (in millions):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2007	**2008**	**2007**	**2008**

Pharmacy locations and administrative offices lease expense	$	3.3	$	4.2	$	6.4	$	12.8
Office equipment lease expense		0.8		1.3		1.3		4.7
Total lease expense	$	4.1	$	5.5	$	7.7	$	17.5

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Future minimum lease payments for those leases having an initial or remaining non-cancelable lease term in excess of one year are as follows for the next five years and thereafter indicated (in millions):

Year Ending December 31,	Operating Leases
2009	$ 13.9
2010	9.7
2011	6.4
2012	4.3
2013	3.0
Thereafter	7.1
Total	$ 44.4

NOTE 7 REVENUES

The Corporation recognizes revenues at the time services are provided or products are delivered. A significant portion of these revenues are billed to PDPs under Medicare Part D (the Part D), state Medicaid programs, long-term care institutions, third party insurance companies, and private payors. Some claims are electronically adjudicated through online processing at the point the prescription is dispensed such that the Corporation s operating systems are automatically updated with the amount to be reimbursed. As a result, revenues and the associated receivables are based upon the actual reimbursement received by the Corporation. For claims that are adjudicated on-line and are rejected or otherwise denied upon submission, the Corporation provides contractual allowances based upon historical trends, contractual reimbursement terms and other factors which may impact ultimate reimbursement. Amounts are adjusted to actual reimbursed amounts upon cash receipt.

Under the Part D benefit, payment is determined in accordance with the agreements the Corporation has negotiated with the Part D Plans. The remainder of the Corporation s billings are paid or reimbursed by individual residents, long-term care facilities (including revenues for residents funded under Medicare Part A) and other third party payors, including Medicaid and private insurers.

The Medicaid and Medicare programs are highly regulated. The failure, even if inadvertent, of the Corporation and/or client facilities to comply with applicable reimbursement regulations could adversely affect the Corporation s reimbursement under these programs and the Corporation s ability to continue to participate in these programs. In addition, failure to comply with these regulations could subject the Corporation to other penalties.

As noted, the Corporation obtains reimbursement for drugs it provides to enrollees of a given Part D Plan in accordance with the terms of the agreement negotiated between it and that Part D Plan. The Corporation has entered into such agreements with nearly all Part D Plan sponsors under which it will provide drugs and associated services to their enrollees. The Corporation continues to have ongoing discussions with Part D Plans in the ordinary course and may, as appropriate, renegotiate agreements.

The Corporation s hospital pharmacy management revenues represent contractually defined management fees and the reimbursement of costs associated with the direct operations of hospital pharmacies, which are primarily comprised of personnel costs.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)

(Unaudited)

NOTE 7 REVENUES (Continued)