

WATSON PHARMACEUTICALS INC  
Form 10-Q  
May 09, 2007

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

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

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007**

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 001-13305**

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**WATSON PHARMACEUTICALS, INC.**

(Exact name of registrant as specified in its charter)

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**Nevada**

(State or other jurisdiction of  
incorporation or organization)

**95-3872914**

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

**311 Bonnie Circle  
Corona, CA 92880-2882**

(Address of principal executive offices, including zip code)

**(951) 493-5300**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer ☒ X

Accelerated filer ☐ o

Non-accelerated filer ☐ o

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

The number of shares outstanding of the Registrant's only class of common stock as of May 3, 2007 was approximately 102,530,000.

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## WATSON PHARMACEUTICALS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited; in thousands)

|                                             | March 31,<br>2007 | December 31,<br>2006 |
|---------------------------------------------|-------------------|----------------------|
| <b>ASSETS</b>                               |                   |                      |
| Current assets:                             |                   |                      |
| Cash and cash equivalents                   | \$ 73,550         | \$ 154,171           |
| Marketable securities                       | 8,981             | 6,649                |
| Accounts receivable, net                    | 375,608           | 384,692              |
| Inventories                                 | 492,345           | 517,236              |
| Prepaid expenses and other current assets   | 63,130            | 86,115               |
| Deferred tax assets                         | 88,055            | 112,813              |
| Total current assets                        | 1,101,669         | 1,261,676            |
| Property and equipment, net                 | 696,119           | 697,415              |
| Investments and other assets                | 73,497            | 76,377               |
| Deferred tax assets                         | 63,351            | 55,348               |
| Product rights and other intangibles, net   | 735,503           | 779,284              |
| Goodwill                                    | 875,443           | 890,477              |
| Total assets                                | \$ 3,545,582      | \$ 3,760,577         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                   |                      |
| Current liabilities:                        |                   |                      |
| Accounts payable and accrued expenses       | \$ 429,112        | \$ 516,875           |
| Income taxes payable                        |                   | 46,773               |
| Current portion of long-term debt           | 5,479             | 107,059              |
| Deferred revenue                            | 17,048            | 19,222               |
| Total current liabilities                   | 451,639           | 689,929              |
| Long-term debt                              | 1,074,210         | 1,124,145            |
| Deferred revenue                            | 57,209            | 58,086               |
| Other long-term liabilities                 | 8,358             | 4,169                |
| Other taxes payable                         | 45,328            |                      |
| Deferred tax liabilities                    | 194,962           | 203,860              |
| Total liabilities                           | 1,831,706         | 2,080,189            |
| Commitments and contingencies               |                   |                      |
| Stockholders' equity:                       |                   |                      |
| Preferred stock                             |                   |                      |
| Common stock                                | 369               | 369                  |
| Additional paid-in capital                  | 941,903           | 937,308              |
| Retained earnings                           | 1,070,317         | 1,041,638            |
| Accumulated other comprehensive income      | 1,287             | 1,073                |
| Treasury stock, at cost                     | (300,000)         | (300,000)            |
| Total stockholders' equity                  | 1,713,876         | 1,680,388            |
| Total liabilities and stockholders' equity  | \$ 3,545,582      | \$ 3,760,577         |

See accompanying Notes to Condensed Consolidated Financial Statements.



**WATSON PHARMACEUTICALS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited; in thousands, except per share amounts)

|                                                        | <b>Three Months Ended<br/>March 31,</b> |                          |
|--------------------------------------------------------|-----------------------------------------|--------------------------|
|                                                        | <b>2007</b>                             | <b>2006<br/>Restated</b> |
| Net revenues                                           | \$ 671,605                              | \$ 407,233               |
| Cost of sales (excludes amortization, presented below) | 424,720                                 | 234,754                  |
| Gross profit                                           | 246,885                                 | 172,479                  |
| Operating expenses:                                    |                                         |                          |
| Research and development                               | 37,808                                  | 29,837                   |
| Selling and marketing                                  | 55,163                                  | 41,913                   |
| General and administrative                             | 48,055                                  | 24,837                   |
| Amortization                                           | 43,933                                  | 41,100                   |
| Total operating expenses                               | 184,959                                 | 137,687                  |
| Operating income                                       | 61,926                                  | 34,792                   |
| Other income (expense):                                |                                         |                          |
| Loss on early extinguishment of debt                   | (2,729 )                                | (720 )                   |
| Interest income                                        | 2,929                                   | 6,252                    |
| Interest expense                                       | (13,876 )                               | (3,301 )                 |
| Other income                                           | 3,403                                   | 3,515                    |
| Total other (expense) income, net                      | (10,273 )                               | 5,746                    |
| Income before income taxes                             | 51,653                                  | 40,538                   |
| Provision for income taxes                             | 20,041                                  | 15,364                   |
| Net income                                             | \$ 31,612                               | \$ 25,174                |
| Earnings per share:                                    |                                         |                          |
| Basic                                                  | \$ 0.31                                 | \$ 0.25                  |
| Diluted                                                | \$ 0.29                                 | \$ 0.23                  |
| Weighted average shares outstanding:                   |                                         |                          |
| Basic                                                  | 101,928                                 | 101,615                  |
| Diluted                                                | 116,612                                 | 116,541                  |

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**WATSON PHARMACEUTICALS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited; in thousands)**

|                                                                     | <b>Three Months Ended<br/>March 31,</b> |                          |
|---------------------------------------------------------------------|-----------------------------------------|--------------------------|
|                                                                     | <b>2007</b>                             | <b>2006<br/>Restated</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                        |                                         |                          |
| Net income                                                          | \$ 31,612                               | \$ 25,174                |
| Reconciliation to net cash provided by operating activities:        |                                         |                          |
| Depreciation                                                        | 18,029                                  | 12,074                   |
| Amortization                                                        | 43,933                                  | 41,100                   |
| Deferred income tax provision (benefit)                             | 250                                     | (18,101 )                |
| Provision for inventory reserve                                     | 11,427                                  | 5,484                    |
| Restricted stock and stock option compensation                      | 3,402                                   | 2,850                    |
| Losses (earnings) on equity method investments                      | (1,439 )                                | 285                      |
| Gain on sale of securities                                          | (1,789 )                                | (3,695 )                 |
| Loss on early extinguishment of debt                                | 2,729                                   | 720                      |
| Tax benefits from employee stock plans                              | 66                                      | 185                      |
| Mark to market on derivative                                        | 23                                      | (453 )                   |
| Other                                                               | 369                                     | (879 )                   |
| Changes in assets and liabilities (net of acquisition of business): |                                         |                          |
| Accounts receivable, net                                            | 12,083                                  | 64,440                   |
| Inventories                                                         | 9,063                                   | (23,698 )                |
| Prepaid expenses and other current assets                           | 32,222                                  | 1,698                    |
| Accounts payable and accrued expenses                               | (83,596 )                               | (4,524 )                 |
| Deferred revenue                                                    | (1,792 )                                | (1,253 )                 |
| Income taxes payable                                                | 10,319                                  | 34,129                   |
| Other assets                                                        | 1,328                                   | 174                      |
| Total adjustments                                                   | 56,627                                  | 110,536                  |
| Net cash provided by operating activities                           | 88,239                                  | 135,710                  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                        |                                         |                          |
| Additions to property and equipment                                 | (16,744 )                               | (9,600 )                 |
| Acquisition of product rights                                       | (153 )                                  | (165 )                   |
| Acquisition of business, net of cash acquired                       |                                         | (29,578 )                |
| Proceeds from sale of marketable equity securities                  | 699                                     | 893                      |
| Proceeds from sale of investments                                   |                                         | 4,695                    |
| Additions to marketable securities                                  | (1,099 )                                | (898 )                   |
| Additions to long-term investments                                  | (1,144 )                                | (12,500 )                |
| Other investing activities, net                                     | 115                                     | (16 )                    |
| Net cash used in investing activities                               | (18,326 )                               | (47,169 )                |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                        |                                         |                          |
| Payments on term debt                                               | (151,661 )                              |                          |
| Principal payments on acquisition liabilities                       |                                         | (3 )                     |
| Proceeds from stock plans                                           | 1,127                                   | 3,745                    |
| Net cash (used in) provided by financing activities                 | (150,534 )                              | 3,742                    |
| Net (decrease) increase in cash and cash equivalents                | (80,621 )                               | 92,283                   |
| Cash and cash equivalents at beginning of period                    | 154,171                                 | 467,451                  |
| Cash and cash equivalents at end of period                          | \$ 73,550                               | \$ 559,734               |

*See accompanying Notes to Condensed Consolidated Financial Statements.*



**WATSON PHARMACEUTICALS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 GENERAL**

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

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

*Merger Agreement with Andrx Corporation*

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

Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders' equity, net of any related tax effect. As required by Accounting Research Bulletin ( ARB ) No. 51, Consolidated Financial Statements ( ARB 51 ), earnings (loss) on equity method investments has been restated for the three months ended March 31, 2006 to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with Accounting Principles Board ( APB ) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock ( APB 18 ). Accumulated other comprehensive income has also been restated for the three months ended March 31, 2006 to reflect these changes.

*Comprehensive Income*

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company's stockholders. Other comprehensive income refers to revenues, expenses, gains and losses that, under generally accepted accounting principles, are included in comprehensive

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income, but excluded from net income as these amounts are recorded directly as an adjustment to stockholders' equity. Watson's other comprehensive income is comprised of unrealized (losses) gains on its holdings of publicly traded debt and equity securities, net of realized (losses) gains included in net income and foreign currency translation adjustments. The components of comprehensive income including attributable income taxes consisted of the following (in thousands):

|                                                 | Three Months Ended March 31,<br>2007 | 2006<br>Restated |
|-------------------------------------------------|--------------------------------------|------------------|
| Net income                                      | \$ 31,612                            | \$ 25,174        |
| Other comprehensive income:                     |                                      |                  |
| Unrealized (loss) gain on securities            | (10 )                                | 1,125            |
| Less related income taxes                       | 4                                    | (426 )           |
| Total unrealized (loss) gain on securities, net | (6 )                                 | 699              |
| Translation gains                               | 218                                  | 165              |
| Total other comprehensive income                | 212                                  | 864              |
| Total comprehensive income                      | \$ 31,824                            | \$ 26,038        |

## Preferred and Common Stock

As of March 31, 2007 and December 31, 2006, 2,500,000 shares of no par value per share preferred stock were authorized, with none issued. As of March 31, 2007 and December 31, 2006, 500,000,000 shares of \$0.0033 par value per share common stock were authorized, with 111,901,000 and 111,867,000 shares issued and 102,502,000 and 102,467,000 outstanding, respectively. Of the issued shares, 9,399,800 shares were held as treasury shares as of March 31, 2007 and December 31, 2006, respectively.

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

## Provisions for Sales Returns and Allowances

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

The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to the Company by our wholesale customer for a particular product and the negotiated contract price that the wholesaler's customer pays for that product. The Company's chargeback provision and related reserve vary with changes in product mix, changes in customer pricing and changes to estimated wholesaler inventory. The provision for chargebacks

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also takes into account an estimate of the expected wholesaler sell-through levels to indirect customers at contract prices. The Company validates the chargeback accrual quarterly through a review of the inventory reports obtained from our largest wholesale customers. This customer inventory information is used to verify the estimated liability for future chargeback claims based on historical chargeback and contract rates. These large wholesalers represent 85% - 90% of the Company's chargeback payments. The Company continually monitors current pricing trends and wholesaler inventory levels to ensure the liability for future chargebacks is fairly stated. The following table summarizes the activity in the Company's major categories of SRA (in thousands):

|                                                             | Chargebacks | Rebates    | Returns and<br>Other<br>Allowances | Cash<br>Discounts | Total        |
|-------------------------------------------------------------|-------------|------------|------------------------------------|-------------------|--------------|
| Balance at December 31, 2005                                | \$ 139,605  | \$ 128,293 | \$ 45,293                          | \$ 12,094         | \$ 325,285   |
| First quarter 2006 provision                                | 255,933     | 90,199     | 38,771                             | 15,479            | 400,382      |
| Credits and payments                                        | (258,087 )  | (110,058 ) | (46,868 )                          | (16,058 )         | (431,071 )   |
| Balance at March 31, 2006                                   | 137,451     | 108,434    | 37,196                             | 11,515            | 294,596      |
| Add: Andrx opening balances                                 | 15,911      | 27,667     | 8,992                              | 1,601             | 54,171       |
| Provision related to three quarters ended December 31, 2006 | 934,521     | 331,201    | 134,438                            | 55,206            | 1,455,366    |
| Credits and payments                                        | (923,403 )  | (286,764 ) | (138,137 )                         | (54,250 )         | (1,402,554 ) |
| Balance at December 31, 2006                                | 164,480     | 180,538    | 42,489                             | 14,072            | 401,579      |
| First quarter 2007 provision                                | 291,831     | 122,766    | 56,133                             | 18,436            | 489,166      |
| Credits and payments                                        | (321,751 )  | (124,215 ) | (33,960 )                          | (16,894 )         | (496,820 )   |
| Balance at March 31, 2007                                   | \$ 134,560  | \$ 179,089 | \$ 64,662                          | \$ 15,614         | \$ 393,925   |

## Earnings Per Share

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

|                                                    | Three months ended<br>March 31,<br>2007 |  | 2006<br>Restated |
|----------------------------------------------------|-----------------------------------------|--|------------------|
| <b>Earnings per share - basic</b>                  |                                         |  |                  |
| Net income                                         | \$ 31,612                               |  | \$ 25,174        |
| Basic weighted average common shares outstanding   | 101,928                                 |  | 101,615          |
| Earnings per share - basic                         | \$ 0.31                                 |  | \$ 0.25          |
| <b>Earnings per share - assuming dilution</b>      |                                         |  |                  |
| Net income                                         | \$ 31,612                               |  | \$ 25,174        |
| Add: Interest expense on CODES, net of tax         | 1,943                                   |  | 1,675            |
| Net income, adjusted                               | \$ 33,555                               |  | \$ 26,849        |
| Basic weighted average common shares outstanding   | 101,928                                 |  | 101,615          |
| Effect of dilutive securities:                     |                                         |  |                  |
| Conversion of CODES                                | 14,357                                  |  | 14,357           |
| Dilutive stock options                             | 327                                     |  | 569              |
| Diluted weighted average common shares outstanding | 116,612                                 |  | 116,541          |

|                              |         |         |
|------------------------------|---------|---------|
| Earnings per share - diluted | \$ 0.29 | \$ 0.23 |
|------------------------------|---------|---------|

Stock awards to purchase 10.1 million and 7.9 million common shares for the three month periods ended March 31, 2007 and 2006, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive.

*Recent Accounting Pronouncements*

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

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

**NOTE 2 SHARE-BASED COMPENSATION**

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

### Stock Option Plans

As a result of adopting SFAS 123R, the Company's operating income and income before income tax provision was reduced by \$1.8 million and net income was reduced by \$1.1 million (\$0.01 per basic share, \$0.01 per diluted share) for the three months ended March 31, 2007, related to the Company's employee stock option plans. For the three months ended March 31, 2006, the Company's operating income and income before income tax provision was reduced by \$1.8 million and net income was reduced by \$1.1 million (\$0.02 per basic share, \$0.01 per diluted share), related to the Company's employee stock option plans. Total stock option cost capitalized as part of inventory was \$0.5 million and \$0.3 for three months ended March 31, 2007 and 2006, respectively.

A summary of the changes in the Company's stock option plans during the three months ended March 31, 2007 is presented below (in thousands, except per share amounts):

|                                               | Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (Years) | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------------------|--------|------------------------------------------|-----------------------------------------------------------------|---------------------------------|
| Outstanding at December 31, 2006              | 10,985 | \$ 36.39                                 |                                                                 |                                 |
| Granted                                       | 37     | 28.07                                    |                                                                 |                                 |
| Exercised                                     | (48 )  | 23.40                                    |                                                                 |                                 |
| Cancelled                                     | (405 ) | 33.94                                    |                                                                 |                                 |
| Outstanding at March 31, 2007                 | 10,569 | \$ 36.51                                 | 5.3                                                             | \$ 1,650                        |
| Vested and expected to vest at March 31, 2007 | 9,991  | \$ 36.96                                 | 5.1                                                             | \$ 1,489                        |
| Options exercisable at March 31, 2007         | 8,078  | \$ 38.94                                 | 4.5                                                             | \$ 941                          |

As of March 31, 2007, the Company had \$8.3 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 1.5 years. Total intrinsic value of stock options exercised for the three months ended March 31, 2007 and 2006 was \$0.2 million and \$0.3 million, respectively.

### Restricted Stock

The Company's operating income and income before income tax provision was reduced by \$1.3 million and net income was reduced by \$0.8 million (\$0.01 per basic share, \$0.01 per diluted share) for the three months ended March 31, 2007, related to the Company's restricted stock plans. For the three months ended March 31, 2006, the Company's operating income and income before income tax provision was reduced by \$0.5 million and net income was reduced by \$0.3 million (\$0.00 per basic share, \$0.00 per diluted share) related to the Company's restricted stock plans. Total restricted stock cost capitalized as part of inventory was \$0.5 million and \$0.2 million for three months ended March 31, 2007 and 2006, respectively.

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A summary of the changes in restricted stock grants during the three months ended March 31, 2007 is presented below (in thousands, except per share amounts):

|                                                    | Shares  | Weighted<br>Average<br>Grant Date<br>Fair Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (Years) | Aggregate<br>Intrinsic<br>Value |
|----------------------------------------------------|---------|-------------------------------------------------|-----------------------------------------------------------------|---------------------------------|
| Restricted shares outstanding at December 31, 2006 | 568.8   | \$ 30.26                                        | 1.9                                                             | \$ 17,211                       |
| Granted                                            | 12.4    | 28.07                                           |                                                                 | 349                             |
| Vested                                             |         |                                                 |                                                                 |                                 |
| Cancelled                                          | (26.3 ) | 31.60                                           |                                                                 | (831 )                          |
| Restricted shares outstanding at March 31, 2007    | 554.9   | \$ 30.15                                        | 1.7                                                             | \$ 16,729                       |

As of March 31, 2007, the Company had \$6.4 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 1.7 years.

### NOTE 3 ACQUISITIONS

#### *Acquisition of Andrx Corporation*

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

*Acquisition of Sekhsaria Chemicals Ltd.*

On March 16, 2006, the Company acquired Sekhsaria Chemicals Ltd. ( Sekhsaria ), a private company located in Mumbai, India that provides active pharmaceutical ingredient and finished dosage formulation expertise to the global pharmaceutical industry. The Company acquired all the outstanding shares of Sekhsaria for approximately \$29.5 million plus acquisition costs. The transaction was accounted for as a purchase in accordance with SFAS No. 141 and accordingly, the tangible assets acquired were recorded at fair value on acquisition date based on reasonable assumptions.

The results of operations of Sekhsaria have been included in the Company's Condensed Consolidated Financial Statements subsequent to the date of acquisition.

*Additional Investment in Scinopharm*

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

**NOTE 4 OTHER INCOME (EXPENSE)**

Other income (expense) consisted of the following (in thousands):

|                                                           | <b>Three Months Ended<br/>March 31,</b> |             |
|-----------------------------------------------------------|-----------------------------------------|-------------|
|                                                           | <b>2007</b>                             | <b>2006</b> |
| Earnings (losses) on equity method investments - restated | \$ 1,439                                | \$ (285 )   |
| Gain on sale of securities                                | 1,789                                   | 3,695       |
| Other income                                              | 175                                     | 105         |
|                                                           | \$ 3,403                                | \$ 3,515    |

**NOTE 5 OPERATING SEGMENTS**

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

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The other revenue classification for the three month period ended March 31, 2007 and 2006 consists primarily of royalties and revenues from research, development and licensing fees. For the three month period ended March 31, 2007, the other classification within the Generic segment includes commission revenue earned as a sales agent, from the sale of fentanyl citrate troche. Also for the three month period ended March 31, 2007, the other classification within the Brand segment includes deferred revenue related to certain contract manufacturing arrangements as a result of the Andrx Acquisition. Net revenues and segment contribution information for the Company's Generic, Brand and Distribution segments, consisted of the following:

|                            | Three Months Ended March 31, 2007 |           |              |            | Three Months Ended March 31, 2006 |           |            |   |
|----------------------------|-----------------------------------|-----------|--------------|------------|-----------------------------------|-----------|------------|---|
|                            | Generic                           | Brand     | Distribution | Total      | Generic                           | Brand     | Total      |   |
| Product sales              | \$ 411,475                        | \$ 90,638 | \$ 145,440   | \$ 647,553 | \$ 321,415                        | \$ 83,237 | \$ 404,652 |   |
| Other                      | 13,150                            | 10,902    |              | 24,052     | 675                               | 1,906     | 2,581      |   |
| Net revenues               | 424,625                           | 101,540   | 145,440      | 671,605    | 322,090                           | 85,143    | 407,233    |   |
| Cost of sales (1)          | 272,623                           | 25,215    | 126,882      | 424,720    | 217,384                           | 17,370    | 234,754    |   |
| Gross profit               | 152,002                           | 76,325    | 18,558       | 246,885    | 104,706                           | 67,773    | 172,479    |   |
| Gross margin               | 36                                | % 75      | % 13         | % 37       | % 33                              | % 80      | % 42       | % |
| Research and development   | 26,513                            | 11,295    |              | 37,808     | 20,495                            | 9,342     | 29,837     |   |
| Selling and marketing      | 14,549                            | 26,411    | 14,203       | 55,163     | 12,938                            | 28,975    | 41,913     |   |
| Contribution               | 110,940                           | 38,619    | 4,355        | 153,914    | 71,273                            | 29,456    | 100,729    |   |
| Contribution margin        | 26                                | % 38      | % 3          | % 23       | % 22                              | % 35      | % 25       | % |
| General and administrative |                                   |           |              | 48,055     |                                   |           | 24,837     |   |
| Amortization               |                                   |           |              | 43,933     |                                   |           | 41,100     |   |
| Operating income           |                                   |           |              | \$ 61,926  |                                   |           | \$ 34,792  |   |
| Operating margin           |                                   |           |              | 9          | %                                 |           | 9          | % |

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

## NOTE 6 INVENTORIES

Inventories consist of finished goods held for sale and distribution, raw materials and work-in-process. Included in inventory at March 31, 2007 and December 31, 2006 is approximately \$35.7 and \$34.2 million, respectively, of inventory that is pending approval by the U.S. Food and Drug Administration ( FDA ) or has not been launched due to contractual restrictions. This inventory consists of generic pharmaceutical products that are capitalized only when the bioequivalence of the product is demonstrated or the product is already FDA approved and is awaiting a contractual triggering event to enter the marketplace.

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

|                   | March 31,<br>2007 | December 31,<br>2006 |
|-------------------|-------------------|----------------------|
| Raw materials     | \$ 105,448        | \$ 113,603           |
| Work-in-process   | 80,700            | 69,621               |
| Finished goods    | 306,197           | 334,012              |
| Total inventories | \$ 492,345        | \$ 517,236           |

## NOTE 7 GOODWILL

Changes in our goodwill balances for the three months ended March 31, 2007 were as follows (in thousands):

|                                 | December 31, 2006 | Goodwill Adjustment | Foreign Currency Translation | March 31, 2007 |
|---------------------------------|-------------------|---------------------|------------------------------|----------------|
| Brand pharmaceutical products   | \$ 368,105        | \$ (1,800 )         | \$                           | \$ 366,305     |
| Generic pharmaceutical products | 433,774           | (10,347 )           | (92 )                        | 423,335        |
| Distributed products            | 88,598            | (2,795 )            |                              | 85,803         |
| Total goodwill                  | \$ 890,477        | \$ (14,942 )        | \$ (92 )                     | \$ 875,443     |

The \$14.9 million decrease in goodwill primarily relates to an adjustment to acquired income tax contingencies.

## NOTE 8 LONG-TERM DEBT

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

|                                                                                                 | March 31,<br>2007 | December 31,<br>2006 |
|-------------------------------------------------------------------------------------------------|-------------------|----------------------|
| Senior Credit Facility, due 2011, bearing interest at LIBOR plus 0.75% ( 2006 Credit Facility ) | \$ 500,000        | \$ 650,000           |
| CODES, face amount of \$575 million, due 2023, net of unamortized discount                      | 574,194           | 574,125              |
| Other notes payable                                                                             | 5,495             | 7,079                |
|                                                                                                 | 1,079,689         | 1,231,204            |
| Less: Current portion                                                                           | 5,479             | 107,059              |
| Total long-term debt                                                                            | \$ 1,074,210      | \$ 1,124,145         |

*Senior Credit Facility*

During the quarter ended March 31, 2007, the Company prepaid \$150 million of the amount outstanding under the Term Facility. As a result of this pre-payment, our results for the first quarter of 2007 reflect a \$2.7 million non-cash charge for debt repurchase charges. As of March 31, 2007, \$500 million is outstanding under the Term Facility.

**NOTE 9 INCOME TAXES**

On January 1, 2007, the Company adopted the provisions of FIN 48. Differences between the amount recognized in the consolidated financial statements prior to the adoption of FIN 48 and the amounts reported as a result of adoption have been accounted for as a cumulative effect adjustment recorded to the January 1, 2007 retained earnings balance. The adoption of FIN 48 decreased the January 1, 2007, balance of retained earnings by \$2.9 million. In addition, the Company reclassified tax reserves for which a cash tax payment is not expected in the next twelve months from current to non-current liabilities.

As of the adoption date, the liability for income tax associated with uncertain tax positions was \$69.2 million. This amount is reduced for timing differences and amounts primarily arising from business combinations which, if recognized, would be recorded to goodwill. The net amount of \$32.5 million, if recognized, would favorably affect the Company's effective tax rate.

As of March 31, 2007, the liability for income tax associated with uncertain tax positions was \$46.7 million. This amount is reduced for timing differences and amounts primarily arising from business combinations which, if recognized, would be recorded to goodwill. The net amount of \$29.3 million, if recognized, would favorably affect the Company's effective tax rate.

The Company's continuing practice is to recognize interest and penalties related to uncertain tax positions in tax expense. At adoption, the Company had accrued \$6.5 million of interest and penalties (net of tax benefit) related to uncertain tax positions and, as of March 31, 2007, the Company had accrued \$5.4 million of interest and penalties (net of tax benefit) related to uncertain tax positions.

We conduct business globally and, as a result, the company or one or more of our subsidiaries files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of

business we are subject to examination by taxing authorities. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2000. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, we believe our reserves for income taxes represent the most probable outcome. We adjust these reserves, as well as the related interest, in light of changing facts and circumstance.

The Company anticipates that the total amount of liability for unrecognized tax benefits may change due to the settlement of audits and the expiration of statute of limitations in the next 12 months. In the first quarter of 2007, the Company paid \$4.8 million (net of tax benefit) in settlement of uncertain tax benefits and accrued interest and penalties.

#### NOTE 10 STOCKHOLDERS EQUITY

A summary of the changes in stockholders equity for the three months ended March 31, 2007 consisted of the following (in thousands):

|                                                                                           |              |
|-------------------------------------------------------------------------------------------|--------------|
| Stockholders equity, December 31, 2006                                                    | \$ 1,680,388 |
| Adoption of FIN 48                                                                        | (2,931 )     |
|                                                                                           | 1,677,457    |
| Common stock issued under employee plans                                                  | 1,127        |
| Increase in additional paid-in capital for restricted stock and stock option compensation | 3,402        |
| Net income                                                                                | 31,612       |
| Comprehensive income                                                                      | 212          |
| Other                                                                                     | 66           |
|                                                                                           |              |
| Stockholders equity, March 31, 2007                                                       | \$ 1,713,876 |

**NOTE 11 CONTINGENCIES***Legal Matters*

*Phen-fen litigation.* Beginning in late 1997, a number of product liability suits were filed against Watson, The Rugby Group ( Rugby ) and certain other Watson affiliates, as well as numerous other manufacturing defendants, for personal injuries allegedly arising out of the use of phentermine hydrochloride. The plaintiffs allege various injuries, ranging from minor injuries and anxiety to heart damage and death. As of May 4, 2007, approximately 27 cases, with a total of approximately 187 plaintiffs, were pending against Watson and its affiliates in numerous state and federal courts. Most of the cases involve multiple plaintiffs, and several were filed or certified as class actions. The Company believes it will be fully indemnified by Rugby's former owner, Aventis Pharmaceuticals ( Aventis , formerly known as Hoechst Marion Roussel, Inc., and now known as Sanofi Aventis) for the defense of all such cases and for any liability that may arise out of these cases. Aventis is currently controlling the defense of all these matters as the indemnifying party under its agreements with the Company. Additionally, Watson may have recourse against the manufacturing defendants in these cases.

*Cipro® Litigation.* Beginning in July 2000, a number of suits were filed against Watson, Rugby and other company affiliates in various state and federal courts alleging claims under various federal and state competition and consumer protection laws. Several plaintiffs have filed amended complaints and motions seeking class certification. As of March 8, 2006, approximately 42 cases had been filed against Watson, Rugby and other Watson entities. Twenty-two of these actions have been consolidated in the U.S. District Court for the Eastern District of New York ( *In re: Ciprofloxacin Hydrochloride Antitrust Litigation, MDL Docket No. 001383* ). On May 20, 2003, the court hearing the consolidated action granted Watson's motion to dismiss and made rulings limiting the theories under which plaintiffs can seek recovery against Rugby and the other defendants. On March 31, 2005, the court hearing the consolidated action granted summary judgment in favor of the defendants on all of plaintiffs' claims, denied the plaintiffs' motions for class certification, and directed the clerk of the court to close the case. On May 7, 2005, three groups of plaintiffs from the consolidated action (the direct purchaser plaintiffs, the indirect purchaser plaintiff purchasers and plaintiffs Rite Aid and CVS) filed notices of appeal in the United States Court of Appeals for the Second Circuit, appealing, among other things, the May 20, 2003 order dismissing Watson and the March 31, 2005 order granting summary judgment in favor of the defendants. The three appeals were consolidated by the appellate court. The defendants have moved to transfer the appeal to the United States Court of Appeals for the Federal Circuit on the ground that patent issues are involved in the appeal. The plaintiffs have opposed the motion to transfer. As of February 26, 2007, the appellate court had not ruled on the motion or the pending appeal. Other actions are pending in various state courts, including New York, California, Kansas, Tennessee, Florida and Wisconsin. The actions generally allege that the defendants engaged in unlawful, anticompetitive conduct in connection with alleged agreements, entered into prior to Watson's acquisition of Rugby from Aventis, related to the development, manufacture and sale of the drug substance ciprofloxacin hydrochloride, the generic version of Bayer's brand drug, Cipro®. The actions generally seek declaratory judgment, damages, injunctive relief, restitution and other relief on behalf of certain purported classes of individuals and other entities. The courts hearing the cases in New York have dismissed the actions. Plaintiffs have sought leave to appeal the dismissal of the New York action. In Wisconsin, the plaintiffs appealed and on May 9, 2006, the appellate court reversed the order of dismissal. On June 8, 2006, the defendants filed a petition for review in the Wisconsin Supreme Court. On July 26, 2006, the Wisconsin Supreme Court granted the petition for review. The Court heard oral argument on the petition on December 12, 2006. As of February 26, 2007, the Court had not ruled on the petition. In the action pending in Kansas, the court has stayed the matter pending the outcome of the appeal in the consolidated case. In the action pending in the California Superior Court for the County of San Diego ( *In re: Cipro Cases I & II, JCCP Proceeding Nos. 4154 & 4220* ), on July 21, 2004, the California Court of Appeal granted in part and denied in part the defendants' petition for a writ of mandate seeking to reverse the trial court's order granting the plaintiffs' motion for class certification. Pursuant to the appellate court's ruling, the majority of the plaintiffs will be permitted to pursue their claims as a class. On April 13, 2005, the Superior Court granted the parties' joint application

to stay the California case pending the outcome of the appeal of the consolidated case. In addition to the pending actions, Watson understands that various state and federal agencies are investigating the allegations made in these actions. Aventis has agreed to defend and indemnify Watson and its affiliates in connection with the claims and investigations arising from the conduct and agreements allegedly undertaken by Rugby and its affiliates prior to Watson's acquisition of Rugby, and is currently controlling the defense of these actions.

*Governmental Reimbursement Investigations and Drug Pricing Litigation* In November 1999, Schein Pharmaceutical, Inc., now known as Watson Pharma, Inc. ( Watson Pharma ) was informed by the U.S. Department of Justice that Watson Pharma, along with numerous other pharmaceutical companies, is a defendant in a qui tam action brought in 1995 under the U.S. False Claims Act currently pending in the U.S. District Court for the Southern District of Florida. Watson Pharma has not been served in the qui tam action. A qui tam action is a civil lawsuit brought by an individual for an alleged violation of a federal statute, in which the U.S. Department of Justice has the right to intervene and take over the prosecution of the lawsuit at its option. Pursuant to applicable federal law, the qui tam action is under seal and, at this time, no details are available concerning, among other things, the various theories of liability against Watson Pharma or the amount of damages sought from it. The Company believes that the qui tam action relates to whether allegedly improper price reporting by pharmaceutical manufacturers led to increased payments by Medicare and/or Medicaid. The qui tam action may seek to recover damages from Watson Pharma based on its price reporting practices. Watson Pharma subsequently also received and responded to notices or subpoenas from the Attorneys General of various states, including Florida, Nevada, New York, California and Texas, relating to pharmaceutical pricing issues and whether allegedly improper actions by pharmaceutical manufacturers led to excessive payments by Medicare and/or Medicaid. On June 26, 2003, the Company received a request for records and information from the U.S. House Committee on Energy and Commerce in connection with that committee's investigation into pharmaceutical reimbursements and rebates under Medicaid. The Company produced documents in response to the request. Other state and federal inquiries regarding pricing and reimbursement issues are anticipated.

Beginning in July 2002, the Company and certain of its subsidiaries, as well as numerous other pharmaceutical companies, were named as defendants in various state and federal court actions alleging improper or fraudulent reporting practices related to the reporting of average wholesale prices and wholesale acquisition costs of certain products, and that the defendants committed other improper acts in order to increase prices and market shares. Some of these actions have been consolidated in the U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 1456*). The consolidated amended complaint in that case alleges that the defendants' acts improperly inflated the reimbursement amounts paid by various public and private plans and programs. The amended complaint alleges claims on behalf of a purported class of plaintiffs that paid any portion of the price of certain drugs, which price was calculated based on its average wholesale price, or contracted with a pharmacy benefit manager to provide others with such drugs. The Company filed an Answer to the Amended Consolidated Class Action Complaint on April 9, 2004. Defendants in the consolidated litigation have been divided into two groups. The Company and its named subsidiaries are contained in a large group of defendants that is currently awaiting a ruling on the plaintiffs' request for certification of classes of plaintiffs to maintain a class action against the drug company defendants. Certain other defendants, referred to as the first-tier defendants, are scheduled to proceed on a more expedited basis, and a trial has been completed with respect to some of the claims against this group of defendants. The defendants in that trial are awaiting the judge's ruling on their case. The court has granted class certification with respect to the first-tier defendants.

The Company and certain of its subsidiaries also are named as defendants in various lawsuits filed by the Attorneys General of numerous states, including Nevada, Montana, Massachusetts, Wisconsin, Kentucky, Alabama, Illinois, Mississippi, Florida, Arizona, Missouri, Alaska, Hawaii, Idaho, and South Carolina. *State of Nevada v. American Home Products, et al., Civil Action No. 02-CV-12086-PBS, United States District Court for the District of Massachusetts; State of Montana v. Abbott Laboratories, et al., Civil Action No. 02-CV-12084-PBS, United States District Court for the District of Massachusetts; Commonwealth of Massachusetts v. Mylan Laboratories, et al., Civil Action No. 03-CV-11865-PBS, United States District Court for the District of Massachusetts; State of Wisconsin v. Abbott Laboratories, et al., Case No. 04-cv-1709, Wisconsin Circuit Court for Dane County; Commonwealth of Kentucky v. Alparma, Inc., et al., Case Number 04-CI-1487, Kentucky Circuit Court for Franklin County; State of Alabama v. Abbott Laboratories, Inc. et al., Civil Action No. CV05-219, Alabama Circuit Court for Montgomery County; State of Illinois v. Abbott Laboratories, Inc. et al., Civil*

*Action No. 05-CH-02474, Illinois Circuit Court for Cook County; State of Mississippi v. Abbott Laboratories, Inc. et al., Civil Action No. G2005-2021 S/2, Mississippi Chancery Court of Hinds County; State of Florida ex rel. Ven-A-Care, Civil Action No 98-3032G, Florida Circuit Court in Leon County; State of Arizona ex rel. Terry Goddard, No. CV 2005-18711, Arizona Superior Court for Maricopa County; State of Missouri ex rel. Jeremiah W. (Jay) Nixon v. Mylan Laboratories, et al, Case no. 054-2486, Missouri Circuit Court of St. Louis. State of Alaska v. Alpharma Branded Products Division Inc., et al., In the Superior Court for the State of Alaska Third Judicial District at Anchorage, C.A. No. 3AN-06-12026 CI. State of Idaho v. Alpharma USPDI Inc. et al., In the District Court of the Fourth Judicial District of the State of Idaho, in and for the County of Ada, C.A. No. CV-0C-0701847. State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7152. State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7155. State of Hawaii v. Abbott Laboratories, Inc. et al., In the Circuit Court of the First Circuit, State of Hawaii, C.A. No. 06-1-0720-04 EEH.*

These cases generally allege that the defendants caused the states to overpay pharmacies and other providers for prescription drugs under state Medicaid Programs by inflating the reported Average Wholesale Price or Wholesale Acquisition Cost, and by reporting false prices to the United States government under the Best Prices rebate program. Several of these cases also allege that state residents were required to make inflated copayments for drug purchases under the federal Medicare program, and companies were required to make inflated payments on prescription drug purchases for their employees. These cases, some of which have been removed to federal court, are in the early stages of pleading or are proceeding through pretrial discovery. On January 20, 2006, the Company was dismissed without prejudice from the actions brought by the States of Montana and Nevada because the Company was not timely served.

The City of New York filed an action in the United States District Court for the Southern District of New York on August 4, 2004, against the Company and numerous other pharmaceutical defendants alleging similar claims. The case was transferred to the United States District Court for the District of Massachusetts, and was consolidated with several similar cases filed by individual New York counties. A corrected Consolidated Complaint was filed on June 22, 2005 (*City of New York v. Abbott Laboratories, Inc., et al., Civil Action No. 01-CV-12257-PBS, United States District Court for the District of Massachusetts*). The Consolidated Complaint included as plaintiffs the City of New York and 30 New York counties. Since the filing of the Consolidated Complaint, cases brought by a total of 14 additional New York counties have been transferred to the District of Massachusetts. The Company is now named as a defendant in cases brought by the City of New York and 44 New York counties, consolidated in the District of Massachusetts case. An additional action raising similar allegations was filed by Orange County, New York, on April 5, 2007, and the Company was served with a copy of the Complaint in that case on April 25, 2007. (*County of Orange v. Abbott Laboratories, Inc., et al., United States District Court for the Southern District of New York, Case No. 07-CV-2777*).

Additional actions by other states, cities and/or counties are anticipated. These actions, if successful, could adversely affect the Company and may have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

**FDA Matters.** In May 2002, Watson reached an agreement with the FDA on the terms of a consent decree with respect to its Corona, California manufacturing facility. The court approved the consent decree on May 13, 2002 (*United States of America v. Watson Laboratories, Inc., and Allen Y. Chao*, United States District Court for the Central District of California, EDCV-02-412-VAP). The consent decree with the FDA does not require any fine, a facility shutdown, product recalls or any reduction in production or service at the Company's Corona facility. The consent decree applies only to the Corona facility and not other manufacturing sites. The decree requires Watson to ensure that its Corona, California facility complies with the FDA's cGMP regulations. Pursuant to the agreement, Watson hired an independent expert to conduct inspections of the Corona facility at least once each year. In February 2003, February 2004, January 2005, and January 2006 and January 2007,

respectively, the first, second, third, fourth and fifth annual inspections were completed and the independent expert submitted its report of the inspection to the FDA. In each instance, the independent expert reported its opinion that, based on the findings of the audit of the facility, the FDA's applicable cGMP requirements, applicable FDA regulatory guidance, and the collective knowledge, education, qualifications and experience of the expert's auditors and reviewers, the systems at Watson's Corona facility audited and evaluated by the expert are in compliance with the FDA's cGMP regulations. However, the FDA is not required to accept or agree with the independent expert's opinion. The FDA conducted an inspection of that facility from March 31, 2004 until May 6, 2004. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection, including observations related to certain laboratory test methods and other procedures in place at the facility. In June 2004 the Company submitted its response to the FDA Form 483 inspectional observations and met with FDA officials to discuss its response, including the corrective actions the Company had taken, and intended to take, to address the inspectional observations. The FDA conducted another inspection of the facility from April 5, 2005 through April 13, 2005. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. The FDA conducted another inspection of the facility from July 9, 2006 through July 21, 2006. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. From February 20, 2007 through March 9, 2007, the FDA conducted another inspection of the facility. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection. In April 2007 the Company submitted its response to the FDA Form 483 inspectional observations, including the corrective actions the Company has taken to address the inspectional observations. If, in the future, the FDA determines that, with respect to its Corona facility, Watson has failed to comply with the consent decree or FDA regulations, including cGMPs, or has failed to adequately address the observations in the Form 483, the consent decree allows the FDA to order Watson to take a variety of actions to remedy the deficiencies. These actions could include ceasing manufacturing and related operations at the Corona facility, and recalling affected products. Such actions, if taken by the FDA, could adversely affect the Company, its results of operations, financial position and/or cash flows.

*Securities Litigation.* Beginning in November 2003, several securities class action lawsuits were commenced in the United States District Court for the Central District of California against Watson and certain of its present and former officers and directors. On February 9, 2004, the federal court issued an order consolidating all of the federal actions (In re: Watson Pharmaceuticals, Inc. Securities Litigation, Case No. CV-03-8236 AHM). In addition to the federal consolidated actions, two shareholder derivative actions were filed in California Superior Court for the County of Riverside ( *Philip Orlando v. Allen Chao, et al.*, Case No. 403717; and *Charles Zimmerman v. Allen Chao, et al*, Case No. 403715 ). These federal and state cases all relate to the drop in the price of the Company's common stock in November 2001, and allege generally that the Company failed to timely advise investors about matters such as falling inventory valuations, increased competition and manufacturing difficulties, and therefore, the Company's published financial statements and public announcements during 2000 and 2001 were false and misleading. The shareholder derivative actions were dismissed without prejudice on November 16, 2004. On August 2, 2004, the United States District Court for the Central District of California court granted the defendants' motion to dismiss the federal consolidated action, and allowed plaintiffs until August 30, 2004 to file an amended complaint. On August 30, 2004, the lead plaintiff in the federal consolidated action notified the court that it did not intend to file an amended complaint in response to the court's order granting the defendants' motion to dismiss. On September 2, 2004, the District Court entered a judgment of dismissal in favor of the defendants. On October 1, 2004, one of the non-lead plaintiffs in the consolidated action filed a Notice of Appeal of the dismissal of the action with the United States Court of Appeals for the Ninth Circuit (Pension Fund v. Watson Pharmaceuticals, Inc., USCA Docket No. 04-56791). The court heard oral argument on the appeal on November 17, 2006. On December 1, 2006, the court ordered appellants to file a new and separate action against defendants within 28 days or show cause why they had not done so. Appellants did not file a new and separate action, responding that such a filing would be time-barred and requesting a ruling on their appeal. As of May 4, 2007, the appellate court had not ruled on the matter. The Company believes that it has substantial meritorious defenses and intends to defend the matters vigorously. However, these actions, if successful, could adversely affect the Company and could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

*Securities Litigation Against Andrx Corporation.* On October 11, 2005, Jerry Lowry filed a class action complaint on behalf of purchasers of the Andrx's common stock during the class period (March 9, 2005 through September 5, 2005) in the U.S. District Court for the Southern District of Florida against Andrx Corporation and its then Chief Executive Officer, Thomas Rice ( *Jerry Lowry v. Andrx Corporation, et al.*, Case No. 05-61640). The complaint seeks damages under the Securities Exchange Act of 1934, and alleges that during the class period, Andrx failed to disclose that its manufacturing facilities were not in compliance with current Good Manufacturing Practices ( cGMP ). The complaint further alleges that Andrx's failure to be cGMP compliant led to the FDA placing Andrx on Official Action Indicated status, which resulted in not being eligible for approvals of Andrx's Abbreviated New Drug Applications. On July 24, 2006, the defendants moved to dismiss the action. On December 8, 2006, the court granted in part and denied in part the defendants' motion to dismiss. Discovery is ongoing. Though we are not in a position to determine the ultimate outcome of this matter, an adverse determination of this action could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

*Naproxen Sodium (Naprelan).* In October 1998, Elan Corporation Plc sued Andrx in the United States District Court for the Southern District of Florida, alleging that Andrx's pending ANDA for a generic version of Elan's Naprelan® infringed Elan's patent No. 5,637,320. ( *Elan Corporation PLC v. Andrx Pharmaceuticals, Inc.*, Case No. 98-7164). In March 2002, the District Court issued an order that Elan's patent was invalid, and in September 2002, Andrx commenced selling the 500mg strength of naproxen sodium, its generic version of Naprelan®. In March 2003, the District Court issued an order denying, among other things, (i) Elan's motion for consideration of the March 2002 order invalidating its patent, and (ii) Andrx's motion asking the District Court for a ruling on its non-infringement defenses. Both parties appealed that March 2003 decision. ( *Elan Corporation PLC v. Andrx Pharmaceuticals, Inc.*, Case No. 03-1354). On May 5, 2004, the Federal Circuit Court of Appeals reversed the District Court's determination that the Elan patent was invalid, and remanded the case back to the District Court for a determination as to whether Andrx's product infringes the Elan patent. On July 12, 2005, the Federal Circuit Court of Appeals issued a decision, in an unrelated case, on how a court should address issues of claim construction, and the District Court instructed the parties to file briefs on how the District Court should proceed in this matter in light of the Federal Circuit Court of Appeals decision. The parties filed their briefs and are awaiting the court's decision.

In January 2005, Elan filed a complaint in the U.S. District Court for the Southern District of Florida seeking willful damages as a result of Andrx's sale of its generic version of Naprelan®. ( *Elan Corporation PLC v. Andrx Pharmaceuticals, Inc.*, Case No. 058-60158). In February 2005, Andrx filed its answer to Elan's January 2005 complaint and filed a counterclaim for declaratory relief for unenforceability due to inequitable conduct and for non-infringement and invalidity of the applicable patent. This matter has been stayed pending resolution of the infringement action. Andrx has sold and is continuing to sell its generic version of the 500mg strength of Naprelan®. Therefore, an adverse determination could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

*Mallinckrodt Claim.* On February 17, 2006, Andrx filed a complaint against Mallinckrodt in the U.S. District Court for the Southern District of Florida. ( *Andrx Therapeutics, Inc v. Mallinckrodt, Inc.*, Case No. 06-60210). The complaint results from a dispute over certain agreements, including a supply and marketing agreement entered into between Andrx and Mallinckrodt. The complaint seeks to establish the parties' rights under the agreements, a judgment declaring that the agreements are still in force and that Andrx has not defaulted in its obligations. In the alternative, Andrx seeks a judgment for either breach of contract for anticipatory repudiation or for breach of duty of good faith. On March 10, 2006, Mallinckrodt filed suit against Andrx in state court in Missouri, arising from the same dispute referenced above. ( *Mallinckrodt, Inc. v. Andrx Laboratories, Inc., et al.*, Case No. 06-1000). In its suit, Mallinckrodt alleges breach of contract, breach of implied covenant of good faith and fair dealing and seeks damages of \$9.5 million, along with a declaratory judgment and injunctive relief. This matter is set for trial on May 21, 2007.

*Department of Health and Human Services Subpoena.* In December 2003, the Company's subsidiary, Watson Pharma, received a subpoena from the Office of the Inspector General ( OIG ) of the Department of Health and Human Services. The subpoena requested documents relating to physician meetings conducted during



2002 and 2003 related to Watson Pharma's Ferrlecit® intravenous iron product. Watson Pharma provided the requested documents and has not been contacted again by the OIG for several years. However, the Company cannot predict what additional actions, if any, may be taken by the OIG, Department of Health and Human Services, or other governmental entities.

*Hormone Replacement Therapy Litigation.* Beginning in early 2004, a number of product liability suits were filed against the Company and certain Company affiliates, for personal injuries allegedly arising out of the use of hormone replacement therapy products, including but not limited to estropipate and estradiol. These complaints also name numerous other pharmaceutical companies as defendants, and allege various injuries, including ovarian cancer, breast cancer and blood clots. As of February 26, 2007, approximately ninety cases were pending against Watson and/or its affiliates in state and federal courts representing claims by approximately 815 plaintiffs. Many of the cases involve multiple plaintiffs. The majority of the cases have been transferred to and consolidated in the United States District Court for the Eastern District of Arkansas (*In re: Prempro Products Liability Litigation, MDL Docket No. 1507*). Discovery in these cases is ongoing. The Company maintains product liability insurance against such claims. However, these actions, if successful, or if insurance does not provide sufficient coverage against the claims, could adversely affect the Company and could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

Watson and its affiliates are involved in various other disputes, governmental and/or regulatory inspections, inquiries, investigations and proceedings, and litigation matters that arise from time to time in the ordinary course of business. The process of resolving matters through litigation or other means is inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows.

#### **NOTE 12 SUBSEQUENT EVENT**

On May 4, 2007 our stockholders approved the Second Amendment and Restatement of the Watson Pharmaceuticals, Inc. Incentive Award Plan (the Amendment). The Amendment provides for, among other things, (i) the replacement of certain shares available for grant that were only available to former Andrx employees and new-hires with shares available for grant to all Watson employees, (ii) the elimination of a cap on the aggregate number of shares that we may issue as restricted stock, (iii) the concept of a full value award, which reduces the number of shares available for grant by two shares for every one share of restricted stock granted and (iv) the extension of the term of the Incentive Award Plan to March 23, 2017.

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

The following discussion of our financial condition and the results of operations should be read in conjunction with the Condensed Consolidated Financial Statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q ( "Quarterly Report" ). This discussion contains forward-looking statements that are subject to known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include, among others, those identified under "Cautionary Note Regarding Forward-Looking Statements" and elsewhere in this Quarterly Report and under "Risks Related to our Business" in our Annual Report on Form 10-K for the year ended December 31, 2006.

### Overview

Watson Pharmaceuticals, Inc. ( "Watson" , the "Company" , we , us or our ) was incorporated in 1985 and is engaged in the development, manufacturing, sale and distribution of brand and off-patent (generic) pharmaceutical products. Watson operates manufacturing, distribution, research and development, and administrative facilities primarily in the United States ( "U.S." ).

Prescription pharmaceutical products in the U.S. are generally marketed as either generic or brand pharmaceuticals. Generic pharmaceutical products are bioequivalents of their respective brand products and provide a cost-efficient alternative to brand products. Brand pharmaceutical products are marketed under brand names through programs that are designed to generate physician and consumer loyalty.

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx Corporation ( "Andrx" ) in an all-cash transaction for \$25 per share, or total consideration of approximately \$1.9 billion (the "Andrx Acquisition" ). Andrx distributes pharmaceutical products primarily to independent and chain pharmacies and physicians' offices and is considered a leader in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products.

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

Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders' equity, net of any related tax effect. As required by Accounting Research Bulletin ( "ARB" ) No. 51, "Consolidated Financial Statements" ( "ARB 51" ), earnings (loss) on equity method investments has been restated for the three months ended March 31, 2006 to account for our investment in common shares of

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Andrx using the equity method of accounting in accordance with Accounting Principles Board ( APB ) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock ( APB 18 ). Accumulated other comprehensive income has also been restated for the three months ended March 31, 2006 to reflect these changes.

### Results of Operations

|                            | Three Months Ended March 31, 2007 |           |              |            | Three Months Ended March 31, 2006 |           |            |   |
|----------------------------|-----------------------------------|-----------|--------------|------------|-----------------------------------|-----------|------------|---|
|                            | Generic                           | Brand     | Distribution | Total      | Generic                           | Brand     | Total      |   |
| Product sales              | \$ 411,475                        | \$ 90,638 | \$ 145,440   | \$ 647,553 | \$ 321,415                        | \$ 83,237 | \$ 404,652 |   |
| Other                      | 13,150                            | 10,902    |              | 24,052     | 675                               | 1,906     | 2,581      |   |
| Net revenues               | 424,625                           | 101,540   | 145,440      | 671,605    | 322,090                           | 85,143    | 407,233    |   |
| Cost of sales(1)           | 272,623                           | 25,215    | 126,882      | 424,720    | 217,384                           | 17,370    | 234,754    |   |
| Gross profit               | 152,002                           | 76,325    | 18,558       | 246,885    | 104,706                           | 67,773    | 172,479    |   |
| Gross margin               | 35.8                              | % 75.2    | % 12.8       | % 36.8     | % 32.5                            | % 79.6    | % 42.4     | % |
| Research and development   | 26,513                            | 11,295    |              | 37,808     | 20,495                            | 9,342     | 29,837     |   |
| Selling and marketing      | 14,549                            | 26,411    | 14,203       | 55,163     | 12,938                            | 28,975    | 41,913     |   |
| Contribution               | 110,940                           | 38,619    | 4,355        | 153,914    | 71,273                            | 29,456    | 100,729    |   |
| Contribution margin        | 26.1                              | % 38.0    | % 3.0        | % 22.9     | % 22.1                            | % 34.6    | % 24.7     | % |
| General and administrative |                                   |           |              | 48,055     |                                   |           | 24,837     |   |
| Amortization               |                                   |           |              | 43,933     |                                   |           | 41,100     |   |
| Operating income           |                                   |           |              | \$ 61,926  |                                   |           | \$ 34,792  |   |
| Operating margin           |                                   |           |              | 9.2        | %                                 |           | 8.5        | % |

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

### Generic Segment

#### Net Revenues

Our generic pharmaceutical business develops, manufactures, markets, sells and distributes generic products that are the therapeutic equivalent to their brand name counterparts and are generally sold at prices significantly less than the brand product. As such, generic products provide an effective and cost-efficient alternative to brand products. When patents or other regulatory exclusivity no longer protect a brand product, opportunities exist to introduce off-patent or generic counterparts to the brand product. Our portfolio of generic products includes products we have internally developed, products we have licensed from third parties, and products we distribute for third parties.

Other revenues include royalties and commission revenue earned as a sales agent from the sale of fentanyl citrate troche.

Our Generic segment develops, manufactures, markets, sells and distributes products within two product lines: Generics and Generic Oral Contraceptives. Our Generics product line includes oral dosage, transdermal, injectible and transmucosal products used for a variety of indications including pain management, depression, hypertension and smoking cessation.

Net revenues from our Generic segment for the three months ended March 31, 2007 increased \$102.5 million or 31.8% over net revenues from the prior year period. This increase in net revenues was mainly attributable to sales of certain authorized generic products including oxycodone HCl controlled-release tablets,

launched during the fourth quarter of 2005, and pravastatin sodium tablets, launched during the second quarter of 2006, the addition of products from the Andrx Acquisition and an increase in other revenue. The increase in net revenues from these authorized generics, the Andrx Acquisition and other revenues for the three months ended March 31, 2007 totaled \$105.7 million. Generic segment sales of oxycodone HCl controlled-release tablets ended in the first quarter of 2007 as the supply and distribution agreement to sell this product terminated during the quarter.

The increase in other revenues in the three months ended March 31, 2007 for the Generic segment was primarily related to commission revenues earned on sales of fentanyl citrate troche (which commenced during the third quarter of 2006) and royalties earned on GlaxoSmithKline's (GSK's) sales of Wellbutrin XL® 150mg (which commenced during the first quarter of 2007).

#### *Gross Profit (Gross Margin)*

Gross profit represents net revenues less cost of sales. Cost of sales includes production and packaging costs for products we manufacture, third party acquisition costs for products manufactured by others, profit-sharing or royalty payments for products sold pursuant to licensing agreements, inventory reserve charges, and excess capacity utilization charges, when applicable. Cost of sales does not include amortization costs for acquired product rights.

Gross profit for our Generic segment increased \$47.3 million to \$152.0 million in the three months ended March 31, 2007 from \$104.7 million in the prior year period. This year over year increase in gross profit was due to the following factors:

- Gross profit from authorized generic products oxycodone HCl controlled-release tablets and pravastatin sodium tablets increased \$18 million primarily as a result of price increases realized in the current year period and more favorable commercial terms on sales of oxycodone HCl controlled-release tablets. Our agreement to sell oxycodone HCl controlled-release tablets ended during the first quarter of 2007. Going forward, we expect to realize minimal gross profit from the sale of pravastatin sodium tablets.
- Other revenue increased \$12.5 million as a result of commission revenue earned from the sale of fentanyl citrate troche and royalties earned in connection with the licensing of a patent to GSK during the quarter.
- Gross profit from products acquired in connection with the Andrx Acquisition, production cost improvements and new products also contributed to the year over year gross profit increase.

Going forward, quarterly gross profit will be negatively impacted by the termination of the oxycodone HCl controlled release distribution agreement. However, we expect this negative impact to be partially offset by an increase in royalty revenues from the sale of metoprolol succinate 50 mg. extended release tablets (the generic version of Toprol XL®) and a full quarter of royalties earned on GSK's sales of Wellbutrin XL® 150mg.

Gross margins for our Generic segment increased to 35.8% for the three months ended March 31, 2007 from 32.5% in the prior year period. The increase in gross margins is primarily due to an increase in other revenue and production cost improvements realized during the first quarter of 2007 offset in part by price erosion within our generic business. We expect further improvement in gross margins due to the termination of the oxycodone HCl controlled release distribution agreement and anticipated royalty revenue from the sale of metoprolol succinate extended release tablets.

#### *Research and Development Expenses*

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Research and development ( R&D ) expenses consist predominantly of personnel costs, contract research, development and facilities costs associated with the development of our products.

R&D expenses within our Generic segment increased \$6.0 million or 29% during the three months ended March 31, 2007, as compared to the same period of the prior year, due to the inclusion of R&D expenditures from the Andrx Acquisition.

### *Selling and Marketing Expenses*

Selling and marketing expenses consist mainly of personnel costs, facilities costs, insurance and professional services costs, which support our sales, marketing, human resources, finance and administration functions.

Generic segment selling and marketing expenses increased slightly during the three months ended March 31, 2007 as compared to the same period of the prior year due partly to the Andrx Acquisition.

## **Brand Segment**

### *Net Revenues*

Our brand pharmaceutical business develops, manufactures, markets, sells and distributes products within two sales and marketing groups: Specialty Products and Nephrology.

Our Specialty Products product line includes urology and a number of other non-promoted products.

Our Nephrology product line consists of products for the treatment of iron deficiency anemia and is generally marketed to nephrologists and dialysis centers. The key product of the Nephrology group is Ferrlecit®, which is used to treat low iron levels in patients undergoing hemodialysis in conjunction with erythropoietin therapy.

Other revenues in the Brand segment consist of co-promotion revenue, royalties, and revenue (including the amortization of deferred revenue) relating to our obligation to manufacture and supply two brand products to a third party. This contract manufacturing agreement was assumed as part of the Andrx Acquisition.

Other revenue also includes revenue recognized from research, development and licensing agreements (including milestone payments and deferred revenue related to certain contract manufacturing arrangements). Revenue from development agreements is deferred and recognized over the entire contract performance period, starting with the contract's commencement, but not prior to the removal of any contingencies for each individual milestone. We recognize this revenue based upon the pattern in which the revenue is earned or the obligation is fulfilled.

Net revenues from our Brand segment for the three months ended March 31, 2007 increased \$16.4 million or 19.3% over net revenues from the prior year period. The increase in net revenues was attributable to a \$9.0 million increase in other revenues related to royalties and deferred revenues recognized from a contract manufacturing agreement assumed from the Andrx Acquisition and our share of profits on the AndroGel® co-promotion agreement, which commenced in the fourth quarter of 2006. Brand segment product sales also increased for certain non-promoted products within our Specialty Products product line from the prior year period as the prior year period was impacted by a reduction in wholesaler inventory levels.

### *Gross Profit (Gross Margin)*

Gross margin from our Brand segment decreased to 75.2% during the three months ended March 31, 2007 from 79.6% in the prior year period. The decrease in gross margins is primarily due to the sale of products from the Andrx Acquisition and a change in product mix as compared to the prior year period.

### *Research and Development Expenses*

R&D expenses within our Brand segment increased \$2.0 million or 21% during the three months ended March 31, 2007, as compared to the same period of the prior year, primarily due to an increase in costs related to Phase III studies on the gel formulation of oxybutynin for overactive bladder.

### *Selling and Marketing Expenses*

Brand segment selling and marketing expenses decreased \$2.6 million or 9% during the three months ended March 31, 2007 as compared to the same period of the prior year primarily due to lower product spending for Oxytrol® and Ferrlecit® during the current quarter.

**Distribution Segment***Net Revenues*

Our Distribution segment mainly distributes generic pharmaceutical products manufactured by third parties, as well as by Watson, primarily to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians' offices. Sales are principally generated through an in-house telemarketing staff and through internally developed ordering systems. The Distribution segment operating results exclude sales of products reported in Watson's Generic and Brand segments.

*Gross Profit (Gross Margin)*

Gross margins within the Distribution segment have been adversely impacted due to acquisition accounting inventory charges of approximately \$2.5 million during the period.

**Segment Contribution**

| (\$ in thousands):   | Three Months Ended March 31, |            | Change    |       |   |
|----------------------|------------------------------|------------|-----------|-------|---|
|                      | 2007                         | 2006       | Dollars   | %     |   |
| Segment contribution |                              |            |           |       |   |
| Generic              | \$ 110,940                   | \$ 71,273  | \$ 39,667 | 55.7  | % |
| Brand                | 38,619                       | 29,456     | 9,163     | 31.1  | % |
| Distribution         | 4,355                        |            | 4,355     | 100.0 | % |
|                      | \$ 153,914                   | \$ 100,729 | \$ 53,185 | 52.8  | % |
| as % of net revenues | 22.9                         | % 24.7     | %         |       |   |

Generic segment contribution increased for the three months ended March 31, 2007, as compared to the same period of the prior year, due to higher net revenues and gross profit from the sale of certain authorized generics and higher levels of other revenues partially offset by higher R&D and selling and marketing costs as a result of the Andrx Acquisition.

Brand segment contribution increased for the three months ended March 31, 2007, as compared to the same period of the prior year, primarily due to an increase in other revenues and an increase in net product revenues related to certain non-promoted products within our Specialty Products product line which was partially offset by a decline in sales from our Nephrology product line.

For more information on segment contribution, refer to above Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 5 in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

**Corporate General and Administrative Expenses**

| (\$ in thousands):                            | Three Months Ended March 31, |           | Change    |      |   |
|-----------------------------------------------|------------------------------|-----------|-----------|------|---|
|                                               | 2007                         | 2006      | Dollars   | %    |   |
| Corporate general and administrative expenses | \$ 48,055                    | \$ 24,837 | \$ 23,218 | 93.5 | % |
| as a % of net revenues                        | 7.2                          | % 6.1     | %         |      |   |

Corporate general and administrative expenses consist mainly of personnel costs, facilities costs, insurance and professional services costs, which support our sales, R&D, marketing, human resources, finance and administration functions.

Corporate general and administrative expenses increased \$23.2 million or 93% during the three months ended March 31, 2007 as compared to the same period of the prior year due to the inclusion of corporate general and administrative costs related to the Andrx Acquisition. Additional costs include higher personnel costs, depreciation, facility costs and management information system costs.

#### Amortization

| (\$ in thousands):     | Three Months Ended March 31, |           | Change   |     |   |
|------------------------|------------------------------|-----------|----------|-----|---|
|                        | 2007                         | 2006      | Dollars  | %   |   |
| Amortization           | \$ 43,933                    | \$ 41,100 | \$ 2,833 | 6.9 | % |
| as a % of net revenues | 6.5                          | % 10.1    | %        |     |   |

The Company's amortizable assets consist primarily of acquired product rights. For the three months ended March 31, 2007 amortization expense includes intangible assets from the Andrx Acquisition

#### Loss on Early Extinguishment of Debt

| (\$ in thousands):                   | Three Months Ended March 31, |        | Change   |       |   |
|--------------------------------------|------------------------------|--------|----------|-------|---|
|                                      | 2007                         | 2006   | Dollars  | %     |   |
| Loss on early extinguishment of debt | \$ 2,729                     | \$ 720 | \$ 2,009 | 279.0 | % |
| as a % of net revenues               | 0.4                          | % 0.2  | %        |       |   |

During the quarter ended March 31, 2007, the Company pre-paid \$150 million of the Term Facility under the terms of the Senior Credit Facility (together the 2006 Credit Facility). The Company entered into the 2006 Credit Facility in November 2006 to provide financing for the Andrx Acquisition. As a result of this pre-payment, our results for the first quarter of 2007 reflect a \$2.7 million debt repurchase charge.

On March 31, 2006, the Company initiated a redemption notice to the holders of all of its outstanding senior unsecured 7 1/8% notes (1998 Senior Notes). The 1998 Senior Notes were redeemed on May 23, 2006. As a result, the Company incurred costs representing redemption fees, expenses, and a premium on the redemption.

#### Interest Income

| (\$ in thousands):     | Three Months Ended March 31, |          | Change     |  |   |
|------------------------|------------------------------|----------|------------|--|---|
|                        | 2007                         | 2006     |            |  |   |
| Interest income        | \$ 2,929                     | \$ 6,252 | \$ (3,323) |  | ) |
| as a % of net revenues | 0.4                          | % 1.5    | %          |  |   |

Interest income decreased during the three month period ended March 31, 2007, as compared to the prior year period due to the use of available cash, cash equivalents and marketable securities to finance the Andrx Acquisition.

### Interest Expense

| (\$ in thousands):                                                             | Three Months Ended March 31, |          |           | Change | % |
|--------------------------------------------------------------------------------|------------------------------|----------|-----------|--------|---|
|                                                                                | 2007                         | 2006     |           |        |   |
| Interest expense - 2006 Credit Facility                                        | \$ 10,374                    | \$       | \$ 10,374 |        |   |
| Interest expense - convertible contingent senior debentures due 2023 ( CODES ) | 3,151                        | 3,151    |           |        |   |
| Interest expense - 1998 Senior Notes                                           |                              | 256      | (256 )    |        |   |
| Interest and fees on credit facility                                           |                              | 247      | (247 )    |        |   |
| Change in derivative value                                                     | 24                           | (453 )   | 477       |        |   |
| Interest expense - other                                                       | 327                          | 100      | 227       |        |   |
| Interest expense                                                               | \$ 13,876                    | \$ 3,301 | \$ 10,575 | 320.4  | % |
| as a % of net revenues                                                         | 2.1                          | % 0.8    | %         |        |   |

Interest expense increased for the three month period ended March 31, 2007 due to interest expense incurred on debt issued to finance the Andrx Acquisition.

### Other Income (Expense)

| (\$ in thousands):                                        | Three Months Ended March 31, |           |           | Change | % |
|-----------------------------------------------------------|------------------------------|-----------|-----------|--------|---|
|                                                           | 2007                         | 2006      |           |        |   |
| Earnings (losses) on equity method investments - restated | \$ 1,439                     | \$ (285 ) | \$ 1,724  |        |   |
| Gain on sale of securities                                | 1,789                        | 3,695     | (1,906 )  |        |   |
| Other income                                              | 175                          | 105       | 70        |        |   |
|                                                           | \$ 3,403                     | \$ 3,515  | \$ (112 ) | (3.2 ) | % |
| as a % of net revenues                                    | 0.5                          | % 0.9     | %         |        |   |

### Earnings (Losses) on Equity Method Investments

The Company's equity investments are accounted for under the equity-method when the Company's ownership does not exceed 50% and when the Company can exert significant influence over the management of the investee. As required by ARB 51, earnings (losses) on equity method investments have been restated for the three months ended March 31, 2006 to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with APB 18.

The earnings recorded during the three months ended March 31, 2007 primarily represent our share of earnings in Somerset Pharmaceuticals, Inc., our joint venture with Mylan Laboratories, Inc.

### Gain on Sale of Securities

The 2006 and 2007 gain on sale of securities resulted from the sale of our investment in Adheris, Inc. During the three months ended March 31, 2006, we received cash proceeds of \$4.7 million from our sale of our investment in Adheris, Inc. and certain contingent consideration. During the three months ended March 31, 2007, all contingencies were removed relating to the contingent consideration received on the sale of our investment in Adheris, Inc. Accordingly, the Company received common shares of inVentiv Health, Inc. ( inVentiv ) during the quarter ended March 31, 2007 as additional proceeds on our sale of our investment in Adheris, Inc. which was recorded as a gain on sale of securities in the quarter ended March 31, 2007.

**Provision for Income Taxes**

| (\$ in thousands):         | Three Months Ended March 31, |           | % Change |       |
|----------------------------|------------------------------|-----------|----------|-------|
|                            | 2007                         | 2006      |          |       |
| Provision for income taxes | \$ 20,041                    | \$ 15,364 |          |       |
| as a % of net revenues     | 3.0                          | 3.8       | %        | %     |
| Effective tax rate         | 38.8                         | 37.9      | %        | 0.9 % |

The provision for income taxes differs from the amount computed by applying the statutory U.S. federal income tax rate primarily due to state taxes and other factors which, combined, increases the effective tax rate.

The provision for income taxes increased in the three months ended March 31, 2007 due to higher levels of income before income taxes. The higher effective tax rate for the three months ended March 31, 2007, as compared to the same period of the prior year, primarily reflect an increase in the level of permanent differences relative to income before income taxes.

**Liquidity and Capital Resources****Working Capital Position**

Working capital at March 31, 2007 and December 31, 2006 is summarized as follows:

| (\$ in thousands):                     | March 31,<br>2007 | December 31,<br>2006 | Increase<br>(Decrease) |
|----------------------------------------|-------------------|----------------------|------------------------|
| <b>Current Assets:</b>                 |                   |                      |                        |
| Cash and cash equivalents              | \$ 73,550         | \$ 154,171           | \$ (80,621 )           |
| Marketable securities                  | 8,981             | 6,649                | 2,332                  |
| Accounts receivable, net of allowances | 375,608           | 384,692              | (9,084 )               |
| Inventories                            | 492,345           | 517,236              | (24,891 )              |
| Other                                  | 151,185           | 198,928              | (47,743 )              |
| Total current assets                   | 1,101,669         | 1,261,676            | (160,007 )             |
| <b>Current liabilities:</b>            |                   |                      |                        |
| Accounts payable and accrued expenses  | 429,112           | 516,875              | (87,763 )              |
| Current portion of long-term debt      | 5,479             | 107,059              | (101,580 )             |
| Other                                  | 17,048            | 65,995               | (48,947 )              |
| Total current liabilities              | 451,639           | 689,929              | (238,290 )             |
| <b>Working Capital</b>                 | <b>\$ 650,030</b> | <b>\$ 571,747</b>    | <b>\$ 78,283</b>       |
| <b>Current Ratio</b>                   | <b>2.44</b>       | <b>1.83</b>          |                        |

Watson's primary source of liquidity is cash from operations. Net working capital at March 31, 2007 was \$650.0 million compared to \$571.7 million at December 31, 2006 and \$1.12 billion at March 31, 2006.

During the first quarter of 2007, our working capital increased by \$78.3 million primarily related to net cash provided by operating activities. The decrease in other current assets at March 31, 2007 was due primarily to the collection of a \$35 million legal settlement during the quarter. Current portion of long-term debt decreased at March 31, 2007 as we pre-paid the current portion and an additional \$50 million of debt incurred to finance the Andrx Acquisition during the quarter. Accounts payable and accrued liabilities decreased during the quarter.

due to payments of trade payables, royalties payable, accrued severance and retention and bonus accruals. Other current liabilities decreased primarily due to a reclassification of income tax payable from current to long term as a result of the implementation of FIN 48.

We expect that 2007 cash flows from operating activities will continue to exceed net income. In addition, management expects that 2007 cash flows from operating activities and available cash balances will be sufficient to fund our operating liquidity needs.

### ***Cash Flows from Operations***

Summarized cash flow from operations is as follows:

| (\$ in thousands):                        | Three months ended March 31, |            |
|-------------------------------------------|------------------------------|------------|
|                                           | 2007                         | 2006       |
| Net cash provided by operating activities | \$ 88,239                    | \$ 135,710 |

Cash flows from operations represents net income adjusted for certain operating related non-cash items and changes in assets and liabilities. For the three months ended March 31, 2007, cash provided by operating activities was \$88.2 million, compared to \$135.7 million in the three months ended March 31, 2006. Net cash provided by operations was higher in the three months ended March 31, 2006 compared to the three months ended March 31, 2007 primarily due to higher reductions in accounts receivable balances during 2006 and higher reductions in accounts payable and accrued liabilities during 2007 which were partially offset by reductions in inventory balances and prepaid and other current asset balances during the 2007 quarter.

### ***Investing Cash Flows***

Our cash flows from investing activities are summarized as follows:

| (\$ in thousands):                    | Three months ended March 31, |              |
|---------------------------------------|------------------------------|--------------|
|                                       | 2007                         | 2006         |
| Net cash used in investing activities | \$ (18,326 )                 | \$ (47,169 ) |

Investing cash flows consist of expenditures related to acquisitions, capital expenditures, investment and marketable security additions as well as proceeds from investment and marketable security sales. We used \$18.3 million in net cash for investing activities during the three months ended March 31, 2007 compared to \$47.2 million used in investing activities during the three months ended March 31, 2006. The higher net cash used in investing activities during the three months ended March 31, 2006 related to our acquisition of Sekhsaria Chemicals Ltd. during 2006.

### ***Financing Cash Flows***

Our cash flows from financing activities are summarized as follows:

| (\$ in thousands):                                  | Three months ended March 31, |          |
|-----------------------------------------------------|------------------------------|----------|
|                                                     | 2007                         | 2006     |
| Net cash (used in) provided by financing activities | \$ (150,534 )                | \$ 3,742 |

Financing cash flows consist primarily of borrowings and repayments of debt, repurchases of common stock and proceeds from exercising of stock awards. For the three months ended March 31, 2007, net cash used in financing activities was \$150.5 compared to \$3.7 million provided by financing activities during the three months ended March 31, 2006. As indicated above we pre-paid \$150 million of debt originally incurred to finance the Andrx Acquisition during the quarter.

### ***Debt and Borrowing Capacity***

Our debt at March 31, 2007 and December 31, 2006 is summarized as follows:

| (\$ in thousands):                | March 31,<br>2007 | December 31,<br>2006 | Increase<br>(Decrease) |
|-----------------------------------|-------------------|----------------------|------------------------|
| Current portion of long-term debt | \$ 5,479          | \$ 107,059           | \$ (101,580 )          |
| Long-term debt                    | 1,074,210         | 1,124,145            | (49,935 )              |
| Total debt                        | \$ 1,079,689      | \$ 1,231,204         | \$ (151,515 )          |
| Debt to capital ratio             | 38.6              | % 42.3               | %                      |

In March 2003, we issued \$575 million of our CODES. As of March 31, 2007, the entire amount of the CODES remained outstanding at an effective annual interest rate of approximately 2.1%.

In May 1998, we issued \$150 million of our 1998 Senior Notes. On March 31, 2006 the Company initiated a redemption notice to the holders of all of its outstanding 1998 Senior Notes. As a result, the remaining 1998 Senior Notes were redeemed on May 23, 2006.

In November 2006, we entered into the 2006 Credit Facility with a syndicate of banks. The 2006 Credit Facility provides an aggregate of \$1.15 billion of senior financing to Watson, consisting of a \$500 million revolving credit facility ( Revolving Facility ) and a \$650 million senior term loan facility ( Term Facility ). The 2006 Credit Facility was entered into in connection with the Andrx Acquisition.

The 2006 Credit Facility has a five year term and will bear interest equal to LIBOR plus 0.75% (subject to certain adjustments) The indebtedness under the 2006 Credit Facility is guaranteed by Watson's material domestic subsidiaries. The Revolving Facility is available for working capital and other general corporate requirements subject to the satisfaction of certain conditions. Indebtedness under the 2006 Credit Facility may be pre-payable, and commitments reduced at the election of Watson without premium (subject to certain conditions). As of March 31, 2007, the Company had not drawn any funds from the Revolving Facility.

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During the quarter ended March 31, 2007, the Company prepaid \$150 million of the amount outstanding under the Term Facility. As of March 31, 2007, \$500 million is outstanding under the Term Facility. As a result of this pre-payment, our results for the first quarter of 2007 reflect a \$2.7 million non-cash charge for debt repurchase charges.

Under the terms of the 2006 Credit Facility, each of our subsidiaries, other than minor subsidiaries, entered into a full and unconditional guarantee on a joint and several basis. We are subject to, and, as of March 31, 2007, were in compliance with financial and operation covenants under the terms of the Credit Facility. The agreement currently contains the following financial covenants:

- maintenance of a minimum net worth of at least \$1.33 billion;
- maintenance of a maximum leverage ratio not greater than 3.25 to 1.0; and
- maintenance of a minimum interest coverage ratio of at least 5.0 to 1.0.

At March 31, 2007, our net worth was \$1.71 billion, and our leverage ratio was 2.24 to 1.0. Our interest coverage ratio for the three months ended March 31, 2007 was 8.3 to 1.0.

Under the 2006 Credit Facility, interest coverage ratio, with respect to any financial covenant period, is defined as the ratio of EBITDA for such period to interest expense for such period. The leverage ratio, for any financial covenant period, is defined as the ratio of the outstanding principal amount of funded debt for the borrower and its subsidiaries at the end of such period, to EBITDA for such period. EBITDA under the Credit Facility, for any covenant period, is defined as net income plus (1) depreciation and amortization, (2) interest expense, (3) provision for income taxes, (4) extraordinary or unusual losses, (5) non-cash portion of nonrecurring losses and charges, (6) other non-operating, non-cash losses, (7) minority interest expense in respect of equity holdings in affiliates, (8) non-cash expenses relating to stock-based compensation expense and (9) any one-time charges related to the Andrx Acquisition; minus (1) extraordinary gains, (2) interest income and (3) other non-operating, non-cash income.

### *Long-term Obligations*

The following table lists our enforceable and legally binding obligations as of March 31, 2007. Some of the amounts included herein are based on management's estimates and assumptions about these obligations, including their duration, the possibility of renewal, anticipated actions by third parties, and other factors. Because these estimates and assumptions are necessarily subjective, the enforceable and legally binding obligation we will actually pay in future periods may vary from those reflected in the table:

| (in thousands):                                                        | Payments Due by Period (Including Interest) |                     |            |            |        | After 5<br>years |
|------------------------------------------------------------------------|---------------------------------------------|---------------------|------------|------------|--------|------------------|
|                                                                        | Total                                       | Less than<br>1 year | 1-3 years  | 4-5 years  | Other  |                  |
| Long-term and other debt                                               | \$ 1,321,443                                | \$ 42,098           | \$ 228,750 | \$ 375,816 | \$     | \$ 674,779       |
| Liabilities incurred for<br>acquisitions of products and<br>businesses | 1,488                                       | 1,197               |            |            |        | 291              |
| Other taxes payable                                                    | 45,328                                      |                     |            |            | 45,328 |                  |
| Operating lease obligations                                            | 146,393                                     | 14,641              | 44,105     | 15,980     |        | 71,667           |
| Total contractual cash obligations                                     | \$ 1,514,652                                | \$ 57,936           | \$ 272,855 | \$ 391,796 | 45,328 | \$ 746,737       |

The Company is involved in certain minor joint venture arrangements that are intended to complement the Company's core business and markets. The Company has the discretion to provide funding on occasion for working capital or capital expenditures. The Company makes an evaluation of additional funding based on an assessment of the venture's business opportunities. The Company believes that any possible commitments arising from the current arrangements will not be significant to the Company's financial condition or results of operations.

The Company does not have any material off-balance sheet arrangements that have, or are reasonably likely to have, a current or future effect on our financial condition, changes in financial conditions, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

*Recent accounting pronouncements*

In July 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes. An Interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for the uncertainty in recognizing income taxes in an organization in accordance with FASB Statement No. 109 by providing detailed guidance for financial statement recognition, measurement and disclosure involving uncertain tax positions. FIN 48 requires an uncertain tax position to meet a more-likely-than-not recognition threshold at the effective date to be recognized both upon the adoption of FIN 48 and in subsequent periods. FIN 48 is effective for fiscal years beginning after December 15, 2006. As the provisions of FIN 48 will be applied to all tax positions upon initial adoption, the cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. As a result of the adoption of FIN 48, the Company recorded a \$2.9 million increase in the liability for unrecognized tax benefits resulting in a decrease to the January 1, 2007 retained earnings balance of \$2.9 million (for additional information on the adoption of FIN 48, see NOTE 9 INCOME TAXES in the accompanying Notes to Condensed Consolidated Financial Statements in this quarterly report on Form 10-Q).

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

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to market risk for changes in the market values of our investments ( Investment Risk ) and the impact of interest rate changes ( Interest Rate Risk ). We have not used derivative financial instruments in our investment portfolio. The quantitative and qualitative disclosures about market risk are set forth below.

#### Investment Risk

As of March 31, 2007, our total holdings in equity securities of other companies, including equity-method investments and available-for-sale securities, were \$51.8 million. Of this amount, we had equity-method investments of \$48.2 million and publicly traded equity securities (available-for-sale securities) at fair value totaling \$3.3 million (\$1.9 million that was included in Marketable securities and \$1.4 million that was included in Investments and other assets ). The fair values of these investments are subject to significant fluctuations due to volatility of the stock market and changes in general economic conditions. Based on the fair value of the publicly traded equity securities we held at March 31, 2007, an assumed 25%, 40% and 50% adverse change in the market prices of these securities would result in a corresponding decline in total fair value of approximately \$0.8 million, \$1.3 million and \$1.7 million, respectively.

We regularly review the carrying value of our investments and identify and recognize losses, for income statement purposes, when events and circumstances indicate that any declines in the fair values of such investments, below our accounting basis, are other than temporary.

#### Interest Rate Risk

Our exposure to interest rate risk relates primarily to our non-equity investment portfolio. Our cash is invested in A-rated money market mutual funds, short-term securities and auction rate securities. Consequently, our interest rate and principal risk are minimal.

During 2004, we acquired a significant amount of U.S. Treasury securities classified as available-for-sale securities, with no security having a maturity in excess of two years. These securities are exposed to interest rate fluctuations. Because of the short-term nature of these investments, we are subject to minimal interest rate risk and do not believe that an increase in market rates would have a significant negative impact on the realized value of our portfolio.

Based on quoted market rates of interest and maturity schedules for similar debt issues, we estimate that the fair values of our CODES, our 2006 Credit Facility and our other notes payable approximated their carrying values on March 31, 2007. While changes in market interest rates may affect the fair value of our fixed-rate debt, we believe the effect, if any, of reasonably possible near-term changes in the fair value of such debt on our financial condition, results of operations or cash flows will not be material.

At this time, we are not party to any interest rate or derivative hedging contracts and have no material foreign exchange or commodity price risks.

We do not believe that inflation has had a significant impact on our revenues or operations.

#### ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Also, the Company has investments in certain unconsolidated entities. As the Company does not control or manage these entities, its disclosure controls and procedures with respect to such entities are necessarily substantially more limited than those it maintains with respect to its consolidated subsidiaries.

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this Report. Based on the foregoing, the Company's Principal Executive Officer and Principal Financial Officer concluded that the Company's disclosure controls and procedures were effective.

There have been no changes in the Company's internal control over financial reporting, during the three months ended March 31, 2007, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION AND SIGNATURES**

**ITEM 1. LEGAL PROCEEDINGS**

For information regarding legal proceedings, refer to PART I, ITEM 3. LEGAL PROCEEDINGS, of our Annual Report on Form 10-K for the year ended December 31, 2006 and *Legal Matters* in NOTE 11 CONTINGENCIES in the accompanying Notes to Condensed Consolidated Financial Statements in this quarterly report on Form 10-Q.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the risk factors previously disclosed in Item 1A. to Part I of our Annual Report on Form 10-K for the year ended December 31, 2006. There were no material changes from these risk factors during the first quarter of 2007.

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

**(a) Recent Sales of Unregistered Securities**

There were no unregistered sales of equity securities.

**(b) Use of Proceeds**

N/A.

**(c) Issuer Purchases of Equity Securities**

On February 15, 2006, the Board authorized the expenditure of \$300.0 million to repurchase shares of the Company's outstanding common stock (the 2006 Repurchase Program).

No common stock was repurchased under the 2006 Repurchase Program which expired on February 15, 2007.

**ITEM 6. EXHIBITS**

**(a) Exhibits:**

Reference is hereby made to the Exhibit Index on page 38.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**WATSON PHARMACEUTICALS, INC.**  
**(Registrant)**

By: **/s/ R. Todd Joyce**  
R. Todd Joyce  
Vice President Corporate Controller and Treasurer  
(Principal Financial Officer and Principal Accounting Officer)

Date: May 9, 2007

**WATSON PHARMACEUTICALS, INC.**

**EXHIBIT INDEX TO FORM 10-Q  
For the Quarterly Period Ended March 31, 2007**

| Exhibit No. | Description                                                                                                                              |
|-------------|------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1        | Second Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc.                                        |
| 31.1        | Certification of Chairman and Chief Executive Officer pursuant to Rule 13a-14a of the Securities Exchange Act of 1934.                   |
| 31.2        | Certification of Executive Vice President and Chief Financial Officer pursuant to Rule 13a-14a of the Securities Exchange Act of 1934.   |
| 32.1        | Certification of Chairman and Chief Executive Officer pursuant to Rule 13a-14(d) of the Securities Exchange Act of 1934.                 |
| 32.2        | Certification of Executive Vice President and Chief Financial Officer pursuant to Rule 13a-14(d) of the Securities Exchange Act of 1934. |