LANNETT CO INC
Form 10-Q
February 08, 2018
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2017

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

FOR THE TRANSITION PERIOD FROM TO

Commission File No. 001-31298

LANNETT COMPANY, INC.

(Exact Name of Registrant as Specified in its Charter)

State of Delaware	**23-0787699**
(State of Incorporation)	(I.R.S. Employer I.D. No.)

9000 State Road

Philadelphia, PA 19136

(215) 333-9000

(Address of principal executive offices and telephone number)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

Indicate the number of shares outstanding of each class of the registrant s common stock, as of the latest practical date

Class	**Outstanding as of January 31, 2018**
Common stock, par value $0.001 per share	37,843,600

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANNETT COMPANY, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	(Unaudited) December 31, 2017	June 30, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	**$ 139,862**	$ 117,737
Investment securities	**27,842**	27,091
Accounts receivable, net	**256,728**	204,066
Inventories	**135,591**	122,604
Prepaid income taxes	**1,760**	16,703
Other current assets	**6,471**	6,592
Total current assets	**568,254**	494,793
Property, plant and equipment, net	**258,206**	243,148
Intangible assets, net	**439,639**	453,861
Goodwill	**339,566**	339,566
Deferred tax assets	**30,584**	52,753
Other assets	**23,146**	19,191
TOTAL ASSETS	**$ 1,659,395**	$ 1,603,312
LIABILITIES		
Current liabilities:		
Accounts payable	**$ 78,633**	$ 44,720
Accrued expenses	**12,730**	12,499
Accrued payroll and payroll-related expenses	**16,036**	4,833
Rebates payable	**48,379**	44,593
Royalties payable	**5,579**	3,015
Restructuring liability	**4,581**	5,431
Settlement liability	**12,000**	17,000
Short-term borrowings and current portion of long-term debt	**66,845**	60,117
Total current liabilities	**244,783**	192,208
Long-term debt, net	**819,220**	843,530
Other liabilities	**2,596**	6,452
TOTAL LIABILITIES	**1,066,599**	1,042,190
Commitments and Contingencies (Note 12 and 13)		
STOCKHOLDERS EQUITY		
Common stock ($0.001 par value, 100,000,000 shares authorized; 37,760,877 and 37,528,450 shares issued; 37,105,338, and 36,919,296 shares outstanding at December 31, 2017 and June 30,	**38**	37

2017, respectively)				
Additional paid-in capital		**298,337**		292,780
Retained earnings		**305,053**		277,774
Accumulated other comprehensive loss		**(347)**		(222)
Treasury stock (655,539 and 609,154 shares at December 31, 2017 and June 30, 2017, respectively)		**(10,285)**		(9,247)
Total stockholders equity		**592,796**		561,122
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	**$**	**1,659,395**	$	1,603,312

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

(In thousands, except share and per share data)

	Three months ended December 31,		Six months ended December 31,	
	2017	**2016**	**2017**	**2016**
Net sales	**$ 184,305**	$ 170,944	**$ 339,266**	$ 332,503
Cost of sales	**88,914**	75,154	**168,467**	145,974
Amortization of intangibles	**7,941**	7,737	**15,678**	16,624
Gross profit	**87,450**	88,053	**155,121**	169,905
Operating expenses:				
Research and development expenses	**10,722**	9,939	**18,131**	22,310
Selling, general and administrative expenses	**28,493**	18,069	**47,531**	39,329
Acquisition and integration-related expenses	**65**	1,027	**83**	2,418
Restructuring expenses	**1,035**	1,712	**1,562**	3,764
Intangible asset impairment charges		23,000		88,084
Total operating expenses	**40,315**	53,747	**67,307**	155,905
Operating income	**47,135**	34,306	**87,814**	14,000
Other income (loss):				
Investment income	**2,325**	1,021	**3,489**	2,048
Interest expense	**(20,686)**	(23,333)	**(41,598)**	(46,327)
Other	**3,386**	(266)	**3,135**	(263)
Total other loss	**(14,975)**	(22,578)	**(34,974)**	(44,542)
Income (loss) before income tax	**32,160**	11,728	**52,840**	(30,542)
Income tax expense (benefit)	**18,138**	3,542	**25,561**	(9,340)
Net income (loss)	**14,022**	8,186	**27,279**	(21,202)
Less: Net income attributable to noncontrolling interest		14		34
Net income (loss) attributable to Lannett Company, Inc.	**$ 14,022**	$ 8,172	**$ 27,279**	$ (21,236)
Earnings (loss) per common share attributable to Lannett Company, Inc.:				
Basic	**$ 0.38**	$ 0.22	**$ 0.74**	$ (0.58)
Diluted	**$ 0.37**	$ 0.22	**$ 0.72**	$ (0.58)
Weighted average common shares outstanding:				
Basic	**37,066,902**	36,810,388	**37,029,483**	36,754,828
Diluted	**38,290,358**	37,676,370	**38,087,826**	36,754,828

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(UNAUDITED)

(In thousands)

	Three months ended December 31,		Six months ended December 31,	
	2017	**2016**	**2017**	**2016**
Net income (loss)	**$ 14,022**	$ 8,186	**$ 27,279**	$ **(21,202)**
Other comprehensive income (loss), before tax:				
Foreign currency translation gain (loss)	**(126)**	41	**(125)**	**38**
Total other comprehensive income (loss), before tax	**(126)**	41	**(125)**	**38**
Income tax related to items of other comprehensive income				
Total other comprehensive income (loss), net of tax	**(126)**	41	**(125)**	**38**
Comprehensive income (loss)	**13,896**	8,227	**27,154**	**(21,164)**
Less: Total comprehensive income attributable to noncontrolling interest		14		**34**
Comprehensive income (loss) attributable to Lannett Company, Inc.	**$ 13,896**	$ 8,213	**$ 27,154**	$ **(21,198)**

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(UNAUDITED)

(In thousands)

	Common Stock		Additional		Accumulated Other		Stockholders Equity
	Shares Issued	Amount	Paid-In Capital	Retained Earnings	Comprehensive Loss	Treasury Stock	Attributable to Lannett Co., Inc.
Balance, June 30, 2017	37,528	$ 37	$ 292,780	$ 277,774	$ (222)	$ (9,247)	$ 561,122
Shares issued in connection with share-based compensation plans	233	1	805				806
Share-based compensation			4,752				4,752
Purchase of treasury stock						(1,038)	(1,038)
Other comprehensive loss, net of tax					(125)		(125)
Net income				27,279			27,279
Balance, December 31, 2017	**37,761**	**$ 38**	**$ 298,337**	**$ 305,053**	**$ (347)**	**$ (10,285)**	**$ 592,796**

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

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LANNETT COMPANY, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(In thousands)

	Six Months Ended December 31,	
	2017	**2016**
OPERATING ACTIVITIES:		
Net income (loss)	**$ 27,279**	$ (21,202)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	**27,354**	27,963
Deferred income tax expense (benefit)	**22,169**	(24,709)
Share-based compensation	**4,752**	4,173
Excess tax benefits on share-based compensation awards		(705)
Intangible asset impairment charge		88,084
Loss on sale of assets	**233**	267
Loss (gain) on investment securities	**(2,834)**	(1,697)
Amortization of debt discount and other debt issuance costs	**9,987**	10,509
Other noncash expenses	**87**	1,056
Changes in assets and liabilities which provided (used) cash:		
Accounts receivable, net	**(52,662)**	(17,219)
Inventories	**(12,987)**	(15,334)
Prepaid income taxes/Income taxes payable	**15,040**	1,827
Other assets	**(8,160)**	(7,099)
Rebates payable	**3,786**	14,891
Royalties payable	**2,564**	(1,577)
Restructuring liability	**(850)**	1,217
Settlement liability		(3,000)
Accounts payable	**28,913**	9,052
Accrued expenses	**231**	2,415
Accrued payroll and payroll-related expenses	**11,203**	(1,662)
Net cash provided by operating activities	**76,105**	67,250
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	**(26,402)**	(21,324)
Proceeds from sale of property, plant and equipment	**17**	33
Purchase of intangible asset	**(2,038)**	
Proceeds from sale of investment securities	**44,924**	31,019
Purchase of investment securities	**(42,841)**	(27,098)
Net cash used in investing activities	**(26,340)**	(17,370)
FINANCING ACTIVITIES:		
Repayments of long-term debt	**(27,283)**	(26,618)
Purchase of noncontrolling interest		(1,500)
Proceeds from issuance of stock	**806**	1,785
Excess tax benefits on share-based compensation awards		705
Purchase of treasury stock	**(1,038)**	(1,806)
Net cash (used in) financing activities	**(27,515)**	(27,434)
Effect on cash and cash equivalents of changes in foreign exchange rates	**(125)**	38
NET INCREASE IN CASH AND CASH EQUIVALENTS	**22,125**	22,484

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		**117,737**		224,769
CASH AND CASH EQUIVALENTS, END OF PERIOD	**$**	**139,862**	$	247,253
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Interest paid (net of capitalized interest of $974 thousand and $876 thousand for the six months ended December 31, 2017 and 2016, respectively)	**$**	**31,250**	$	34,986
Income taxes paid (received)	**$**	**(7,567)**	$	13,553
Credits issued pursuant to a Settlement Agreement	**$**	**5,000**	$	

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

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LANNETT COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for the presentation of interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations and cash flows for the periods presented. In the opinion of management, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. Operating results for the three and six months ended December 31, 2017 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2018. These unaudited financial statements should be read in combination with the other Notes in this section; Management s Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Consolidated Financial Statements, including the Notes to the Consolidated Financial Statements, included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2017. The Consolidated Balance Sheet for the fiscal year ended June 30, 2017 was derived from audited financial statements.

Note 2. The Business And Nature of Operations

Lannett Company, Inc. (a Delaware corporation) and its subsidiaries (collectively, the Company or Lannett) develop, manufacture, package, market and distribute solid oral and extended release (tablets and capsules), topical, nasal and oral solution finished dosage forms of drugs, that address a wide range of therapeutic areas. Certain of these products are manufactured by others and distributed by the Company, most notably under the Jerome Stevens Distribution Agreement. The Company also manufactures active pharmaceutical ingredients through its Cody Laboratories, Inc. (Cody Labs) subsidiary, providing a vertical integration benefit.

On November 25, 2015, the Company completed the acquisition of Kremers Urban Pharmaceuticals, Inc. (KUPI), the former U.S. specialty generic pharmaceuticals subsidiary of global biopharmaceuticals company UCB S.A (UCB). KUPI is a specialty pharmaceuticals manufacturer focused on the development of products that are difficult to formulate or utilize specialized delivery technologies. Strategic benefits of the acquisition include expanded manufacturing capacity, a diversified product portfolio and pipeline and complementary research and development expertise.

The Company operates pharmaceutical manufacturing plants in Philadelphia, Pennsylvania; Cody, Wyoming; Carmel, New York and Seymour, Indiana. The Company s customers include generic pharmaceutical distributors, drug wholesalers, chain drug stores, private label distributors, mail-order pharmacies, other pharmaceutical manufacturers, managed care organizations, hospital buying groups, governmental entities and health maintenance organizations.

Note 3. Summary of Significant Accounting Policies

Basis of Presentation

The Consolidated Financial Statements have been prepared in conformity with U.S. GAAP.

Principles of consolidation

The Consolidated Financial Statements include the accounts of Lannett Company, Inc. and its wholly-owned subsidiaries, as well as Cody LCI Realty, LLC (Realty), a variable interest entity (VIE) in which the Company had a 50% ownership interest until November 30, 2016, when the Company acquired the remaining 50% interest. Noncontrolling interest in Realty was recorded net of tax as net income attributable to the noncontrolling interest. Additionally, all intercompany accounts and transactions have been eliminated. In December 2017, the Company legally dissolved Realty.

Business Combinations

Acquired businesses are accounted for using the acquisition method of accounting, which requires that the assets acquired and liabilities assumed be recorded at the date of acquisition at their respective estimated fair values. The fair values and useful lives assigned to each class of assets acquired and liabilities assumed are based on, among other factors, the expected future period of benefit of the asset, the various characteristics of the asset and projected future cash flows. Significant judgment is employed in

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determining the assumptions utilized as of the acquisition date and for each subsequent measurement period. Accordingly, changes in assumptions described above, could have a material impact on our consolidated results of operations.

Reclassifications

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

Use of estimates

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

Foreign currency translation

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

Cash and cash equivalents

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

Investment securities

The Company s investment securities consist of publicly-traded equity securities which are classified as trading investments. Investment securities are recorded at fair value based on quoted market prices from broker or dealer quotations or transparent pricing sources at each reporting date. Realized and unrealized gains and losses are included in the Consolidated Statements of Operations under Other income (loss).

Allowance for doubtful accounts

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

Inventories

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

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Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is computed on a straight-line basis over the assets estimated useful lives.

Intangible Assets

Definite-lived intangible assets are stated at cost less accumulated amortization. Amortization of definite-lived intangible assets is computed on a straight-line basis over the assets estimated useful lives, generally for periods ranging from 10 to 15 years. The Company continually evaluates the reasonableness of the useful lives of these assets. Indefinite-lived intangible assets are not amortized, but instead are tested at least annually for impairment. Costs to renew or extend the term of a recognized intangible asset are expensed as incurred.

Valuation of Long-Lived Assets, including Intangible Assets

The Company s long-lived assets primarily consist of property, plant and equipment and definite and indefinite-lived intangible assets. Property, plant and equipment and definite-lived intangible assets are reviewed for impairment whenever events or changes in circumstances (triggering events) indicate that the carrying amount of the asset may not be recoverable. If a triggering event is determined to have occurred, the asset s carrying value is compared to the future undiscounted cash flows expected to be generated by the asset. If the carrying value exceeds the undiscounted cash flow of the asset, then impairment exists. Indefinite-lived intangible assets are tested for impairment at least annually during the fourth quarter of each fiscal year or more frequently if events or changes in circumstances indicate that the asset might be impaired. An impairment loss is measured as the excess of the asset s carrying value over its fair value, which in most cases is calculated using a discounted cash flow model. Discounted cash flow models are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates and the probability of achieving the estimated cash flows.

In-Process Research and Development

Amounts allocated to in-process research and development (IPR&D) in connection with a business combination are recorded at fair value and are considered indefinite-lived intangible assets subject to impairment testing in accordance with the Company s impairment testing policy for indefinite-lived intangible assets. As products in development are approved for sale, amounts will be allocated to product rights and will be amortized over their estimated useful lives. Definite-lived intangible assets are amortized over the expected lives of the related assets. The judgments made in determining the estimated fair value of in-process research and development, as well as asset lives, can materially impact our results of operations. The Company s fair value assessments are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates and the probability of achieving the estimated cash flows.

Goodwill

Goodwill, which represents the excess of purchase price over the fair value of net assets acquired, is carried at cost. Goodwill is tested for impairment on an annual basis on the first day of the fourth quarter of each fiscal year or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company first performs a qualitative assessment to determine if the quantitative impairment test is required. If changes in circumstances indicate an asset may be impaired, the Company performs the quantitative impairment test. The Company first determines the fair value of our reporting unit (generic pharmaceuticals). If the net book value of our reporting unit exceeds its fair value, the difference will be recorded as a goodwill impairment, not to exceed the carrying amount of goodwill. The Company s fair value assessments are highly reliant on various assumptions which are considered Level 3 inputs, including estimates of future cash flows (including long-term growth rates), discount rates and the probability of achieving the estimated cash flows. The judgments made in determining the estimated fair value of goodwill can materially impact our results of operations.

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Segment Information

The Company operates in one reportable segment, generic pharmaceuticals. As such, the Company aggregates its financial information for all products. The following table identifies the Company s net sales by medical indication for the three and six months ended December 31, 2017 and 2016:

(In thousands)	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
Medical Indication	**2017**	**2016**	**2017**	**2016**
Antibiotic	$ 3,552	$ 4,792	$ 6,900	$ 8,572
Anti-Psychosis	22,799	15,365	37,791	32,685
Cardiovascular	10,135	11,975	21,441	24,669
Central Nervous System	6,925	10,555	15,742	20,904
Gallstone	5,282	13,425	11,846	26,308
Gastrointestinal	15,055	18,977	29,608	37,029
Glaucoma	2,164	5,311	4,832	11,095
Migraine	15,484	7,863	30,499	15,023
Muscle Relaxant	3,219	3,004	7,010	6,536
Pain Management	6,128	7,439	11,889	14,047
Respiratory	2,230	2,957	3,876	5,170
Thyroid Deficiency	68,794	45,431	116,008	85,269
Urinary	2,840	4,693	5,837	9,794
Other	13,105	11,133	25,802	22,314
Contract manufacturing revenue	6,593	8,024	10,185	13,088
Net sales	$ 184,305	$ 170,944	$ 339,266	$ 332,503

Customer, Supplier and Product Concentration

The following table presents the percentage of total net sales, for the three and six months ended December 31, 2017 and 2016, for certain of the Company s products, defined as products containing the same active ingredient or combination of ingredients, which accounted for at least 10% of net sales in any of those periods:

	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
	2017	**2016**	**2017**	**2016**
Product 1	37%	27%	34%	26%
Product 2	12%	8%	10%	9%

The following table presents the percentage of total net sales, for the three and six months ended December 31, 2017 and 2016, for certain of the Company s customers which accounted for at least 10% of net sales in any of those periods:

	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
	2017	2016	2017	2016
Customer A	22%	28%	25%	28%
Customer B	19%	20%	20%	20%
Customer C	13%	4%	8%	4%

The Company s primary finished goods inventory supplier is Jerome Stevens Pharmaceuticals, Inc. (JSP), in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for approximately 39% of the Company s inventory purchases during the three months ended December 31, 2017 and 2016. Purchases of finished goods inventory from JSP accounted for approximately 36% and 38% of the Company s inventory purchases during the six months ended December 31, 2017 and 2016, respectively. See Note 21 Material Contracts with Suppliers for more information.

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Revenue Recognition

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

Net Sales Adjustments

When revenue is recognized a simultaneous adjustment to gross sales is made for estimated chargebacks, rebates, returns, promotional adjustments and other potential adjustments. These provisions are primarily estimated based on historical experience, future expectations, contractual arrangements with wholesalers and indirect customers and other factors known to management at the time of accrual. Accruals for provisions are presented in the Consolidated Financial Statements as a reduction to gross sales with the corresponding reserve presented as a reduction of accounts receivable or included as rebates payable, depending on the nature of the reserve. The reserves, presented as a reduction of accounts receivable, totaled $155.5 million and $175.8 million at December 31, 2017 and June 30, 2017, respectively. Rebates payable at December 31, 2017 and June 30, 2017 totaled $48.4 million and $44.6 million, respectively, for certain rebate programs, primarily related to Medicare Part D and Medicaid and certain sales allowances and other adjustments paid to indirect customers.

Cost of Sales, including Amortization of Intangibles

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

Research and Development Expenses

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

Contingencies

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

Restructuring Costs

The Company records charges associated with approved restructuring plans to remove duplicative headcount and infrastructure associated with business acquisitions or to simplify business processes. Restructuring charges can include severance costs to eliminate a specified number of employees, infrastructure charges to vacate facilities and consolidate operations and contract cancellation costs. The Company records restructuring charges based on estimated employee terminations, site closure and consolidation plans. The Company accrues severance and other employee separation costs under these actions when it is probable that a liability exists and the amount is reasonably estimable.

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Share-Based Compensation

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

Self-Insurance

Effective January 1, 2017, the Company self-insures for certain employee medical and prescription benefits. The Company also maintains stop loss coverage with third party insurers to limit its total liability exposure. The liability for self-insured risks is primarily calculated using independent third party actuarial valuations which take into account actual claims, claims growth and claims incurred but not yet reported. Actual experience, including claim frequency and severity as well as health-care inflation, could result in different liabilities than the amounts currently recorded. The liability for self-insured risks under this plan as of December 31, 2017 totaled $3.2 million and was not material to the financial position of the Company as of June 30, 2017.

Income Taxes

The Company uses the liability method to account for income taxes as prescribed by Accounting Standards Codification (ASC) 740, *Income Taxes*. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense (benefit) is the result of changes in deferred tax assets and liabilities. Deferred income tax assets and liabilities are adjusted to recognize the effects of changes in tax laws or enacted tax rates in the period during which they are signed into law. The factors used to assess the likelihood of realization are the Company s forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Under ASC 740, *Income Taxes*, a valuation allowance is required when it is more likely than not that all or some portion of the deferred tax assets will not be realized through generating sufficient future taxable income. Failure to achieve forecasted taxable income in applicable tax jurisdictions could affect the ultimate realization of deferred tax assets and could result in an increase in the Company s effective tax rate on future earnings.

The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative accounting standards also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures.

On December 22, 2017, President Trump signed the Tax Cut and Jobs Act legislation (2017 Tax Reform) into law, which included a broad range of tax reform provisions affecting businesses, including corporate tax rates, business deductions and international tax provisions. Many of these provisions significantly differ from current U.S. tax law, resulting in pervasive financial reporting implications. As a result of the new law, the SEC issued Staff Accounting Bulletin No. 118 (SAB 118) to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed in reasonable detail to complete the accounting for certain income tax effects of 2017 Tax Reform. SAB 118 requires registrants to report the tax effects of 2017 Tax Reform, inclusive of provisional amounts for which the accounting is incomplete but a reasonable estimate can be determined. SAB 118 also allows for a measurement period of up to one year in cases where a registrant reports a provisional amount or is unable to reasonably estimate the impact of 2017 Tax Reform.

Earnings (Loss) Per Common Share

Basic earnings (loss) per common share attributable to the Company is computed by dividing net income attributable to Lannett Company, Inc. common stockholders by the weighted average number of shares outstanding during the period. Diluted earnings (loss) per common share attributable to the Company is computed by dividing net income attributable to Lannett Company, Inc. common stockholders by the weighted average number of shares outstanding during the period including additional shares that would have been outstanding related to potentially dilutive securities. These potentially dilutive securities consist of stock options, unvested restricted stock, performance-based shares and an outstanding warrant. Anti-dilutive securities are excluded from the calculation. Dilutive shares are also excluded in the calculation in periods of net loss because the effect of including such securities would be anti-dilutive.

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Comprehensive Income (Loss)

Comprehensive income (loss) 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 (loss) refers to gains and losses that are included in comprehensive income (loss), but excluded from net income as these amounts are recorded directly as an adjustment to stockholders equity.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued ASU 2014-09, *Revenue from Contracts with Customers*. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The authoritative guidance is effective for annual reporting periods beginning after December 15, 2017. Based on a preliminary review of the contracts representing a substantial portion of our revenues, the Company does not expect the guidance to have a material impact on our disclosures or the timing and recognition of our revenues. The Company is in the process of establishing and documenting key accounting policies, conducting training and education throughout the organization, and evaluating impacts on business processes, information technology, and controls resulting from the adoption of this new standard. The Company also continues to accumulate the necessary information to determine the cumulative effects of the accounting change to be recorded upon adoption of the guidance. The Company intends to use the modified retrospective approach upon implementation.

In November 2015, the FASB issued ASU 2015-17, Income Taxes Balance Sheet Classification of Deferred Taxes. ASU 2015-17 requires all deferred tax assets and liabilities to be classified as noncurrent on the balance sheet. The guidance may be applied either prospectively or retrospectively. The guidance became effective for the Company in the first quarter of Fiscal 2018. Accordingly, the Company currently presents all deferred tax assets and liabilities as noncurrent on the balance sheet. All prior period amounts have also been reclassified to conform with the current year presentation.

In February 2016, the FASB issued ASU 2016-02, *Leases.* ASU 2016-02 requires an entity to recognize right-of-use assets and liabilities on its balance sheet for all leases with terms longer than 12 months. Lessees and lessors are required to disclose quantitative and qualitative information about leasing arrangements to enable a user of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period and requires a modified retrospective application, with early adoption permitted. The Company is currently in the process of assessing the impact this guidance will have on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows Classification of Certain Cash Receipts and Cash Payments.* ASU 2016-15 addresses how certain cash receipts and cash payments are presented and classified in the statement of cash flows. ASU 2016-15 is effective for annual reporting periods, and interim periods therein, beginning after December 15, 2017. The Company is currently in the process of assessing the impact this guidance will have on the consolidated financial statements.

Note 4. Restructuring Charges

2016 Restructuring Program

On February 1, 2016, in connection with the acquisition of KUPI, the Company announced a plan related to the future integration of KUPI and the Company s operations. The plan focuses on the closure of KUPI s corporate functions and the consolidation of manufacturing, sales, research and development and distribution functions. The Company estimates that it will incur an aggregate of up to approximately $20.0 million in restructuring charges for actions that have been announced or communicated since the 2016 Restructuring Program began. Of this amount, approximately $11.0 million relates to employee separation costs, approximately $1.0 million relates to contract termination costs and approximately $8.0 million relates to facility closure costs and other actions. The 2016 Restructuring Program is expected to be completed by the end of Fiscal 2019. The expenses associated with the restructuring program included in restructuring expenses during the three and six months ended December 31, 2017 and 2016 were as follows:

	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
(In thousands)	**2017**	**2016**	**2017**	**2016**
Employee separation costs (credits)	$ 210	$ 1,004	$ (380)	$ 2,161
Facility closure costs	825	708	1,942	1,603
Total	$ 1,035	$ 1,712	$ 1,562	$ 3,764

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In the first quarter of Fiscal 2018, the Company decided to retain certain employees who were previously included in the 2016 Restructuring Program. As a result, the Company reversed all previous charges incurred related to these employees.

A reconciliation of the changes in restructuring liabilities associated with the 2016 Restructuring Program from June 30, 2017 through December 31, 2017 is set forth in the following table:

(In thousands)	Employee Separation Costs	Contract Termination Costs	Facility Closure Costs	Total
Balance at June 30, 2017	$ 5,431	$	$	$ 5,431
Restructuring Charges (Credits)	(380)		1,942	1,562
Payments	(470)		(1,942)	(2,412)
Balance at December 31, 2017	$ 4,581	$	$	$ 4,581

Note 5. Accounts Receivable

Accounts receivable consisted of the following components at December 31, 2017 and June 30, 2017:

(In thousands)	December 31, 2017	June 30, 2017
Gross accounts receivable	$ 414,584	$ 380,653
Less Chargebacks reserve	(54,460)	(79,537)
Less Rebates reserve	(38,239)	(43,023)
Less Returns reserve	(44,795)	(42,135)
Less Other deductions	(18,006)	(11,096)
Less Allowance for doubtful accounts	(2,356)	(796)
Accounts receivable, net	$ 256,728	$ 204,066

For the three months ended December 31, 2017, the Company recorded a provision for chargebacks, rebates (including rebates presented as rebates payable), returns and other deductions of $220.2 million, $77.6 million, $4.1 million, and $16.3 million, respectively. For the three months ended December 31, 2016, the Company recorded a provision for chargebacks, rebates (including rebates presented as rebates payable), returns and other deductions of $217.7 million, $73.5 million, $7.9 million, and $13.9 million, respectively.

For the six months ended December 31, 2017, the Company recorded a provision for chargebacks, rebates (including rebates presented as rebates payable), returns, and other deductions of $474.9 million, $156.1 million, $14.5 million, and $28.6 million, respectively. For the six months ended December 31, 2016, the Company recorded a provision for chargebacks, rebates (including rebates presented as rebates payable), returns, and other deductions of $416.2 million, $143.0 million, $14.7 million, and $29.3 million, respectively.

Note 6. Inventories

Inventories at December 31, 2017 and June 30, 2017 consisted of the following:

(In thousands)	December 31, 2017	June 30, 2017
Raw materials	$ 64,057	$ 57,442
Work-in-process	20,285	15,676
Finished goods	51,249	49,486
Total	$ 135,591	$ 122,604

Inventories were reduced by $5.0 million and $4.5 million at December 31, 2017 and June 30, 2017, respectively for excess and obsolete inventory amounts. During the three months ended December 31, 2017 and 2016, the Company recorded provisions for excess and obsolete inventory of $2.2 million and $2.1 million, respectively. During the six months ended December 31, 2017 and 2016, the Company recorded provisions for excess and obsolete inventory of $4.4 million and $5.4 million, respectively.

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Note 7. Property, Plant and Equipment

Property, plant and equipment, net at December 31, 2017 and June 30, 2017 consisted of the following:

(In thousands)	Useful Lives	December 31, 2017	June 30, 2017
Land		$ 6,191	$ 6,191
Building and improvements	10 - 39 years	108,740	108,730
Machinery and equipment	5 - 10 years	142,040	142,086
Furniture and fixtures	5 - 7 years	3,942	2,953
Less: accumulated depreciation		(82,016)	(71,461)
		178,897	188,499
Construction in progress		79,309	54,649
Property, plant and equipment, net		$ 258,206	$ 243,148

Depreciation expense for the three months ended December 31, 2017 and 2016 was $5.4 million and $5.5 million, respectively. Depreciation expense for the six months ended December 31, 2017 and 2016 was $11.1 million and $10.6 million, respectively.

Property, plant and equipment, net included amounts held in foreign countries in the amount of $1.0 million at December 31, 2017 and June 30, 2017.

Note 8. Fair Value Measurements

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

The Company follows the authoritative guidance of ASC Topic 820 Fair Value Measurements and Disclosures. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The authoritative guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company s financial assets and liabilities measured at fair value are entirely within Level 1 of the hierarchy as defined below:

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

Level 2 Directly or indirectly observable inputs, other than quoted prices, such as quoted prices for similar assets or liabilities; quoted prices for identical or similar instruments in markets that are not active; or model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Unobservable inputs that are supported by little or no market activity and that are material to the fair value of the asset or liability. Financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant judgment or estimation are examples of Level 3 assets and liabilities.

If the inputs used to measure the financial assets and liabilities fall within more than one level described above, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

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The Company s financial assets and liabilities measured at fair value at December 31, 2017 and June 30, 2017, were as follows:

	December 31, 2017			
(In thousands)	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets				
Investment securities	$ 27,842	$	$	$ 27,842
Total Assets	$ 27,842	$	$	$ 27,842

	June 30, 2017			
(In thousands)	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets				
Investment securities	$ 27,091	$	$	$ 27,091
Total Assets	$ 27,091	$	$	$ 27,091

Note 9. Investment Securities

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

The Company had a net gain on investment securities of $2.0 million during the three months ended December 31, 2017, which included an unrealized gain related to securities still held at December 31, 2017 of $1.2 million. The Company had a net gain on investment securities of $888 thousand during the three months ended December 31, 2016, which primarily consisted of realized gains.

The Company had a net gain on investment securities of $2.8 million during the six months ended December 31, 2017, which included an unrealized gain related to securities still held at December 31, 2017 of $1.1 million. The Company had a net gain on investment securities of $1.7 million during the six months ended December 31, 2016, which included an unrealized gain related to securities still held at December 31, 2016 of $557 thousand.

Note 10. Intangible Assets

Intangible assets, net as of December 31, 2017 and June 30, 2017, consisted of the following:

	Weighted	Gross Carrying Amount		Accumulated Amortization		Intangible Assets, Net	
(In thousands)	**Avg. Life (Yrs.)**	**December 31, 2017**	**June 30, 2017**	**December 31, 2017**	**June 30, 2017**	**December 31, 2017**	**June 30, 2017**
Definite-lived:							

Cody Labs import license	15	$	582	$	582	$	(366)	$	(347)	$	216	$ 235
KUPI product rights	15		434,000		434,000		(57,753)		(43,286)		376,247	390,714
KUPI trade name	2		2,920		2,920		(2,920)		(2,338)			582
KUPI other intangible assets	15		19,000		19,000		(2,662)		(2,028)		16,338	16,972
Silarx product rights	15		10,000		10,000		(1,722)		(1,389)		8,278	8,611
Other product rights	4		2,691		653		(580)		(355)		2,111	298
Total definite-lived		$	469,193	$	467,155	$	(66,003)	$	(49,743)	$	403,190	$ 417,412
Indefinite-lived:												
KUPI in-process research and development		$	18,000	$	18,000	$		$		$	18,000	$ 18,000
Silarx in-process research and development			18,000		18,000						18,000	18,000
Other product rights			449		449						449	449
Total indefinite-lived			36,449		36,449						36,449	36,449
Total intangible assets, net		$	505,642	$	503,604	$	(66,003)	$	(49,743)	$	439,639	$ 453,861

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For the three months ended December 31, 2017 and 2016, the Company recorded amortization expense of $8.2 million and $8.1 million, respectively. For the six months ended December 31, 2017 and 2016, the Company recorded amortization expense of $16.3 million and $17.4 million, respectively.

Future annual amortization expense consisted of the following as of December 31, 2017:

(In thousands) Fiscal Year Ending June 30,	Annual Amortization Expense
2018	$ 16,493
2019	31,761
2020	30,938
2021	30,938
2022	30,938
Thereafter	262,122
	$ 403,190

Note 11. Long-Term Debt

Long-term debt, net consisted of the following:

(In thousands)	December 31, 2017	June 30, 2017
Term Loan A due 2020	$ 247,500	$ 254,375
Unamortized discount and other debt issuance costs	(13,398)	(16,238)
Term Loan A, net	234,102	238,137
Term Loan B due 2022	708,209	727,881
Unamortized discount and other debt issuance costs	(56,246)	(63,106)
Term Loan B, net	651,963	664,775
Revolving Credit Facility due 2020		
Other		735
Total debt, net	886,065	903,647
Less short-term borrowings and current portion of long-term debt	(66,845)	(60,117)
Total long-term debt, net	$ 819,220	$ 843,530

Long-term debt amounts due, for the twelve month periods ending December 31 are as follows:

(In thousands)	Amounts Payable to Institutions
2018	$ 66,845
2019	66,845
2020	231,845
2021	39,345

2022		550,829
Total	$	955,709

Note 12. Legal, Regulatory Matters and Contingencies

Connecticut Attorney General Inquiry

In July 2014, the Company received interrogatories and subpoena from the State of Connecticut Office of the Attorney General concerning its investigation into the pricing of digoxin. According to the subpoena, the Connecticut Attorney General is investigating whether anyone engaged in any activities that resulted in (a) fixing, maintaining or controlling prices of digoxin or (b) allocating and dividing customers or territories relating to the sale of digoxin in violation of Connecticut antitrust law. In June 2016, the Connecticut Attorney General issued interrogatories and a subpoena to an employee of the Company in order to gain access to documents and responses previously supplied to the Department of Justice. In December 2016, the Connecticut Attorney General, joined by numerous other State Attorneys General, filed a civil complaint alleging that six pharmaceutical companies engaged in anti-competitive behavior related to Doxycycline Hyclate and Gliburide. The Company was not named in the action and does not compete

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on the products that formed the basis of the complaint. On October 31, 2017, the state Attorneys General filed a motion for leave to amend their complaint to add numerous additional defendants, including the Company, and claims relating to 13 additional drugs. The claim amended in October 2017 relating to Lannett involves alleged price-fixing for one drug, doxycycline monohydrate, but did not involve the pricing for digoxin. The state Attorneys General also allege that all defendants were part of an overarching, industry-wide conspiracy to allocate markets and fix prices generally. None of the defendants, including the Company, has responded yet to the motion of the state Attorneys General.

The Company maintains that it acted in compliance with all applicable laws and regulations and continues to cooperate with the Connecticut Attorney General investigation.

Federal Investigation into the Generic Pharmaceutical Industry

In fiscal years 2015 and 2016, the Company and certain affiliated individuals each were served with a grand jury subpoena relating to a federal investigation of the generic pharmaceutical industry into possible violations of the Sherman Act. The subpoenas request corporate documents of the Company relating to corporate, financial and employee information, communications or correspondence with competitors regarding the sale of generic prescription medications and the marketing, sale, or pricing of certain products, generally for the period of 2005 through the dates of the subpoenas.

Based on reviews performed to date by outside counsel, the Company currently believes that it has acted in compliance with all applicable laws and regulations and continues to cooperate with the federal investigation.

Texas Medicaid Investigation

In August 2015, KUPI received a letter from the Texas Office of the Attorney General alleging that it had inaccurately reported certain price information in violation of the Texas Medicaid Fraud Prevention Act. UCB, KUPI s previous parent company is handling the defense and is evaluating the allegations and cooperating with the Texas Attorney General s Office. Per the terms of the Stock Purchase Agreement between the Company and UCB (Stock Purchase Agreement) dated September 2, 2015, the Company is fully indemnified for any pre-acquisition amounts. The Company is currently unable to estimate the timing or the outcome of this matter.

Government Pricing

During the quarter ended December 31, 2016, the Company completed a contract compliance review, for the period January 1, 2012 through June 30, 2016, for one of KUPI s government-entity customers. As a result of the review, the Company identified certain commercial customer prices and other terms that were not properly disclosed to the government-entity resulting in potential overcharges. As of December 31, 2017 and June 30, 2017, the Company s best estimate of the liability for potential overcharges was approximately $9.3 million. For the period January 1, 2012 through November 24, 2015 (the pre-acquisition period), the Company is fully indemnified per the Stock Purchase Agreement. Accordingly, the Company has recorded an indemnification asset and related liability of $8.3 million related to the pre-acquisition period. The Company does not believe that the ultimate resolution of this matter will have a significant impact on our financial position, results of operations

or cash flows.

AWP Litigation

The Company and some of our competitors have been named as defendants in two lawsuits filed in 2016 alleging that the Company and a number of other generic pharmaceutical manufacturers caused the Average Wholesale Prices (AWPs) of our and their products to be inflated, thereby injuring government programs, entities and persons who reimbursed prescription drugs based on AWPs. The Company stopped using AWP as a basis for establishing prices in or around 2002 and the bulk of prescription drugs manufactured by the Company was sold under private label. The first lawsuit, filed in the United States District Court for the Eastern of Pennsylvania, was dismissed on September 25, 2017 (the Federal Action). The second lawsuit, pending in the Philadelphia (Pennsylvania) County Court of Common Pleas, was stayed pending the final resolution of the Federal Action. The Company disputes these allegations and does not believe that the ultimate resolution of these lawsuits will have a significant impact on our financial position, results of operations or cash flows.

EPA Violation Notice

On July 13, 2017, the United States Department of Environmental Protection Agency (EPA) sent a Finding of Violation to KUPI alleging several violations of national emissions standards for hazardous air pollutants at KUPI s Seymour, Indiana facility. The EPA is giving the company the opportunity to discuss the matter with the agency before filing a formal complaint or assessing fines with respect to the alleged violations. The Company is conducting an investigation into the matter and cannot reasonably predict the outcome of any potential EPA action at this time.

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Private Antitrust and Consumer Protection Litigation

The Company and certain competitors have been named as defendants in a number of lawsuits filed in 2016 and 2017 alleging that the Company and certain generic pharmaceutical manufacturers have conspired to fix prices of generic digoxin, levothyroxine, ursodiol and baclofen. These cases are part of a larger group of more than 100 lawsuits generally alleging that over 30 generic pharmaceutical manufacturers and distributors conspired to fix prices for at least 18 different generic drugs in violation of the federal Sherman Act, various state antitrust laws, and various state consumer protection statutes. The United States also has been granted leave to intervene in the cases. On April 6, 2017, the Judicial Panel on Multidistrict Litigation (the JPML) ordered that all of the cases alleging price-fixing for generic drugs be consolidated for pretrial proceedings in the United States District Court for the Eastern District of Pennsylvania under the caption *In re: Generic Pharmaceuticals Pricing Antitrust Litigation*. The various plaintiffs are grouped into three categories Direct Purchaser Plaintiffs, End Payer Plaintiffs, and Indirect Reseller Purchasers and filed Consolidated Amended Complaints (CACs) against the Company and the other defendants on August 15, 2017. The CACs naming the Company as a defendant involve generic digoxin, levothyroxine, ursodiol and baclofen. Pursuant to a court-ordered schedule grouping the 18 different drug cases into three separate tranches, the Company and other generic pharmaceutical manufacturer defendants on October 6, 2017 filed joint and individual motions to dismiss the CACs involving the six drugs in the first tranche, including digoxin. Those motions are pending.

On January 22, 2018, three opt-out direct purchasers filed a complaint alleging an overarching conspiracy and individual conspiracies on behalf of the Company and numerous other defendants to fix the prices of and allocate markets for at least 30 different drugs, including digoxin, doxycycline, levothyroxine, ursodiol and baclofen. None of the defendants, including the Company, has responded yet to the complaint.

In addition to the lawsuits brought by private plaintiffs, the Attorneys General of 45 states, the District of Columbia and Puerto Rico have filed *parens patriae* lawsuits alleging price-fixing conspiracies by various generic pharmaceutical manufacturers, but not involving the Company. The JPML has consolidated the suits by the state Attorneys General in the Eastern District of Pennsylvania as part of the multidistrict litigation. The original lawsuits did not name the Company, but the state Attorneys General on October 31, 2017 filed a motion with the District Court for leave to amend their complaint to add numerous additional defendants, including the Company, and claims relating to 13 additional drugs. The claim relating to Lannett involves alleged price-fixing for one drug, doxycycline monohydrate, although the state Attorneys General allege that all defendants were part of an overarching, industry-wide conspiracy to allocate markets and fix prices generally. All of the existing and proposed defendants, including the Company, have opposed the motion of the state Attorneys General. The motion is pending.

The Company believes that it acted in compliance with all applicable laws and regulations. Accordingly, the Company disputes the allegations set forth in these class actions.

Shareholder Litigation

In November 2016, a putative class action lawsuit was filed against the Company and two of its officers claiming that the Company damaged the purported class by including in its securities filings false and misleading statements regarding the Company s drug pricing methodologies and internal controls. A first amended complaint was filed in May 2017, and the Company filed a motion to dismiss the amended complaint in September 2017. In December 2017, counsel for the putative class filed a second amended complaint, and the Court denied as moot the Company s motion to dismiss the first amended complaint. The Company expects to file a motion to dismiss the second amended complaint in the coming months. The Company cannot reasonably predict the outcome of the suit at this time.

Patent Infringement (Paragraph IV Certification)

There is substantial litigation in the pharmaceutical industry with respect to the manufacture, use and sale of new products which are the subject of conflicting patent and intellectual property claims. Certain of these claims relate to paragraph IV certifications, which allege that an innovator patent is invalid or would not be infringed upon by the manufacture, use, or sale of the new drug.

Zomig®

The Company filed with the Food and Drug Administration an ANDA No. 206350, along with a paragraph IV certification, alleging that the two patents associated with the Zomig® nasal spray product (U.S. Patent No. 6,750,237 and U.S. Patent No. 67,220,767) are invalid.

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In July 2014, AstraZeneca AB, AstraZeneca UK Limited and Impax Laboratories, Inc. filed two patent infringement lawsuits in the United States District Court for the District of Delaware, alleging that the Company s filing of ANDA No. 206350 constitutes an act of patent infringement and seeking a declaration that the two patents at issue are valid and infringed.

In September 2014, the Company filed a motion to dismiss one patent infringement lawsuit for lack of standing and responded to the second lawsuit by denying that any valid patent claim would be infringed. In the second lawsuit, the Company also counterclaimed for a declaratory judgment that the patent claims are invalid and not infringed. The Court has consolidated the two actions and denied the motion to dismiss the first action without prejudice.

In July 2015, the Company filed with the United States Patent and Trademark Office (USPTO) a Petition for Inter Partes Review of each of the patents in suit seeking to reject as invalid all claims of the patents in suit. The USPTO has issued a decision denying initiation of the Inter Partes Review.

A trial was conducted in September 2016. The Court issued its decision on March 29, 2017, finding that Lannett did not prove that the patents at issue are invalid. The Company has appealed the decision. All briefing to the appellate court has been submitted, and the parties are waiting for the appellate court to set a date for oral argument before the court. A final decision of the appellate court is expected in early to mid-2018.

Thalomid®

The Company filed with the Food and Drug Administration an ANDA No. 206601, along with a paragraph IV certification, alleging that the fifteen patents associated with the Thalomid drug product (U.S. Patent Nos. 6,045,501; 6,315,720; 6,561,976; 6,561,977; 6,755,784; 6,869,399; 6,908,432; 7,141,018; 7,230,012; 7,435,745; 7,874,984; 7,959,566; 8,204,763; 8,315,886; 8,589,188 and 8,626,53) are invalid, unenforceable and/or not infringed. On January 30, 2015, Celgene Corporation and Children s Medical Center Corporation filed a patent infringement lawsuit in the United States District Court for the District of New Jersey, alleging that the Company s filing of ANDA No. 206601 constitutes an act of patent infringement and seeking a declaration that the patents at issue are valid and infringed. The Company filed an answer and affirmative defenses, and an amended answer to the complaint.

A settlement agreement was reached and the Court dismissed the lawsuit in October 2017. Pursuant to the settlement agreement, the Company entered into a license agreement that permits Lannett to manufacture and market in the U.S. its generic thalidomide product as of August 1, 2019 or earlier under certain circumstances.

SUPREP®

The Company filed ANDA No. 209941 with the Food and Drug Administration seeking approval to sell a bowel preparation oral solution (the Company s Oral Solution), along with a paragraph IV certification, alleging that US Patent 6,946,149 associated with the Suprep® bowel preparation kit would not be infringed by the Company s Oral Solution and/or that the patent is invalid.

In March 2017, Braintree Laboratories, Inc. (Braintree) filed a patent infringement lawsuit in the United States District Court for the District of Delaware (C.A. No. 1:17-cv-00293-GMS), alleging that the Company s filing of ANDA No. 209941 constitutes an act of patent infringement and seeking a declaration that the patent at issue was infringed by the submission of ANDA No. 209941. The Company answered the complaint denying infringement and raising invalidity as a defense, and has filed counterclaims seeking a declaration of non-infringement and invalidity. On July 28, 2017, the Company filed a motion for judgment on the pleadings, seeking a ruling that its ANDA product does not infringe the Braintree patent and seeking judgment as a matter of law. Braintree opposed the motion and has alternatively requested that the Court delay its decision on the motion until discovery is taken. The Company opposed Braintree s request to delay the decision. While the motions were pending, the parties agreed to resolve this dispute. The parties signed a confidential settlement agreement and filed a Stipulation of Dismissal Without Prejudice on December 13, 2017. On December 17, 2017, the Court granted the parties Stipulation of Dismissal Without Prejudice. In connection with the settlement agreement, the Company received $3.5 million, which is included in Other Income within the Consolidated Statements of Operations.

Although the Company cannot currently predict the length or outcome of paragraph IV litigation, legal expenses associated with these lawsuits could have a significant impact on the financial position, results of operations and cash flows of the Company.

Other Litigation Matters

The Company is also subject to various legal proceedings arising out of the normal course of its business including, but not limited to, product liability, intellectual property, patent infringement claims and antitrust matters. It is not possible to predict the outcome of these various proceedings. An adverse determination in any of these proceedings in the future could have a significant impact on the financial position, results of operations and cash flows of the Company.

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Note 13. Commitments

Leases

The Company leases certain manufacturing and office equipment, in the ordinary course of business. These leases are typically renewed annually. Rental and lease expense was not material for all periods presented.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) for the remainder of Fiscal 2018 and the twelve month periods ending June 30 thereafter are as follows:

(In thousands)	**Amounts Due**
Remainder of 2018	$ 864
2019	1,835
2020	1,855
2021	1,406
2022	1,080
Thereafter	5,238
Total	$ 12,278

Other Commitment

During the third quarter of Fiscal 2017, the Company signed an agreement with a company operating in the pharmaceutical business, under which the Company agreed to provide up to $15.0 million in revolving loans for the purpose of expansion and other business needs. The decision to provide any portion of the revolving loan is at the Company s sole discretion. At any time after the outstanding revolving loan balance is equal to or greater than $7.5 million, the Company has the option to convert the first $7.5 million into a 50% ownership interest in the entity. As of December 31, 2017, $6.6 million was outstanding under the revolving loan. The board of the entity is comprised of five members, two of which are employees of the Company. Based on the guidance set forth in ASC 810-10 *Consolidation,* the Company has concluded that it has a variable interest in the entity. However, the Company is not the primary beneficiary to the entity and as such, is not required to consolidate the entity s results of operations.

Note 14. Accumulated Other Comprehensive Loss

The Company s Accumulated Other Comprehensive Loss was comprised of the following components as of December 31, 2017 and 2016:

(In thousands)	**December 31, 2017**	**December 31, 2016**

Foreign Currency Translation		
Beginning Balance, June 30	$ (222)	$ (295)
Net gain (loss) on foreign currency translation (net of tax of $0 and $0)	(125)	38
Reclassifications to net income (net of tax of $0 and $0)		
Other comprehensive income (loss), net of tax	(125)	38
Ending Balance, December 31	(347)	(257)
Total Accumulated Other Comprehensive Loss	$ (347)	$ (257)

Note 15. Earnings (Loss) Per Common Share

A dual presentation of basic and diluted earnings (loss) per common share is required on the face of the Company s Consolidated Statement of Operations as well as a reconciliation of the computation of basic earnings per common share to diluted earnings per common share. Basic earnings (loss) per common share excludes the dilutive impact of potentially dilutive securities and is computed by dividing net income (loss) attributable to Lannett Company, Inc. by the weighted average number of common shares outstanding for the period. Diluted earnings (loss) per common share is computed using the treasury stock method and includes the effect of potential dilution from the exercise of outstanding stock options, a warrant and treats unvested restricted stock and performance-based shares as if it were vested. Potentially dilutive securities have been excluded in the weighted average number of common shares used for the calculation of earnings per share in periods of net loss because the effect of including such securities would be anti-dilutive. A reconciliation of the Company s basic and diluted earnings (loss) per common share was as follows:

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(In thousands, except share and per share data)	Three Months Ended December 31, 2017	2016
Net income attributable to Lannett Company, Inc.	$ 14,022	$ 8,172
Basic weighted average common shares outstanding	37,066,902	36,810,388
Effect of potentially dilutive stock options, warrants and restricted stock awards	1,223,456	865,982
Diluted weighted average common shares outstanding	38,290,358	37,676,370
Earnings per common share attributable to Lannett Company, Inc.:		
Basic	$ 0.38	$ 0.22
Diluted	$ 0.37	$ 0.22

(In thousands, except share and per share data)	Six Months Ended December 31, 2017	2016
Net income (loss) attributable to Lannett Company, Inc.	$ 27,279	$ (21,236)
Basic weighted average common shares outstanding	37,029,483	36,754,828
Effect of potentially dilutive stock options, warrants and restricted stock awards	1,058,343	
Diluted weighted average common shares outstanding	38,087,826	36,754,828
Earnings (loss) per common share attributable to Lannett Company, Inc.:		
Basic	$ 0.74	$ (0.58)
Diluted	$ 0.72	$ (0.58)

The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the three months ended December 31, 2017 and 2016 were 3.0 million. The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the six months ended December 31, 2017 and 2016 were 3.0 million and 4.4 million, respectively.

Note 16. Warrant

In connection with the KUPI acquisition on November 25, 2015, Lannett issued to UCB Manufacturing a warrant to purchase up to a total of 2.5 million shares of Lannett s common stock (the Warrant).

The Warrant has a term of three years (expiring November 25, 2018) and an exercise price of $48.90 per share, subject to customary adjustments, including for stock splits, dividends and combinations. The Warrant also has a weighted average anti-dilution adjustment provision. The fair value included as part of the total consideration transferred to UCB at the acquisition date was $29.9 million. The fair value assigned to the Warrant was determined using the Black-Scholes valuation model. The Company concluded that the warrant was indexed to its own stock and therefore the Warrant has been classified as an equity instrument.

Note 17. Share-Based Compensation

At December 31, 2017, the Company had two share-based employee compensation plans (the 2011 Long-Term Incentive Plan LTIP and the 2014 LTIP). Together these plans authorized an aggregate total of 4.5 million shares to be issued. The plans have a total of 1.6 million shares available for future issuances.

The Company issues share-based compensation awards with a vesting period ranging up to 3 years and a maximum contractual term of 10 years. The Company issues new shares of stock when stock options are exercised. As of December 31, 2017, there was $10.2 million of total unrecognized compensation cost related to non-vested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 2.3 years.

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Stock Options

The Company measures share-based compensation cost for options using the Black-Scholes option pricing model. The following table presents the weighted average assumptions used to estimate fair values of the stock options granted during the six months ended December 31, 2017 and 2016:

	Six Months Ended	
	December 31, 2017	**December 31, 2016**
Risk-free interest rate	1.9%	1.1%
Expected volatility	57.4%	55.6%
Expected dividend yield	%	%
Forfeiture rate	6.5%	6.5%
Expected term (in years)	5.4 years	5.2 years
Weighted average fair value	$ 9.06	$ 15.33

Expected volatility is based on the historical volatility of the price of our common shares during the historical period equal to the expected term of the option. The Company uses historical information to estimate the expected term, which represents the period of time that options granted are expected to be outstanding. The risk-free rate for the period equal to the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The forfeiture rate assumption is the estimated annual rate at which unvested awards are expected to be forfeited during the vesting period. This assumption is based on our actual forfeiture rate on historical awards. Periodically, management will assess whether it is necessary to adjust the estimated rate to reflect changes in actual forfeitures or changes in expectations. Additionally, the expected dividend yield is equal to zero, as the Company has not historically issued and has no immediate plans to issue, a dividend.

A stock option roll-forward as of December 31, 2017 and changes during the six months then ended, is presented below:

(In thousands, except for weighted average price and life data)	**Awards**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**	**Weighted Average Remaining Contractual Life (yrs.)**
Outstanding at June 30, 2017	1,475	$ 18.02	$ 12,212	5.7
Granted	18	$ 17.40		
Exercised	(42)	$ 8.14	$ 596	
Forfeited, expired or repurchased	(12)	$ 30.77		
Outstanding at December 31, 2017	1,439	$ 18.20	$ 14,479	5.2
Vested and expected to vest at December 31, 2017	1,436	$ 18.18	$ 14,467	5.2
Exercisable at December 31, 2017	1,402	$ 17.76	$ 14,376	5.2

Restricted Stock

The Company measures restricted stock compensation costs based on the stock price at the grant date less an estimate for expected forfeitures. The annual forfeiture rate used to calculate compensation expense was 6.5% for the six months ended December 31, 2017 and 2016.

A summary of restricted stock awards as of December 31, 2017 and changes during the six months then ended, is presented below:

(In thousands, except for weighted average price and life data)	Awards	Weighted Average Grant - date Fair Value	Aggregate Intrinsic Value
Non-vested at June 30, 2017	334	$ 30.71	
Granted	470	$ 17.29	
Vested	(162)	$ 31.15	$ 3,598
Forfeited	(35)	$ 22.05	
Non-vested at December 31, 2017	607	$ 20.67	

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Performance-Based Shares

On September 22, 2017, the Company approved and granted performance-based awards to certain key executives. The stock-settled awards will vest based on relative Total Shareholder Return (TSR) over a three-year period. The Company measures share-based compensation cost for TSR awards using a Monte-Carlo simulation model. The impact of the grant was not material to the consolidated financial statements during the six months ended December 31, 2017.

Employee Stock Purchase Plan

In February 2003, the Company s stockholders approved an Employee Stock Purchase Plan (ESPP). Employees eligible to participate in the ESPP may purchase shares of the Company s stock at 85% of the lower of the fair market value of the common stock on the first day of the calendar quarter or the last day of the calendar quarter. Under the ESPP, employees can authorize the Company to withhold up to 10% of their compensation during any quarterly offering period, subject to certain limitations. The ESPP was implemented on April 1, 2003 and is qualified under Section 423 of the Internal Revenue Code. The Board of Directors authorized an aggregate total of 1.1 million shares of the Company s common stock for issuance under the ESPP. During the six months ended December 31, 2017 and 2016, 28 thousand shares and 27 thousand shares were issued under the ESPP, respectively. As of December 31, 2017, 571 thousand total cumulative shares have been issued under the ESPP.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
(In thousands)	**2017**	**2016**	**2017**	**2016**
Selling, general and administrative expenses	$ 1,926	$ 1,251	$ 3,713	$ 3,223
Research and development expenses	176	152	327	325
Cost of sales	461	314	712	625
Total	$ 2,563	$ 1,717	$ 4,752	$ 4,173
Tax benefit at statutory rate	$ 756	$ 627	$ 1,402	$ 1,523

Note 18. Employee Benefit Plan

The Company has a 401k defined contribution plan (the Plan) covering substantially all employees. Pursuant to the Plan provisions, the Company is required to make matching contributions equal to 50% of each employee s contribution, not to exceed 4% of the employee s compensation for the Plan year. Contributions to the Plan during the three months ended December 31, 2017 and 2016 were $458 thousand and $492 thousand, respectively. Contributions to the Plan during the six months ended December 31, 2017 and 2016 were $1.0 million and $1.1 million, respectively.

Note 19. Income Taxes

The Company uses the liability method to account for income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense (benefit) is the result of changes in deferred tax assets and liabilities.

The federal, state and local income tax expense for the three months ended December 31, 2017 and 2016 was $18.1 million and $3.5 million, respectively. The effective tax rates for the three months ended December 31, 2017 and 2016 were 56.4% and 30.2%, respectively. The federal, state and local income tax expense for the six months ended December 31, 2017 was $25.6 million compared to income tax benefit of $9.3 million for the six months ended December 31, 2016. The effective tax rates were 48.4% and 30.6%, respectively.

The effective tax rates for the three and six months ended December 31, 2017 were higher compared to the same prior-year periods primarily due to 2017 Tax Reform which was signed into law on December 22, 2017. Among numerous provisions included in the new law was the reduction of the statutory corporate federal income tax rate from 35% to 21%. In the second quarter of Fiscal 2018, the Company applied the newly enacted corporate federal income tax rate of 21% resulting in an approximately $18.7 million revaluation of the Company s net long term deferred tax assets which are expected to reverse in future periods. The increase in the effective tax rate as a result of the revaluation was partially offset by a lower blended federal statutory tax rate of approximately 28.0% as compared to 35.0% in the same prior-year period. This resulted in an approximately $2.3 million and $3.8 million income tax benefit for the three and six months ended December 31, 2017, respectively. Overall, the Company anticipates the decrease in the

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U.S. federal statutory rate resulting from the enactment of the 2017 Tax Reform will have a favorable impact on future U.S. tax expense and operating cash flows. The Company recorded the impact of 2017 Tax Reform in the three months ended December 31, 2017, inclusive of provisional amounts based on reasonable estimates. However, the final impact of 2017 Tax Reform may differ due to and among other things, changes in interpretations, assumptions made by the Company, the issuance of additional guidance, and actions the Company may take as a result of 2017 Tax Reform. Adjustments, if any, will be made in accordance with SAB 118.

The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

As of December 31, 2017 and June 30, 2017, the Company has total unrecognized tax benefits of $2.0 million and $5.9 million, respectively. The decrease was the result of an expiration in the statute of limitations related to several state-related unrecognized tax benefits. As a result of the positions taken during the period, the Company has not recorded any interest and penalties for the period ended December 31, 2017 in the statement of operations and no cumulative interest and penalties have been recorded in the Company s statement of financial position as of December 31, 2017 and June 30, 2017. The Company will recognize interest accrued on unrecognized tax benefits in interest expense and any related penalties in operating expenses.

The Company files income tax returns in the United States federal jurisdiction and various states. The Company s tax returns for Fiscal Year 2013 and prior generally are no longer subject to review as such years generally are closed. The Company s Fiscal Year 2016 federal return is currently under examination by the Internal Revenue Service. The Company cannot reasonably predict the outcome of the examination at this time.

Note 20. Related Party Transactions

The Company had sales of $1.2 million and $1.1 million during the three months ended December 31, 2017 and 2016, respectively, to a generic distributor, Auburn Pharmaceutical Company (Auburn). Sales to Auburn for the six months ended December 31, 2017 and 2016 were $2.0 million for both periods. Jeffrey Farber, Chairman of the Board, is the owner of Auburn. Accounts receivable includes amounts due from Auburn of $1.0 million and $751 thousand at December 31, 2017 and June 30, 2017, respectively.

The Company also had sales of $516 thousand and $262 thousand during the three months ended December 31, 2017 and 2016, respectively, to a generic distributor, KeySource. Sales to KeySource for the six months ended December 31, 2017 and 2016 were $983 thousand and $329 thousand, respectively. Albert Paonessa, a current board member, was appointed the CEO of KeySource in May 2017. Accounts receivable includes amounts due from KeySource of $456 thousand and $606 thousand as of December 31, 2017 and June 30, 2017, respectively.

In connection with the termination of the employment of Arthur P. Bedrosian, the Company s former Chief Executive Officer, effective as of December 31, 2017, the Company entered into a separation agreement pursuant to which he will receive certain benefits including, among others, 36 months base salary, a pro-rated Fiscal 2018 cash bonus as well as accelerated vesting of his outstanding equity awards. The total benefits resulted in an approximately $3.4 million charge to the Company s consolidated statements of operations in the second quarter of Fiscal 2018. On January 20, 2018, the Company also entered into a consulting agreement with Mr. Bedrosian to work on several important projects, primarily involving existing and new partnering efforts to expand and diversify opportunities, including but not limited to spearheading the effort to transition and strengthen the Company s existing contractual relationships with its key partners.

Note 21. Material Contracts with Suppliers

Jerome Stevens Pharmaceuticals Distribution Agreement:

The Company s primary finished goods inventory supplier is JSP, in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for approximately 39% of the Company s inventory purchases in the three months ended December 31, 2017 and 2016. Purchases of finished goods inventory from JSP accounted for 36% and 38% of the Company s inventory purchases in the six months ended December 31, 2017 and 2016, respectively.

On August 19, 2013, the Company entered into an agreement with JSP to extend its initial contract to continue as the exclusive distributor in the United States of three JSP products: Butalbital, Aspirin, Caffeine with Codeine Phosphate Capsules USP; Digoxin Tablets USP; and Levothyroxine Sodium Tablets USP. The amendment to the original agreement extends the initial contract, which was due to expire on March 22, 2014, for five years through March 2019. In connection with the amendment, the Company issued a total of 1.5 million shares of the Company s common stock to JSP and JSP s designees. In accordance with its policy related to

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renewal and extension costs for recognized intangible assets, the Company recorded a $20.1 million expense in cost of sales, which represents the fair value of the shares on August 19, 2013. If the parties agree to a second five year extension from March 23, 2019 to March 23, 2024, the Company is required to issue to JSP or its designees an additional 1.5 million shares of the Company s common stock. Both Lannett and JSP have the right to terminate the contract if one of the parties does not cure a material breach of the contract within thirty (30) days of notice from the non-breaching party.

During the renewal term of the JSP Distribution Agreement, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP products. There is no guarantee that the Company will be able to meet the minimum purchase requirement for Fiscal 2018 and in the future. If the Company does not meet the minimum purchase requirements, JSP s sole remedy is to terminate the JSP Distribution Agreement.

Note 22. Subsequent Events

In February 2018, the Company made a $25.0 million voluntary prepayment against its outstanding debt balance.

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

Cautionary Statement About Forward-Looking Statements

This Report on Form 10-Q and certain information incorporated herein by reference contains forward-looking statements which are not historical facts made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not promises or guarantees and investors are cautioned that all forward-looking statements involve risks and uncertainties, including but not limited to the impact of competitive products and pricing, product demand and market acceptance, new product development, acquisition-related challenges, the regulatory environment, interest rate fluctuations, reliance on key strategic alliances, availability of raw materials, fluctuations in operating results and other risks detailed from time to time in our filings with the Securities and Exchange Commission (the SEC). These statements are based on management s current expectations and are naturally subject to uncertainty and changes in circumstances. We caution you not to place undue reliance upon any such forward-looking statements which speak only as of the date made. Lannett is under no obligation to, and expressly disclaims any such obligation to, update or alter its forward-looking statements, whether as a result of new information, future events or otherwise.

The following information should be read in conjunction with the consolidated financial statements and notes in Part I, Item 1 of this Quarterly Report and with Management s Discussion and Analysis of Financial Condition and Results of Operations contained in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2017. All references to Fiscal 2018 or Fiscal Year 2018 shall mean the fiscal year ending June 30, 2018 and all references to Fiscal 2017 or Fiscal Year 2017 shall mean the fiscal year ended June 30, 2017.

Company Overview

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

On November 25, 2015, the Company completed the acquisition of Kremers Urban Pharmaceutical, Inc. (KUPI), the former subsidiary of global biopharmaceuticals company UCB S.A. KUPI is a specialty pharmaceuticals manufacturer focused on the development of products that are difficult to formulate or utilize specialized delivery technologies. Strategic benefits of the acquisition include expanded manufacturing capacity, a diversified product portfolio and pipeline and complementary research and development expertise.

The Company operates pharmaceutical manufacturing plants in Philadelphia, Pennsylvania; Cody, Wyoming; Carmel, New York and Seymour, Indiana. The Company s customers include generic pharmaceutical distributors, drug wholesalers, chain drug stores, private label distributors, mail-order pharmacies, other pharmaceutical manufacturers, managed care organizations, hospital buying groups, governmental entities and health maintenance organizations.

2016 Restructuring Plan

On February 1, 2016, in connection with the acquisition of KUPI, the Company announced a plan related to the future integration of KUPI and the Company s operations (the 2016 Restructuring Program). The plan focuses on the closure of KUPI s corporate functions and the consolidation of manufacturing, sales, research and development and distribution functions. The Company estimates that it will incur an aggregate of up to approximately $20.0 million in restructuring charges for actions that have been announced or communicated since the 2016 Restructuring Program began. Of this amount, approximately $11.0 million relates to employee separation costs, approximately $1.0 million relates to contract termination costs and approximately $8.0 million relates to facility closures costs and other actions.

The plan is currently estimated to generate annualized synergies of approximately $50.0 million by the end of Fiscal 2018 and is expected to achieve an ultimate annual run rate of synergies totaling approximately $65.0 million by the end of Fiscal 2020.

These amounts are estimates based on the information currently available to management. It is possible that additional charges and future cash payments could occur in relation to the restructuring actions.

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Financial Summary

For the second quarter of Fiscal Year 2018, net sales increased to $184.3 million compared to $170.9 million in the same prior-year period. Gross profit decreased to $87.5 million compared to $88.1 million in the prior-year period and gross profit percentage decreased to 47% compared to 52% in the prior-year period. R&D expenses increased 8% to $10.7 million compared to $9.9 million in the second quarter of Fiscal Year 2017 while SG&A expenses increased 58% to $28.5 million from $18.1 million in the prior-year period. Acquisition and integration-related expenses decreased to $65 thousand from $1.0 million in the prior-year period. Restructuring expenses decreased to $1.0 million from $1.7 million in the prior-year period. Operating income for the second quarter of Fiscal Year 2018 was $47.1 million compared to $34.3 million in the second quarter of Fiscal Year 2017, which included a $23.0 million intangible asset impairment charge. Net income attributable to the Company for the second quarter of Fiscal Year 2018 was $14.0 million, or $0.37 per diluted share compared to $8.2 million, or $0.22 per diluted share in the second quarter of Fiscal Year 2017.

For the first six months of Fiscal 2018, net sales increased to $339.3 million compared to $332.5 million in the same prior-year period. Gross profit decreased $14.8 million to $155.1 million, compared to $169.9 million in the prior-year period. Gross profit percentage decreased to 46% compared to 51% in the prior-year period. R&D expenses decreased 19% to $18.1 million compared to $22.3 million in the first six months of Fiscal 2017 while SG&A expenses increased 21% to $47.5 million from $39.3 million in the prior-year period. Acquisition and integration-related expenses decreased to $83 thousand from $2.4 million in the prior-year period. Restructuring expenses decreased to $1.6 million from $3.8 million in the prior-year period. Operating income for the first six months of Fiscal 2018, was $87.8 million compared to $14.0 million in the prior-year period, which included an $88.1 million intangible asset impairment charge. Net income attributable to the Company for the first six months of Fiscal 2018 was $27.3 million, or $0.72 per diluted share compared to net loss attributable to the Company of $21.2 million, or $0.58 per diluted share in the prior-year period.

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

Results of Operations - Three months ended December 31, 2017 compared with the three months ended December 31, 2016

Net sales increased 8% to $184.3 million for the three months ended December 31, 2017. The following table identifies the Company s net product sales by medical indication for the three months ended December 31, 2017 and 2016:

(In thousands)	Three Months Ended December 31,	
Medical Indication	**2017**	**2016**
Antibiotic	$ 3,552	$ 4,792
Anti-Psychosis	22,799	15,365
Cardiovascular	10,135	11,975
Central Nervous System	6,925	10,555
Gallstone	5,282	13,425
Gastrointestinal	15,055	18,977
Glaucoma	2,164	5,311
Migraine	15,484	7,863
Muscle Relaxant	3,219	3,004

Pain Management		6,128		7,439
Respiratory		2,230		2,957
Thyroid Deficiency		68,794		45,431
Urinary		2,840		4,693
Other		13,105		11,133
Contract manufacturing revenue		6,593		8,024
Net sales	$	184,305	$	170,944

The increase in net sales was driven by increased volumes of $19.4 million, partially offset by decreased average selling price of products of $6.0 million. Volumes were favorably impacted due to a temporary disruption of our competitor s supplies in the Thyroid Deficiency and Migraine medical indications. Although the Company has benefited in the past from favorable pricing trends, these trends have reversed. The level of competition in the marketplace is constantly changing and the Company cannot predict with certainty that these trends will continue.

In January 2017, a provision in the Bipartisan Budget Act of 2015 required drug manufacturers to pay additional rebates to state Medicaid programs if the prices of their generic drugs rise at a rate faster than inflation. The provision negatively impacted the Company s net sales by $7.1 million during the three months ended December 31, 2017, which contributed to the overall decreased average selling price.

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

Medical indication	Sales volume change %	Sales price change %
Antibiotic	(12)%	(14)%
Anti-Psychosis	6%	42%
Cardiovascular	9%	(24)%
Central Nervous System	(28)%	(6)%
Gallstone	(25)%	(36)%
Gastrointestinal	6%	(27)%
Glaucoma	(6)%	(53)%
Migraine	104%	(7)%
Muscle Relaxant	61%	(54)%
Pain Management	(16)%	(2)%
Respiratory	3%	(28)%
Thyroid Deficiency	34%	17%
Urinary	(18)%	(21)%

Central Nervous System. *Methylphenidate Hydrochloride Extended Release Tablets (Methylphenidate ER)*

During a teleconference in November 2014, the FDA informed KUPI that it had concerns about whether generic versions of Concerta (methylphenidate hydrochloride extended release tablets), including KUPI s Methylphenidate ER product, are therapeutically equivalent to Concerta. The FDA indicated that its concerns were based in part on adverse event reports concerning lack of effect and its analyses of pharmacokinetic data. The FDA informed KUPI that it was changing the therapeutic equivalence rating of its product from AB (therapeutically equivalent) to BX. A BX-rated drug is a product for which data are insufficient to determine therapeutic equivalence; it is still approved and can be prescribed, but the FDA does not recommend it as automatically substitutable for the brand-name drug at the pharmacy.

During the November 2014 teleconference, the FDA also asked KUPI to either voluntarily withdraw its product or to conduct new bioequivalence (BE) testing in accordance with the recommendations for demonstrating bioequivalence to Concerta proposed in a new draft BE guidance that the FDA issued earlier that November. The FDA had approved the KUPI product (and originally granted it an AB rating) in 2013, on the basis of KUPI data showing its product met BE criteria set forth in draft BE guidance that the FDA had issued in 2012. The FDA s position concerning the KUPI product was the subject of a public announcement by the agency. The Company agreed to conduct new BE studies per the new draft BE guidance. KUPI submitted the data from those studies to the FDA in June 2015 and met with the FDA to discuss the results in July 2015.

On October 18, 2016, the Company received notice from the FDA that it will seek to withdraw approval of the Company s ANDA for Methylphenidate ER. The FDA s notice includes an opportunity for the Company to request a hearing on this matter. Following the Company s request under the Freedom of Information Act (FOIA) for documents to support its request for a hearing, the FDA granted an extension to submit all data, information and analyses upon which the request for a hearing relies.

In response to the Company s FOIA requests, the FDA provided four sets of documents between April 4, 2017 and October 25, 2017 and, on December 4, 2017, the Company submitted extensive information, data, analyses, and expert reports to the FDA that demonstrate the existence of genuine and substantial issues of fact that necessitate a hearing to prove the therapeutic equivalence of its product. On December 8, 2017, the

documents were posted on the public docket. The FDA has not yet made a decision as to whether to grant a hearing to the Company.

The Company intends to continue working with the FDA to regain the AB rating, and in the meantime, maintain the drug on the U.S. market with a BX rating. However, there can be no assurance as to when or if the Company will regain the AB rating or be permitted to remain on the market. If the Company were to receive the AB rating, net sales of the product could increase subject to market factors existing at that time. The Company also agreed to potential acquisition-related contingent payments to UCB related to Methylphenidate ER if the FDA reinstates the AB-rating and certain sales thresholds are met. Such potential contingent payments are set to expire after December 31, 2020.

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Pain Management. *Cocaine Topical Solution (C-Topical)*

In December 2017, a competitor received approval from the FDA to market and sell a Cocaine Hydrochloride topical product. This approval effects the Company s right to market and sell its unapproved Grandfathered C-Topical product. According to FDA guidance, the FDA typically allows the marketing of unapproved products for up to one year following the approval of an NDA for the product. Subsequently, the Company would not be permitted to market and sell its unapproved C-Topical product. For the three and six month periods ended December 31, 2017, the Company s net sales of C-Topical were $5.1 million and $9.7 million, respectively. At this time, the Company cannot predict the ultimate impact that these developments will have on its business and financial performance, including but not limited to any possible price reductions should the competitor commence marketing and selling its C-Topical product in the future, for how long the Company will continue to be permitted to market and sell C-Topical or the possible effect on the Company s pending NDA application.

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

(In thousands) **Customer Distribution Channel**		**December 31, 2017**		**December 31, 2016**
Wholesaler/Distributor	$	126,765	$	129,585
Retail Chain		40,233		19,457
Mail-Order Pharmacy		10,714		13,878
Contract manufacturing revenue		6,593		8,024
Net sales	$	184,305	$	170,944

Net sales to retail chains increased significantly as a result of additional sales to a customer that was unable to obtain supply from a competitor due to a temporary disruption in the competitor s supply chain.

Cost of Sales, including amortization of intangibles. Cost of sales, including amortization of intangibles, for the second quarter of Fiscal 2018 increased 17% to $96.9 million from $82.9 million in the same prior-year period. The increase was primarily attributable to higher sales as well as changes in our product sales mix and increased product royalties. Product royalties expense included in cost of sales totaled $7.2 million for the second quarter of Fiscal Year 2018 and $5.1 million for the second quarter of Fiscal Year 2017. Amortization expense included in cost of sales totaled $7.9 million for the second quarter of Fiscal Year 2018 compared to $7.7 million for the second quarter of Fiscal Year 2017.

Gross Profit. Gross profit for the second quarter of Fiscal 2018 decreased 1% to $87.5 million or 47% of net sales. In comparison, gross profit for the second quarter of Fiscal 2017 was $88.1 million or 52% of net sales. The decrease in gross profit percentage was primarily attributable to lower average selling prices of certain key products as well as additional product royalties.

Research and Development Expenses. Research and development expenses for the second quarter increased 8% to $10.7 million in Fiscal 2018 from $9.9 million in Fiscal 2017. The increase was primarily due to the higher incentive compensation-related costs, partially offset by lower product development expenses.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 58% to $28.5 million in the second quarter of Fiscal 2018 compared with $18.1 million in Fiscal 2017. The increase was primarily driven by higher incentive compensation-related costs as well as approximately $3.4 million related to separation benefits for the former chief executive officer.

The Company is focused on controlling operating expenses and has implemented its 2016 Restructuring Plan as noted above, however increases in personnel and other costs to facilitate enhancements in the Company s infrastructure and expansion may continue to impact operating expenses in future periods.

Acquisition and Integration-related Expenses. Acquisition and integration-related expenses decreased $962 thousand to $65 thousand for the second quarter of Fiscal Year 2018 as compared to the prior-year period. The decrease was due to the timing of the acquisition of KUPI.

Restructuring Expenses. Restructuring expenses decreased $677 thousand to $1.0 million for the second quarter of Fiscal Year 2018 compared to the prior-year period primarily due to higher employee separation costs incurred in connection with the 2016 Restructuring Program during the three months ended December 31, 2016.

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Other Income (Loss). Interest expense for the three months ended December 31, 2017 totaled $20.7 million compared to $23.3 million for the three months ended December 31, 2016. The weighted average interest rate for the second quarter of Fiscal 2018 and 2017 was 8.3% and 8.0%, respectively. Investment income totaled $2.3 million in the second quarter of Fiscal 2018 compared with $1.0 million in the second quarter of Fiscal 2017. In December 2017, the Company received $3.5 million as part of the settlement of the Braintree patent litigation. See Note 12. Legal, Regulatory Matters and Contingencies for further details.

Income Tax. The Company recorded income tax expense in the second quarter of Fiscal 2018 of $18.1 million compared to $3.5 million in the second quarter of Fiscal 2017. The effective tax rate for the three months ended December 31, 2017 was 56.4%, compared to 30.2% for the three months ended December 31, 2016. The effective tax rate for the three months ended December 31, 2017 was higher compared to the same prior-year period primarily due to the Tax Cut and Jobs Act legislation (2017 Tax Reform). Among numerous provisions included in the new law was the reduction of the statutory corporate federal income tax rate from 35% to 21%. In the second quarter of Fiscal 2018, the Company applied the newly enacted corporate federal income tax rate of 21% resulting in an approximately $18.7 million revaluation of the Company s net long term deferred tax assets which are expected to reverse in future periods. The increase in the effective tax rate as a result of the revaluation was partially offset by a lower blended federal statutory tax rate of approximately 28.0% as compared to 35.0% in the same prior-year period. This resulted in an approximately $2.3 million income tax benefit for the three months ended December 31, 2017. Overall, the Company anticipates the decrease in the U.S. federal statutory rate resulting from the enactment of the 2017 Tax Reform will have a favorable impact on future U.S. tax expense and operating cash flows.

Net Income. For the three months ended December 31, 2017, the Company reported net income attributable to Lannett Company, Inc. of $14.0 million, or $0.37 per diluted share. Comparatively, net income attributable to Lannett Company, Inc. in the corresponding prior-year period was $8.2 million, or $0.22 per diluted share.

Results of Operations - Six months ended December 31, 2017 compared with the six months ended December 31, 2016

Net sales increased 2% to $339.3 million for the six months ended December 31, 2017. The following table identifies the Company s net product sales by medical indication for the six months ended December 31, 2017 and 2016:

(In thousands) Medical Indication	Six Months Ended December 31, 2017	2016
Antibiotic	$ 6,900	$ 8,572
Anti-Psychosis	37,791	32,685
Cardiovascular	21,441	24,669
Central Nervous System	15,742	20,904
Gallstone	11,846	26,308
Gastrointestinal	29,608	37,029
Glaucoma	4,832	11,095

Migraine		30,499		15,023
Muscle Relaxant		7,010		6,536
Pain Management		11,889		14,047
Respiratory		3,876		5,170
Thyroid Deficiency		116,008		85,269
Urinary		5,837		9,794
Other		25,802		22,314
Contract manufacturing revenue		10,185		13,088
Net sales	$	339,266	$	332,503

The increase in net sales was driven by increased volumes of $45.4 million, partially offset by decreased average selling price of products of $38.6 million. Volumes were favorably impacted due to a temporary disruption of our competitor s supplies in the Thyroid Deficiency and Migraine medical indications. Average selling prices were impacted by competitive pricing pressure across a number of products, product mix and changes within distribution channels. Although the Company has benefited in the past from favorable pricing trends, these trends have reversed. The level of competition in the marketplace is constantly changing and the Company cannot predict with certainty that these trends will continue.

In January 2017, a provision in the Bipartisan Budget Act of 2015 required drug manufacturers to pay additional rebates to state Medicaid programs if the prices of their generic drugs rise at a rate faster than inflation. The provision negatively impacted the Company s net sales by $12.5 million during the six months ended December 31, 2017 which contributed to the overall decreased average selling price.

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

Medical indication	Sales volume change %	Sales price change %
Antibiotic	(6)%	(14)%
Anti-Psychosis	3%	13%
Cardiovascular	25%	(38)%
Central Nervous System	(10)%	(15)%
Gallstone	(21)%	(34)%
Gastrointestinal	10%	(30)%
Glaucoma	(4)%	(52)%
Migraine	116%	(13)%
Muscle Relaxant	91%	(84)%
Pain Management	(14)%	(1)%
Respiratory	4%	(29)%
Thyroid Deficiency	25%	11%
Urinary	(3)%	(37)%

The Company sells its products to customers in various distribution channels. The table below presents the Company s net sales to each distribution channel for the six months ended December 31, 2017 and 2016:

(In thousands) Customer Distribution Channel	December 31, 2017	December 31, 2016
Wholesaler/Distributor	$ 247,566	$ 254,510
Retail Chain	59,001	39,551
Mail-Order Pharmacy	22,514	25,355
Contract manufacturing revenue	10,185	13,087
Net sales	$ 339,266	$ 332,503

Net sales to retail chains increased significantly as a result of additional sales to a customer that was unable to obtain supply from a competitor due to a temporary disruption in the competitor s supply chain. Net sales within the various distribution channels remained consistent in the first six months of Fiscal 2018 as compared to the prior-year period.

Cost of Sales, including amortization of intangibles. Cost of sales, including amortization of intangibles for the first six months of Fiscal 2018 increased 13% to $184.1 million from $162.6 million in the same prior-year period. The increase was primarily attributable to higher sales as well as changes in our product sales mix and increased product royalties, partially offset by lower amortization expense. Product royalties expense included in cost of sales totaled $13.9 million for the first six months of Fiscal Year 2018 and $9.9 million for the first six months of Fiscal Year 2017. Amortization expense included in cost of sales totaled $15.7 million for the first six months of Fiscal Year 2018 and $16.6 million for the first six months of Fiscal Year 2017. The decrease was primarily due to a lower intangible assets base in the first six months of Fiscal 2018 as a result of impairment charges in Fiscal 2017.

Gross Profit. Gross profit for the first six months of Fiscal 2018 decreased 9% to $155.1 million or 46% of net sales. In comparison, gross profit for the first six months of Fiscal 2017 was $169.9 million or 51% of net sales. The decrease in gross profit percentage was primarily attributable to lower average selling prices of certain key products as well as additional product royalties.

Research and Development Expenses. Research and development expenses for the first six months decreased 19% to $18.1 million in Fiscal 2018 from $22.3 million in Fiscal 2017. The decrease was primarily due to lower product development expenses as well as decreased spend related to the C-Topical clinical trials, partially offset by higher incentive compensation-related expenses.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 21% to $47.5 million in the first six months of Fiscal 2018 compared with $39.3 million in Fiscal 2017. The increase was primarily driven by higher incentive compensation-related costs as well as approximately $3.4 million related to separation benefits for the former chief executive officer.

The Company is focused on controlling operating expenses and has implemented its 2016 Restructuring Plan as noted above, however increases in personnel and other costs to facilitate enhancements in the Company s infrastructure and expansion may continue to impact operating expenses in future periods.

Acquisition and Integration-related Expenses. Acquisition and integration-related expenses decreased $2.3 million compared to the prior-year period. The decrease was due to the timing of the acquisition of KUPI.

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Restructuring Expenses. Restructuring expenses decreased $2.2 million compared to the prior-year period primarily due to higher employee separation costs incurred in connection with the 2016 Restructuring Program during the six months ended December 31, 2016.

Other Income (Loss). Interest expense in the first six months of Fiscal 2018 totaled $41.6 million compared to $46.3 million in Fiscal 2017. The weighted average interest rate for the first six months of Fiscal 2018 and 2017 was 8.3% and 7.9%, respectively. Investment income in the first six months of Fiscal 2018 totaled $3.5 million compared with investment income of $2.0 million in Fiscal 2017. In December 2017, the Company received $3.5 million as part of the settlement of the Braintree patent litigation. See Note 12. Legal, Regulatory Matters and Contingencies for further details.

Income Tax. The Company recorded income tax expense in the first six months of Fiscal 2018 of $25.6 million compared to an income tax benefit of $9.3 million in the first six months of Fiscal 2017. The effective tax rate for the six months ended December 31, 2017 was 48.4% compared to 30.6% for the six months ended December 31, 2016. The effective tax rate for the six months ended December 31, 2017 was higher compared to the same prior-year period primarily due to 2017 Tax Reform. Among numerous provisions included in the new law was the reduction of the statutory corporate federal income tax rate from 35% to 21%. In the second quarter of Fiscal 2018, the Company applied the newly enacted corporate federal income tax rate of 21% resulting in an approximately $18.7 million revaluation of the Company s net long term deferred tax assets which are expected to reverse in future periods. The increase in the effective tax rate as a result of the revaluation was partially offset by a lower blended federal statutory tax rate of approximately 28.0% as compared to 35.0% in the same prior-year period. This resulted in an approximately $3.8 million income tax benefit for the six months ended December 31, 2017.

Net Income (Loss). For the six months ended December 31, 2017, the Company reported net income attributable to Lannett Company, Inc. of $27.3 million, or $0.72 per diluted share. Comparatively, net loss attributable to Lannett Company, Inc. in the corresponding prior-year period was $21.2 million, or $0.58 per diluted share.

Liquidity and Capital Resources

Cash Flow

Until November 25, 2015, the date of the KUPI acquisition, the Company had historically financed its operations with cash flow generated from operations supplemented with borrowings from various government agencies and financial institutions. At December 31, 2017, working capital was $323.5 million as compared to $302.6 million at June 30, 2017, an increase of $20.9 million. Current product portfolio sales as well as sales related to future product approvals are anticipated to continue to generate positive cash flow from operations.

Net cash provided by operating activities of $76.1 million for the six months ended December 31, 2017 reflected net income of $27.3 million, adjustments for non-cash items of $61.7 million, as well as cash used by changes in operating assets and liabilities of $12.9 million. In comparison, net cash provided by operating activities of $67.3 million for the six months ended December 31, 2016 reflected net loss of $21.2 million, adjustments for non-cash items of $104.9 million, as well as cash used by changes in operating assets and liabilities of $16.4 million.

Significant changes in operating assets and liabilities from June 30, 2017 to December 31, 2017 were comprised of:

- An increase in accounts receivable of $52.7 million mainly due to increased sales as well as the timing of collections during the quarter ended December 31, 2017 compared to the quarter ended June 30, 2017. The Company s days sales outstanding (DSO) at December 31, 2017, based on gross sales for the six months ended December 31, 2017 and gross accounts receivable at December 31, 2017 was 75 days. The level of DSO at December 31, 2017 was comparable to the Company s expectations that DSO will be in the 70 to 80 day range based on customer payment terms.

- An increase in accounts payable totaling $28.9 million primarily due to the timing of payments to a few major suppliers.

- An increase in inventories totaling $13.0 million primarily due to the timing of customer order fulfillment.

- An increase in accrued payroll and payroll-related costs of $11.2 million primarily due to higher incentive compensation-related costs as well as approximately $2.6 million related to severance benefits for the former chief executive officer.

- A decrease in prepaid income taxes totaling $15.0 million primarily due to income tax refunds received from the Internal Revenue Service.

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Significant changes in operating assets and liabilities from June 30, 2016 to December 31, 2016 were comprised of:

- An increase in accounts receivable of $17.2 million mainly due to the timing of collections during the quarter ended December 31, 2016 compared to the quarter ended June 30, 2016. The Company s days sales outstanding (DSO) at December 31, 2016, based on gross sales for the six months ended December 31, 2016 and gross accounts receivable at December 31, 2016 was 75 days. The level of DSO at December 31, 2016 was comparable to the Company s expectations that DSO will be in the 70 to 80 day range based on customer payment terms.

- An increase in inventories totaling $15.3 million primarily due to a decision to increase our inventory supply of certain key products in order to meet customer demands.

- An increase in rebates payable of $14.9 million due to an increase in rebate-eligible sales to government programs as well as the timing of processed rebates.

- An increase in accounts payable totaling $9.1 million due to the timing of vendor payments.

Net cash used in investing activities of $26.3 million for the six months ended December 31, 2017 is mainly the result of purchases of investment securities of $42.8 million, purchases of property, plant and equipment of $26.4 million and the purchase of an intangible asset of $2.0 million, partially offset by proceeds from the sale of investment securities of $44.9 million. Net cash used in investing activities of $17.4 million for the six months ended December 31, 2016 is mainly the result of purchases of investment securities of $27.1 million and purchases of property, plant and equipment of $21.3 million, partially offset by proceeds from the sale of investment securities of $31.0 million.

Net cash used in financing activities of $27.5 million for the six months ended December 31, 2017 was primarily due to debt repayments of $27.3 million and purchases of treasury stock totaling $1.0 million, partially offset by proceeds from issuance of stock pursuant to stock compensation plans of $806 thousand. Net cash used in financing activities of $27.4 million for the six months ended December 31, 2016 was primarily due to debt repayments of $26.6 million, purchases of treasury stock totaling $1.8 million and purchase of the noncontrolling interest in Realty of $1.5 million, partially offset by proceeds from issuance of stock pursuant to stock compensation plans of $1.8 million and excess tax benefits on share-based compensation awards of $705 thousand.

Credit Facility and Other Indebtedness

The Company has previously entered into and may enter into future agreements with various government agencies and financial institutions to provide additional cash to help finance the Company s various capital investments and potential strategic opportunities. These borrowing arrangements as of December 31, 2017 are as follows:

Amended Senior Secured Credit Facility

On November 25, 2015, in connection with its acquisition of KUPI, Lannett entered into a credit and guaranty agreement (the Credit and Guaranty Agreement) among certain of its wholly-owned domestic subsidiaries, as guarantors, Morgan Stanley Senior Funding, Inc., as administrative agent and collateral agent and other lenders providing for a senior secured credit facility (the Senior Secured Credit Facility). The Senior Secured Credit Facility consisted of Term Loan A in an aggregate principal amount of $275.0 million, Term Loan B in an aggregate principal amount of $635.0 million and a revolving credit facility providing for revolving loans in an aggregate principal amount of up to $125.0 million.

On June 17, 2016, Lannett amended the Senior Secured Credit Facility and the Credit and Guaranty Agreement to raise an incremental term loan in the principal amount of $150.0 million (the Incremental Term Loan) and amended certain sections of the agreement (the Amended Senior Secured Credit Facility). The terms of this Incremental Term Loan are substantially the same as those applicable to the Term Loan B. The Company used the proceeds of the Incremental Term Loan and cash on hand to repurchase the outstanding $250.0 million aggregate principal amount of Lannett s 12.0% Senior Notes due 2023 (the Senior Notes) issued in connection with the KUPI acquisition.

Refer to the Company s Form 10-K for the fiscal year ended June 30, 2017 for further details on the Amended Senior Secured Credit Facility.

Other Liquidity Matters

Material Suppliers

During the renewal term of the JSP Distribution Agreement, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP products. There is no guarantee that the Company will continue to meet the minimum

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purchase requirement for Fiscal 2018 and thereafter. If the Company does not meet the minimum purchase requirements, JSP s sole remedy is to terminate the agreement.

Cody Expansion

In January 2017, the Company announced a $50 million expansion plan in conjunction with Forward Cody to expand operations in Cody, WY. The project is expected to be completed by the middle of Fiscal 2020.

Future Acquisitions

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

We may also from time to time depending on market conditions and prices, contractual restrictions, our financial liquidity and other factors, seek to prepay outstanding debt or repurchase our outstanding debt through open market purchases, privately negotiated purchases, or otherwise. The amounts involved in any such transactions, individually or in the aggregate, may be material and may be funded from available cash or from additional borrowings.

Research and Development Arrangements

In the normal course of business, the Company has entered into certain research and development and other arrangements. As part of these arrangements, the Company has agreed to certain contingent payments which generally become due and payable only upon the achievement of certain developmental, regulatory, commercial and/or other milestones. In addition, under certain arrangements, we may be required to make royalty payments based on a percentage of future sales, or other metric, for products currently in development in the event that the Company begins to market and sell the product. Due to the inherent uncertainty related to these developmental, regulatory, commercial and/or other milestones, it is unclear if the Company will ever be required to make such payments.

Critical Accounting Policies

The preparation of our consolidated financial statements in accordance with accounting principles generally accepted in the United States and the rules and regulations of the U.S. Securities & Exchange Commission requires the use of estimates and assumptions. A listing of the Company s significant accounting policies are detailed in Note 3 Summary of Significant Accounting Policies. A subsection of these accounting policies have been identified by management as Critical Accounting Policies. Critical accounting policies are those which require management

to make estimates using assumptions that were uncertain at the time the estimates were made and for which the use of different assumptions, which reasonably could have been used, could have a material impact on the financial condition or results of operations.

Management has identified the following as Critical Accounting Policies : Revenue Recognition, Inventories, Income Taxes, Valuation of Long-Lived Assets, including Goodwill and Intangible Assets, In-Process Research and Development and Share-based Compensation.

Revenue Recognition

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

When revenue is recognized, a simultaneous adjustment to gross sales is made for chargebacks, rebates, returns, promotional adjustments and other potential adjustments. These provisions are primarily estimated based on historical experience, future expectations, contractual arrangements with wholesalers and indirect customers and other factors known to management at the time of accrual. Accruals for provisions are presented in the Consolidated Financial Statements as a reduction to gross sales with the corresponding reserve presented as a reduction of accounts receivable or included as rebates payable. The reserves presented as a reduction of accounts receivable totaled $155.5 million and $175.8 million at December 31, 2017 and June 30, 2017, respectively. Rebates payable at December 31, 2017 and June 30, 2017 were $48.4 million and $44.6 million, respectively, for certain rebate programs, primarily related to Medicare Part D, Medicaid and certain sales allowances and other adjustments paid to indirect customers.

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The following table identifies the activity and ending balances of each major category of revenue-related reserve for the six months ended December 31, 2017 and 2016:

Reserve Category (In thousands)	Chargebacks	Rebates	Returns	Other	Total
Balance at June 30, 2017	$ 79,537	$ 87,616	$ 42,135	$ 11,096	$ 220,384
Current period provision	474,882	156,073	14,541	28,623	674,119
Credits issued during the period	(499,959)	(157,071)	(11,881)	(21,713)	(690,624)
Balance at December 31, 2017	$ 54,460	$ 86,618	$ 44,795	$ 18,006	$ 203,879

Reserve Category (In thousands)	Chargebacks	Rebates	Returns	Other	Total
Balance at June 30, 2016	$ 86,495	$ 54,084	$ 40,593	$ 16,851	$ 198,023
Measurement-period adjustments		8,329	5,955		14,284
Current period provision	416,212	143,016	14,728	29,307	603,263
Credits issued during the period	(420,422)	(129,583)	(16,668)	(32,829)	(599,502)
Balance at December 31, 2016	$ 82,285	$ 75,846	$ 44,608	$ 13,329	$ 216,068

For the three months ending December 31, 2017 and 2016, as a percentage of gross sales the provision for chargebacks was 44.4% and 45.7%, the provision for rebates was 15.7% and 15.5%, the provision for returns was 0.8% and 1.7%, and the provision for other adjustments was 3.3% and 2.9%, respectively.

For the six months ending December 31, 2017 and 2016, as a percentage of gross sales the provision for chargebacks was 47.3% and 45.1%, the provision for rebates was 15.6% and 15.5%, the provision for returns was 1.4% and 1.6%, and the provision for other adjustments was 2.9% and 3.2%, respectively.

The decrease in total reserves from June 30, 2017 to December 31, 2017 was mainly due to a decrease in the chargebacks reserve, which was the result of lower inventory levels on-hand at the Company s wholesaler customers in December 31, 2017 as compared to June 30, 2017. The activity in the Other category for the six months ended December 31, 2017 and 2016 includes shelf-stock, shipping and other sales adjustments including prompt payment discounts. Historically, we have not recorded any material amounts in the current period related to reversals or additions of prior period reserves. If the Company were to record a material reversal or addition of any prior period reserve amount it would be separately disclosed.

Refer to the Company s Form 10-K for the fiscal year ended June 30, 2017 for a description of our remaining Critical Accounting Policies.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

On November 25, 2015, in connection with the acquisition of KUPI, the Company entered into a Senior Secured Credit Facility, which was subsequently amended in June 2016. Based on the variable-rate debt outstanding at December 31, 2017, each 1/8% increase in interest rates would yield $1.2 million of incremental annual interest expense.

The Company invests in equity securities, U.S. government agency securities and corporate bonds, which are exposed to market and interest rate fluctuations. The market value, interest and dividends earned on these investments may vary based on fluctuations in interest rate and market conditions.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Form 10-Q, management performed, with the participation of our Chief Executive Officer and Chief Financial Officer, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act). Our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that Lannett s disclosure controls and procedures were effective as of the end of the period covered by this report.

Change in Internal Control Over Financial Reporting

During the third quarter of Fiscal 2017, the Company completed the carve-out of data and software systems supporting the operations of KUPI from the hosted environment of UCB. The integration of the Company s entities into a single consolidated system is planned in phases and is expected to be completed in Fiscal 2018. As such, internal controls have and will continue to change in various functional areas within the Company. However, management has taken steps to ensure that any changes to the design and implementation of internal controls continue to function appropriately. There have been no other changes in Lannett s internal control over financial reporting during the six months ended December 31, 2017, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information pertaining to legal proceedings can be found in Note 12. Legal, Regulatory Matters and Contingencies of the Consolidated Financial Statements included in Part I, Item 1. of this Quarterly Report on Form 10-Q and is incorporated by reference herein.

ITEM 1A. RISK FACTORS

Lannett Company, Inc. s Annual Report on Form 10-K for the fiscal year ended June 30, 2017 includes a detailed description of its risk factors.

ITEM 6. EXHIBITS

(a) A list of the exhibits required by Item 601 of Regulation S-K to be filed as a part of this Form 10-Q is shown on the Exhibit Index filed herewith.

Exhibit Index

31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith
101.INS	XBRL Instance Document	Filed Herewith
101.SCH	XBRL Taxonomy Extension Schema Document	Filed Herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	Filed Herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	Filed Herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	Filed Herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	Filed Herewith

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SIGNATURES

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

LANNETT COMPANY, INC.

Dated: February 8, 2018

By: /s/ Timothy C. Crew
Timothy C. Crew
Chief Executive Officer

Dated: February 8, 2018

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

Dated: February 8, 2018

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