PharMerica CORP
Form 10-Q
November 01, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2012

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____.

Commission File Number: 001-33380

PHARMERICA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**87-0792558**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
1901 Campus Place	**40299**

Louisville, KY
(Address of Principal Executive Offices) **(Zip Code)**

(502) 627-7000

(Registrant s Telephone Number, Including Area Code)

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

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes ¨ No

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

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

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

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

Class of Common Stock	**Outstanding at October 26, 2012**
Common stock, $0.01 par value	29,484,890 shares

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PHARMERICA CORPORATION

FORM 10-Q

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED INCOME STATEMENTS

For the Three Months and Nine Months Ended September 30, 2011 and 2012

(Unaudited)

(In millions, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Revenues	$ 518.7	$ 442.0	$ 1,585.5	$ 1,399.4
Cost of goods sold	443.0	366.4	1,366.7	1,175.1
Gross profit	75.7	75.6	218.8	224.3
Selling, general and administrative expenses	55.1	54.0	162.8	161.5
Amortization expense	3.0	3.2	8.4	9.0
Impairment of intangible assets (Note 4)	5.1	-	5.1	-
Merger, acquisition, integration costs and other charges	1.8	6.1	11.6	14.3
Operating income	10.7	12.3	30.9	39.5
Interest expense, net	2.6	2.4	6.3	7.6
Income before income taxes	8.1	9.9	24.6	31.9
Provision for income taxes	3.3	3.9	9.1	12.7
Net income	$ 4.8	$ 6.0	$ 15.5	$ 19.2
Earnings per common share:				
Basic	$ 0.16	$ 0.20	$ 0.53	$ 0.65
Diluted	$ 0.16	$ 0.20	$ 0.53	$ 0.64
Shares used in computing earnings per common share:				
Basic	29,366,998	29,491,234	29,324,094	29,470,473
Diluted	29,531,095	29,846,679	29,423,330	29,829,169

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

As of December 31, 2011 and September 30, 2012

(Unaudited)

(In millions, except share and per share amounts)

	(As Adjusted) December 31, 2011	September 30, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17.4	$ 49.5
Accounts receivable, net	232.2	209.9
Inventory	130.6	98.0
Deferred tax assets, net	36.5	33.1
Prepaids and other assets	34.5	34.4
	451.2	424.9
Equipment and leasehold improvements	145.0	157.1
Accumulated depreciation	(92.6)	(105.5)
	52.4	51.6
Deferred tax assets, net	0.6	0.1
Goodwill	214.9	214.9
Intangible assets, net	100.2	94.0
Other	14.7	12.7
	$ 834.0	$ 798.2
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 54.7	$ 43.6
Salaries, wages and other compensation	35.1	33.7
Current portion of long-term debt	6.3	9.4
Other accrued liabilities	6.7	15.0
	102.8	101.7
Long-term debt	293.7	234.4
Other long-term liabilities	23.7	24.8
Commitments and contingencies (See Note 6)		
Stockholders equity:		
Preferred stock, $0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2011 and September 30, 2012	-	-
Common stock, $0.01 par value per share; 175,000,000 shares authorized; 30,794,000 and 30,940,109 shares issued as of December 31, 2011 and September 30, 2012, respectively	0.3	0.3
Capital in excess of par value	355.9	361.4
Retained earnings	68.4	87.6
Treasury stock at cost, 1,350,128 shares and 1,455,347 shares at December 31, 2011 and September 30, 2012, respectively	(10.8)	(12.0)

	413.8	437.3
	$ 834.0	$ 798.2

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three and Nine Months Ended September 30, 2011 and 2012

(Unaudited)

(In millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Cash flows provided by (used in) operating activities:				
Net income	$ 4.8	$ 6.0	$ 15.5	$ 19.2
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation	4.8	4.6	14.9	13.9
Amortization	3.0	3.2	8.4	9.0
Impairment charge	5.1	-	5.1	-
Merger, acquisition, integration costs and other charges	0.5	0.3	1.2	2.2
Stock-based compensation	1.3	2.3	4.5	5.2
Amortization of deferred financing fees	0.2	0.3	0.7	0.7
Deferred income taxes	2.9	(2.1)	9.8	3.9
Loss (gain) on disposition of equipment	0.1	-	0.3	(0.1)
Other	(0.2)	0.1	(0.2)	0.1
Change in operating assets and liabilities:				
Accounts receivable, net	6.1	9.4	(2.2)	22.3
Inventory	10.8	11.1	(29.1)	32.7
Prepaids and other assets	1.9	2.9	(6.9)	0.1
Accounts payable	(28.3)	7.2	(21.3)	(10.8)
Salaries, wages and other compensation	(0.9)	0.8	11.6	(3.8)
Other accrued liabilities	(0.1)	5.3	-	8.6
Net cash provided by operating activities	12.0	51.4	12.3	103.2
Cash flows provided by (used in) investing activities:				
Purchase of equipment and leasehold improvements	(3.2)	(6.6)	(9.4)	(13.5)
Acquisitions, net of cash acquired	-	(0.4)	(8.5)	(0.8)
Cash proceeds from the sale of assets	0.1	-	0.1	0.3
Net cash used in investing activities	(3.1)	(7.0)	(17.8)	(14.0)
Cash flows provided by (used in) financing activities:				
Repayments of long-term debt	-	(6.3)	(240.0)	(6.3)
Proceeds from long-term debt	-	-	250.0	-
Net activity of long-term revolving credit facility	(13.0)	-	5.4	(50.0)
Payments of debt issuance costs	-	-	(9.8)	-
Repayments of capital lease obligations	(0.3)	-	(0.7)	(0.1)
Issuance of common stock	0.1	0.4	0.2	0.5
Treasury stock at cost	-	(1.0)	(0.1)	(1.2)
Net cash (used in) provided by financing activities	(13.2)	(6.9)	5.0	(57.1)
Change in cash and cash equivalents	(4.3)	37.5	(0.5)	32.1
Cash and cash equivalents at beginning of period	14.6	12.0	10.8	17.4
Cash and cash equivalents at end of period	$ 10.3	$ 49.5	$ 10.3	$ 49.5

Supplemental information:				
Cash paid for interest	$ 2.6	$ 2.2	$ 5.1	$ 7.2
Cash paid for taxes	$ (0.2)	$ 1.8	$ 0.1	$ 4.0

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

For the Nine Months Ended September 30, 2012

(Unaudited)

(In millions, except share amounts)

	Common Stock		Capital in Excess of	Retained	Treasury	
	Shares	Amount	Par Value	Earnings	Stock	Total
Balance at December 31, 2011	29,443,872	$ 0.3	$ 355.9	$ 68.4	$ (10.8)	$ 413.8
Net income	-	-	-	19.2	-	19.2
Exercise of stock options and tax components of stock-based awards, net	39,295	-	0.3	-	-	0.3
Vested restricted stock units	106,814	-	-	-	-	-
Treasury stock at cost	(105,219)	-	-	-	(1.2)	(1.2)
Stock-based compensation - non-vested restricted stock	-	-	3.7	-	-	3.7
Stock-based compensation - stock options	-	-	1.5	-	-	1.5
Balance at September 30, 2012	29,484,762	$ 0.3	$ 361.4	$ 87.6	$ (12.0)	$ 437.3

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

PharMerica Corporation (the Corporation) is an institutional pharmacy services company that services healthcare facilities and provides pharmacy management services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States based on revenues, operating 94 institutional pharmacies in 44 states. The Corporation s customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 89 hospitals in the United States.

Principles of Consolidation

All intercompany transactions have been eliminated.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Corporation and related footnotes for the year ended December 31, 2011, included in the Corporation s Annual Report on Form 10-K. The balance sheet as of December 31, 2011 has been derived from the audited consolidated financial statements adjusted for acquisition related measurement period adjustments as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

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

Use of Estimates

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

Potential risks and uncertainties, many of which are beyond the control of the Corporation, include, but are not necessarily limited to, such factors as overall economic, financial and business conditions; delays and reductions in reimbursement by the government and other payers to the Corporation and/or its customers; the overall financial condition of the Corporation s customers and suppliers; retaining existing customers and service contracts and attracting new customers; the effects of renegotiating contract pricing relating to significant customers and suppliers; risk of loss of revenues due to a customer or owner of a skilled nursing facility entering the institutional pharmacy business; the Corporation s ability to successfully transition information technology services being provided by its current vendor to another vendor effectively; successfully pursuing development and acquisition activities; attracting and retaining key executives, pharmacists, and other healthcare personnel; the effect of new government regulations, executive orders and/or legislative initiatives, including those relating to reimbursement and drug pricing policies and changes in the interpretation and application of such policies; efforts by payers to control costs; the outcome of litigation; the outcome of audit, compliance, administrative or investigatory reviews, including governmental/regulatory inquiries; delays or difficulties in integrating acquired businesses; other contingent liabilities; changes in interest rates; changes in tax laws and regulations; the Corporation s ability to implement short cycle dispensing requirements of the 2010 Health Care Legislation; access to capital and financing; the demand for the Corporation s products and services; changes to safety risk profiles of drugs and/or drug transitioning to over-the-counter products; pricing

and other competitive factors in the industry; changes in volatility of the Corporation s stock price; changes in manufacturers rebate programs; shifts in demand for generic drug equivalents; changes in insurance claims experience and related assumptions; variations in costs or expenses; changes to critical accounting estimates and changes in and interpretations of accounting rules and standards.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Unsolicited Tender Offer by Omnicare

On August 23, 2011, Omnicare, Inc. (Omnicare) made public an unsolicited proposal to acquire all of the outstanding shares of the Corporation s common stock for $15.00 per share in cash. On January 27, 2012, the Federal Trade Commission (FTC) issued an administrative complaint to block Omnicare s proposed acquisition of the Corporation. The complaint alleged that the proposed acquisition would be illegal and in violation of Section 15 of the FTC Act and Section 7 of the Clayton Act because it would harm competition and enable Omnicare to raise the price of drugs for Medicare Part D consumers and others. On February 21, 2012 the unsolicited tender offer expired and Omnicare did not extend the offer.

In connection with these matters, in the nine months ended September 30, 2011 and September 30, 2012, the Corporation expensed $1.1 million and $1.9 million, respectively, of legal, investment banking, and other fees, which are included in merger, acquisition, integration costs and other charges in the condensed consolidated income statements.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and cash equivalents with original maturities of three months or less. The Corporation places its cash in financial institutions that are federally insured. As of December 31, 2011 and September 30, 2012, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets.

Fair Value of Financial Instruments

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

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

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

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

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

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

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

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Financial liabilities and non-financial assets recorded at fair value at December 31, 2011 and September 30, 2012, are set forth in the tables below (dollars in millions):

As of December 31, 2011	Asset/ (Liability)	Level 1	Level 2	Level 3	Valuation Technique
Non-financial Assets					
Intangible Assets	$ -	$ -	$ -	$ -	C
Financial Assets/(Liabilities)					
Deferred Compensation Plan	$ (3.9)	$ -	$ (3.9)	$ -	A
Contingent Consideration	-	-	-	-	C

As of September 30, 2012	Asset/ (Liability)	Level 1	Level 2	Level 3	Valuation Technique
Financial Assets/(Liabilities)					
Deferred Compensation Plan	$ (4.7)	$ -	$ (4.7)	$ -	A

During the third quarter 2011, certain intangible assets with carrying amounts of $5.1 million were written down to their implied fair value resulting in an impairment charge of $5.1 million. The fair value of intangible assets was derived using the income approach, which uses valuation techniques to convert future amounts to a single present amount. See Note 4 for a further description of the impairment.

The deferred compensation plan liability represents an unfunded obligation associated with the deferred compensation plan offered to eligible employees and members of the Board of Directors of the Corporation. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for similar assets or liabilities generated by market transactions.

The contingent consideration represented a future earn-out associated with our acquisition of an institutional pharmacy business based in West Virginia (the West Virginia Acquisition). The fair value of the liability associated with the contingent consideration was derived using the income approach with unobservable inputs, which included future gross profit forecast and present value assumptions, and there was little or no market data. The liability was relieved as of December 31, 2010 when it became apparent the contingent consideration would not be paid. The Corporation assessed the fair value of the liability through the date of determination which was August 10, 2012 when it was concluded that the gross profit requirement for the payout of the contingent consideration was not met. There were no transfers between the three-tier fair value hierarchy levels during the period.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, inventory and accounts payable approximate fair value because of the short-term maturity of these instruments. The Corporation s debt approximates fair value due to the terms of the interest being set at variable market interest rates (Level 2).

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily consist of amounts due from Prescription Drug Plans (PDPs) under Medicare Part D, institutional healthcare providers, the respective state Medicaid programs, third party insurance companies, and private payers. The Corporation s ability to collect outstanding receivables is critical to its results of operations and cash flows. To provide for accounts receivable that could become uncollectible in the future, the Corporation establishes an allowance for doubtful accounts to reduce the carrying value of such receivables to the extent it is

probable that a portion or all of a particular account will not be collected.

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

	December 31, 2011	September 30, 2012
Institutional healthcare providers	$ 169.0	$ 164.6
Medicare Part D	46.9	46.0
Private payer and other	33.3	30.4
Insured	10.7	10.2
Medicaid	20.1	14.0
Medicare	0.8	0.8
Allowance for doubtful accounts	(48.6)	(56.1)
	$ 232.2	$ 209.9
0 to 60 days	61.2 %	58.6 %
61 to 120 days	19.5 %	15.7 %
Over 120 days	19.3 %	25.7 %
	100.0 %	100.0 %

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

	Beginning Balance	Charges to Costs and Expenses	Write-offs	Ending Balance
Allowance for doubtful accounts:				
Year Ended December 31, 2011	$ 36.8	$ 24.8	$ (13.0)	$ 48.6
Nine Months Ended September 30, 2012	$ 48.6	$ 19.7	$ (12.2)	$ 56.1

Concentration of Credit Risk

For the three months ended September 30, 2011 and 2012, the Corporation derived approximately 13.5% and 14.8%, respectively, of its revenues from a single customer, including all payer sources associated with the residents of its long-term care facilities. For the nine months ended September 30, 2011 and 2012, the Corporation derived approximately 13.6% and 14.5%, respectively, of its revenues from a single customer, including all payer sources associated with the residents of its long-term care facilities.

Deferred Financing Fees

The Corporation capitalizes financing fees related to acquiring or issuing new debt instruments. These expenditures include bank fees and premiums, legal costs, and filing fees. The Corporation amortizes these deferred financing fees using the effective interest method.

Inventory

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Equipment and Leasehold Improvements

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

	Estimated Useful Lives
Leasehold improvements	1-7
Equipment and software	3-10

Expenditures for maintenance, repairs and renewals of minor items are expensed as incurred. Major rebuilds and improvements are capitalized. For the three months ended September 30, 2011 and 2012, maintenance and repairs were $1.8 million and $2.0 million, respectively. For the nine months ended September 30, 2011 and 2012, maintenance and repairs were $5.6 million and $5.9 million, respectively.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset or asset group to the estimated future undiscounted net cash flows expected to be generated by the asset or group of assets. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset or asset group to its then fair value. The Corporation did not record impairment charges on equipment and leasehold improvements for the nine months ended September 30, 2011 or 2012.

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

Capitalization of Internal Software Costs

The Corporation capitalizes the costs incurred during the application development stage, which include costs to design the software configuration and interfaces, coding, installation, and testing. Costs incurred during the preliminary project stage along with post-implementation stages of internal use computer software are expensed as incurred. Capitalized development costs are amortized generally over three years and are subject to impairment evaluations. Costs incurred to maintain existing software development are expensed as incurred. The capitalization and ongoing assessment of recoverability of development costs requires judgment by management with respect to certain external factors, including, but not limited to, technological and economic feasibility and estimated economic life. For the three months ended September 30, 2011 and 2012, the Corporation capitalized internally developed software costs of $0.6 million and $1.9 million, respectively. For the nine months ended September 30, 2011 and 2012, the Corporation capitalized internally developed software costs of $1.3 million and $4.3 million, respectively. As of December 31, 2011 and September 30, 2012, net capitalized software costs, including acquired assets and amounts for projects which have and have not been completed, totaled $13.2 million and $13.4 million, respectively.

Goodwill and Other Intangibles

Goodwill represents the excess purchase price of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. The Corporation s business is comprised of two reporting units, institutional pharmacy and hospital management, each of which are reviewed separately for impairment. The Corporation s policy is to perform a qualitative assessment on goodwill impairment to determine whether it is more likely than not (defined as having a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying

amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. The Corporation performed a qualitative assessment of its institutional pharmacy reporting unit, as of December 31, 2011, and did not find it necessary to perform the first step of the two-step impairment test based on that analysis. There were no triggering events during the nine months ended September 30, 2012 requiring the Corporation to perform a qualitative assessment prior to the annual assessment.

The Corporation s finite-lived intangible assets are comprised primarily of trade names, customer relationship assets and non-compete agreements primarily originating from business acquisitions. Finite-lived intangible assets are amortized on a straight-line basis over the course of their lives ranging from 5 to 20 years. For impairment reviews, intangible assets are reviewed on a specific pharmacy basis or as a group of pharmacies depending on the intangible assets under review. The Corporation s goodwill and intangible assets are further described in Note 4.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

During the third quarter of 2011, the Corporation recorded a pre-tax impairment charge of $5.1 million related to finite lived customer relationships. The impairment, which related to the Institutional Pharmacy Segment, was incurred as the result of non-renewal of certain customer contracts. The impairment was related to intangible assets acquired in an acquisition during the year ended December 31, 2005. These asset groups were assessed for recoverability and management determined the finite lived customer relationship assets to be impaired, but no other assets within the asset groups were deemed impaired. Using a discounted cash flow analysis, the Corporation determined the pre-tax impairment charge of $5.1 million was required to write the carrying value down to fair value, resulting in a loss per diluted share impact of $0.11. The Corporation recognized the impairment as a permanent write-down of the cost basis and accumulated amortization of the affected assets.

Self-Insured Employee Health Benefits

The Corporation is self-insured for the majority of its employee health benefits. The Corporation s self-insurance for employee health benefits includes a stop-loss policy to limit the maximum potential liability of the Corporation for both individual and aggregate claims per year. The Corporation records a monthly expense for self-insurance based on historical claims data and inputs from third-party administrators. For the three months ended September 30, 2011 and 2012, the expense for employee health benefits was $4.9 million and $5.4 million, respectively, and for the nine months ended September 30, 2011 and 2012 the expense for employee health benefits was $15.0 million and $16.9 million, respectively, the majority of which was related to its self-insured plans. As of December 31, 2011 and September 30, 2012, the Corporation had $3.1 million and $3.3 million, respectively, recorded as a liability for self-insured employee health benefits.

Supplier Rebates

The Corporation receives rebates on purchases from its vendors and suppliers for achieving market share or purchase volumes. Rebates for brand name products are generally based upon achieving a defined market share tier within a therapeutic class and can be based on either purchasing volumes or actual prescriptions dispensed. Rebates for generic products are primarily based on achieving purchasing volume requirements. The Corporation generally accounts for these rebates and other incentives received from its vendors and suppliers, relating to the purchase or distribution of inventory, on an accrual basis as an estimated reduction of cost of goods sold and inventory. The estimated accrual is adjusted, if necessary, after the third party validates the appropriate data and notifies the Corporation of its agreement under the terms of the contract. The Corporation considers these rebates to represent product discounts, and as a result, the rebates are allocated as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory or as a reduction of inventory for drugs which have not yet been sold.

Delivery Expenses

The Corporation incurred delivery expenses of $16.6 million and $15.7 million for the three months ended September 30, 2011 and 2012, respectively, and $51.3 million and $47.8 million for the nine months ended September 30, 2011 and 2012, respectively, to deliver products sold to its customers. Delivery expenses are reported as a component of cost of goods sold in the accompanying condensed consolidated income statements.

Stock Option Accounting

The Corporation recognizes stock-based compensation expense in its condensed consolidated financial statements using the Black-Scholes-Merton option valuation model (see Note 9).

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Corporation accrues for tax obligations as required by facts and circumstances in the various regulatory environments. Deferred tax assets and liabilities are more fully described in Note 10.

Measurement Period Adjustments

For the nine months ended September 30, 2012, the Corporation has adjusted certain amounts on the condensed consolidated balance sheet as of December 31, 2011 as a result of measurement period adjustments related to the 2011 Acquisitions (See Note 2).

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS

2011 Acquisitions

On April 1, 2011 the Corporation acquired an institutional pharmacy in Greenville, South Carolina. On December 31, 2011, the Corporation acquired the membership interests of an institutional pharmacy which operated three pharmacies in Ohio and Pennsylvania. Both acquisitions (the 2011 Acquisitions) were accounted for under the acquisition method of accounting. The aggregate purchase price of the 2011 Acquisitions was $51.3 million in cash and assumed liabilities, including, the working capital adjustment in the second quarter of 2012. During the nine months ended September 30, 2012 the final working capital adjustment was completed for the 2011 Acquisitions resulting in additional purchase price paid of $0.3 million. The total purchase price of the 2011 Acquisitions was allocated to the net tangible and identifiable intangible assets based on their fair values at the date of acquisition. The excess of the purchase price over the fair values of the net tangible and identifiable intangible assets was recorded as goodwill. For tax purposes, the transactions were considered asset acquisitions; therefore, the amount of goodwill recorded in the transactions of $35.5 million will be tax deductible to the Corporation. The resulting amount of goodwill reflects the Corporation s expectation of the synergistic benefits of the 2011 Acquisitions.

The combined allocation of the purchase price associated with the 2011 Acquisitions was based upon the fair value of net tangible and identifiable intangible assets as of the date of acquisition. The purchase price allocations were as follows (dollars in millions):

	Amounts Previously Recognized as of Acquisition Date (1)	Measurement Period Adjustments	Recognized as of Acquisition Date
Accounts receivable	$ 4.6	$ (0.2)	$ 4.4
Inventory	3.7	0.1	3.8
Other current assets	0.4	-	0.4
Equipment and software	0.4	-	0.4
Identifiable intangibles	12.5	-	12.5
Goodwill	34.8	0.7	35.5
Total assets	56.4	0.6	57.0
Current liabilities	(5.3)	(0.3)	(5.6)
Other long-term liabilities	(0.1)	-	(0.1)
Total liabilities	(5.4)	(0.3)	(5.7)
Purchase price of 2011 Acquisitions	$ 51.0	$ 0.3	$ 51.3

(1) As previously reported in the Corporation s 2011 Annual Report on Form 10-K.

The following is the fair value of the equipment and software of the 2011 Acquisitions at the date of acquisition (dollars in millions):

Equipment and software	Fair-Value

		Weighted Average Useful Life (Yr.)
Equipment and software	$ 0.4	4.7

The following are the fair values of the identifiable intangible assets of the 2011 Acquisitions acquired at the date of acquisition (dollars in millions):

Identifiable Intangibles	Fair-Value
Customer relationships	$ 11.1
Trade name	0.5
Non-compete agreement	0.9
	$ 12.5

Other

For the three months ended September 30, 2011 and 2012, the Corporation incurred $2.1 million and $3.9 million, respectively, and $11.2 million and $8.7 million for the nine months ended September 30, 2011 and 2012, respectively, of acquisition related costs, which have been classified as a component of merger, acquisition, integration costs and other charges.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS (Continued)

Pro forma

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

The unaudited pro forma effect of the acquisitions assuming the acquisitions occurred on January 1, 2011, excluding the merger, acquisition, integration costs and other charges, impairment charges, and assuming the Corporation s effective tax rate of 40.9% and 37.0% for the three and nine months ended September 30, 2011, respectively, would be as follows (dollars in millions, except per share amounts):

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Revenues	$ 532.6	$ 1,632.2
Net income	$ 9.1	$ 27.2
Earnings per common share:		
Basic	$ 0.31	$ 0.93
Diluted	$ 0.31	$ 0.93

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS

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

	December 31, 2011	September 30, 2012
Leasehold improvements	$ 14.3	$ 14.9
Equipment and software	123.2	131.6
Leased equipment	2.9	-
Construction in progress	4.6	10.6
	145.0	157.1
Accumulated depreciation	(92.6)	(105.5)
Total Equipment and leasehold improvements	$ 52.4	$ 51.6

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS (Continued)

The following is a progression of equipment and leasehold improvements for the period presented (dollars in millions):

	Balance at December 31, 2011	Additions	Disposals	Balance at September 30, 2012
Equipment and leasehold improvements:				
Leasehold improvements	$ 14.3	$ 0.6	$ -	$ 14.9
Equipment and software	123.2	9.7	(1.3)	131.6
Leased equipment	2.9	(2.9)	-	-
Construction in progress	4.6	6.0	-	10.6
Sub-Total	145.0	13.4	(1.3)	157.1
Accumulated depreciation	(92.6)	(13.9)	1.0	(105.5)
Total	$ 52.4	$ (0.5)	$ (0.3)	$ 51.6

Depreciation expense totaled $4.8 million and $4.6 million for the three months ended September 30, 2011 and 2012, respectively. Depreciation expense totaled $14.9 million and $13.9 million for the nine months ended September 30, 2011 and 2012, respectively.

Total estimated depreciation expense for the Corporation s equipment and leasehold improvements for the current year and next four years and thereafter are as follows (dollars in millions):

Year Ending December 31,	
2012	$ 18.2 *
2013	14.0
2014	9.2
2015	6.0
2016	3.4
Thereafter	14.7
Total	$ 65.5

* The 2012 amount shown includes depreciation expense for the nine months ended September 30, 2012 of $13.9 million.

NOTE 4 GOODWILL AND INTANGIBLES

As of December 31, 2011 and September 30, 2012 the carrying amount of goodwill was $214.9 million.

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

Finite Lived Intangible Assets	Balance at December 31, 2011	Additions	Balance at September 30, 2012
Customer relationships	$ 96.0	$ 0.4	$ 96.4
Trade name	30.0	-	30.0
Non-compete agreements	8.4	2.4	10.8
Sub T otal	134.4	2.8	137.2
Accumulated amortization	(34.2)	(9.0)	(43.2)
Net intangible assets	$ 100.2	$ (6.2)	$ 94.0

Amortization expense relating to finite-lived intangible assets was $3.0 million and $3.2 million for the three months ended September 30, 2011 and 2012, respectively. Amortization expense relating to finite-lived intangible assets was $8.4 million and $9.0 million for the nine months ended September 30, 2011 and 2012, respectively.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 GOODWILL AND INTANGIBLES (Continued)

During the third quarter of 2011, the Corporation recorded a pre-tax impairment charge of $5.1 million related to finite-lived customer relationships. The impairment, which related to the Institutional Pharmacy Segment, was incurred as the result of non-renewal of certain customer contracts. The impairment was related to intangible assets acquired in an acquisition during the year ended December 31, 2005. These asset groups were assessed for recoverability and management determined the finite-lived customer relationship assets to be impaired. No other assets within the asset groups were deemed impaired. Using a discounted cash flow analysis, the Corporation determined that the pre-tax impairment charge of $5.1 million was required to write the carrying value down to fair value, resulting in a loss per diluted share impact of $0.11. The Corporation recognized the impairment as a permanent write-down of the cost basis and accumulated amortization of the affected assets.

Total estimated amortization expense for the Corporation s finite-lived intangible assets for the current year and next four years and thereafter are as follows (dollars in millions):

Year Ending December 31,	
2012	$ 12.2*
2013	11.2
2014	10.5
2015	10.4
2016	9.9
Thereafter	48.8
	$ 103.0

* The 2012 amount shown includes amortization expense for the nine months ended September 30, 2012 of $9.0 million.

NOTE 5 CREDIT AGREEMENT

On May 2, 2011, the Corporation entered into a long-term credit agreement (the Credit Agreement) among the Corporation, the Lenders named therein, and Citibank, N.A. (Citibank), as Administrative Agent. The Credit Agreement consists of a $250.0 million term loan facility and a $200.0 million revolving credit facility. The terms and conditions of the Credit Agreement are customary to facilities of this nature.

As of September 30, 2012, $243.8 million was outstanding under the term loan facility and there was no outstanding balance under the revolving credit facility. Indebtedness under the Credit Agreement matures on June 30, 2016, at which time the commitments of the Lenders to make revolving loans also expire.

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

Credit Agreement:	**December 31, 2011**	**September 30, 2012**
	$ 250.0	$ 243.8

Term Debt - payable to lenders at LIBOR plus applicable margin (2.97% as of September 30, 2012), matures June 30, 2016		
Revolving Credit Facility payable to lenders, interest at base rate plus applicable margin (5.00% as of September 30, 2012), matures June 30, 2016	50.0	-
Total debt	300.0	243.8
Less: Current portion of long-term debt	6.3	9.4
Total long-term debt	$ 293.7	$ 234.4

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

The Corporation s indebtedness has the following maturities for the current year and the next four years (dollars in millions):

Year Ending December 31,	Term Debt	Revolving Credit Facility	Total Maturities
2012*	$ -	$ -	$ -
2013	12.5	-	12.5
2014	12.5	-	12.5
2015	112.5	-	112.5
2016	106.3	-	106.3
	$ 243.8	$ -	$ 243.8

* The Corporation prepaid the September and December 2012 principal payments due under the Credit Agreement in the third quarter 2012.

The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of September 30, 2012 was $2.0 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $198.0 million as of September 30, 2012. The revolving credit facility contains a $100.0 million accordion feature, which permits the Corporation to increase the total debt capacity, up to an aggregate of $543.8 million, subject to securing additional commitments from existing or new lenders.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at the Corporation s option, a base rate plus a margin between 1.25% and 2.00% per annum, or an adjusted London Interbank Offered Rate (LIBO Rate or LIBOR) plus a margin between 2.25% and 3.00% per annum, in each case depending on the leverage ratio of the Corporation as defined by the Credit Agreement.

The base rate is the greater of the prime lending rate in effect on such day, the federal funds effective rate published by the Federal Reserve Bank of New York on such day plus 0.5%, or the adjusted LIBO Rate for deposits for a period equal to one month plus 1.0%. Any changes in the base rate, federal funds rate or adjusted LIBO Rate shall be effective from and including the effective date of such change in the rate, as applicable. The Credit Agreement also provides for letter of credit fees between 2.25% and 3.00% and a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.375% to 0.500%, in each case depending on the leverage ratio of the Corporation.

The Corporation s obligations under the Credit Agreement are secured by substantially all of the Corporation s assets. Those obligations are guaranteed by many of the Corporation s wholly-owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of the Corporation s direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries.

Covenants

The Credit Agreement requires the Corporation to satisfy an interest coverage ratio and a leverage ratio. The interest coverage ratio, which is tested as of the last day of any fiscal quarter on a trailing four quarter basis, can be no less than: 3.00:1.00. The leverage ratio, which also is tested quarterly, cannot exceed 4.00:1.00 from the end of the first full fiscal quarter ending after the effective date, through the quarter ending

December 31, 2012; cannot exceed 3.75:1.00 for each of the four quarters in the year ending December 31, 2013; and cannot exceed 3.50:1.00 for all remaining quarters through the expiration of the Credit Agreement. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance proceeds) are restricted in any fiscal year to 3.0% of revenues.

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

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

	Interest Coverage Ratio	Leverage Ratio	Capital Expenditures
Requirement	> = 3.00 to 1.00	< = 4.00 to 1.00	< = 3.00 %
September 30, 2012	10.96	1.67	**

** Not applicable as the capital expenditures covenant is an annual requirement under the terms of the Credit Agreement.

Deferred Financing Fees

The Corporation capitalized a total of $9.8 million in deferred financing fees associated with the Credit Agreement and recorded them as other assets in the accompanying condensed consolidated balance sheets. As of September 30, 2012, the Corporation had $8.5 million of unamortized deferred financing fees.

NOTE 6 COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

On September 9, 2011, the Louisiana Municipal Police Employees Retirement System (LMPERS) filed a lawsuit in the Court of Chancery of the State of Delaware, purportedly on behalf of a class of the Corporation s stockholders, against the Corporation and the members of the Corporation s Board of Directors, styled Louisiana Municipal Police Employees Retirement System v. Frank Collins, et al., Civil Action No. 6851-CS. In the action, LMPERS alleged that the members of the Board of Directors breached their fiduciary duties to the Corporation and its stockholders by, among other things, adopting the Rights Agreement and failing to respond appropriately to the tender offer. LMPERS sought declaratory and injunctive relief, including an order certifying the case as a class action and an order enjoining application of the Rights Agreement and Section 203 of the DGCL to the tender offer and proposed merger.

On September 22, 2011, Hugh F. Drummond as Trustee of the FBO Hugh F. Drummond Trust (Drummond) filed a lawsuit in the Court of Chancery of the State of Delaware, purportedly on behalf of a class of the Corporation s stockholders, against the Corporation and the members of the Corporation s Board of Directors, styled Hugh F. Drummond as Trustee of the FBO Hugh F. Drummond Trust v. PharMerica Corp., et al., Civil Action No. 6882. In the action, Drummond alleged that the members of the Board of Directors breached their fiduciary duties to the Corporation and the Corporation s stockholders by, among other things, adopting the Rights Agreement and failing to respond appropriately to the tender offer. Drummond sought declaratory and injunctive relief, including an order certifying the case as a class action and an order enjoining the directors and the Corporation from excluding strategic bidders, including Omnicare, imposing unreasonable preconditions on such strategic bidders, refusing to provide due diligence to strategic bidders, and conducting a limited sale process not designed to produce the best transaction for PharMerica s stockholders.

On October 3, 2011, the Court of Chancery of the State of Delaware entered an order consolidating the LMPERS and Drummond actions under the caption *In re PharMerica Corporation Shareholders Litigation*, Consolidated Civil Action No. 6851-CS. Plaintiffs in the consolidated action designated the complaint filed in the *Drummond* action as operative. On May 15, 2012, the case was dismissed.

The Corporation is responding to an investigation by the U.S. Attorney for the Eastern District of Wisconsin and by the Drug Enforcement Agency into the Corporation s alleged failure to comply with various laws and regulations relating to the control and dispensing of certain controlled substances as well as the potential filing of false claims for payments of certain controlled substances that the Corporation dispensed to nursing home residents. The Corporation has been informed that the government believes that the claims at issue were not eligible for payment due to the alleged non-compliance with various Medicare, Medicaid and other laws and regulations relating to the dispensing, control, sale, billing and reimbursement for such controlled substances. The Corporation denies the allegations made by the government and will defend itself in the event any actions are brought by the government. At this time, we are unable to estimate the outcome of the investigation. If the government brings claims and the Corporation is not successful in defending them, it could result in fines and recoupment of government claims.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

In addition, the Corporation is involved in certain legal actions and regulatory investigations arising in the ordinary course of business. At this time, the Corporation is unable to determine the impact of these investigations on its consolidated financial position, results of operations, or liquidity.

FUL and AMP Changes

The 2010 Health Care Legislation amended the Deficit Reduction Act of 2005 (the DRA) to change the definition of the Federal Upper Limit or FUL by requiring the calculation of the FUL as no less than 175% of the weighted average, based on utilization, of the most recently reported monthly Average Manufacturer s Price or AMP for pharmaceutically and therapeutically equivalent multi-source drugs available through retail community pharmacies nationally.

In addition, the definition of AMP changed to reflect net sales only to drug wholesalers that distribute to retail community pharmacies and to retail community pharmacies that directly purchase from drug manufacturers. Further, the 2010 Health Care Legislation continues the current statutory exclusion of prompt pay discounts offered to wholesalers and adds three other exclusions to the AMP definition: i) bona fide services fees; ii) reimbursement for unsalable returned goods (recalled, expired, damaged, etc.); and iii) payments from and rebates/discounts to certain entities not conducting business as a wholesaler or retail community pharmacy. In addition to reporting monthly, the manufacturers are required to report the total number of units used to calculate each monthly AMP. CMS will use this information when it establishes FULs as a result of the new volume-weighted requirements pursuant to the 2010 Health Care Legislation.

In September 2011, Centers for Medicare and Medicaid Services (CMS) issued the first draft FUL reimbursement files for multiple source drugs, including the draft methodology used to calculate the FULs in accordance with the Health Care Legislation. These draft FUL prices are based on the manufacturer reported and certified July 2011 monthly AMP and AMP unit data. CMS continues to release this data monthly and is expected to do so going forward. CMS has not posted monthly AMPs for individual drugs, but only posted the weighted average of monthly AMPs in a FUL group and the calculation methodology.

On February 2, 2012, CMS issued proposed regulations further clarifying the AMP and FUL changes described above and indicated that the final rule would be issued sometime in 2013.

Until CMS provides final guidance and the industry adapts to this now public available pricing information, the Corporation is unable to fully evaluate the impact of the changes in FUL and AMP to its business.

CMS Proposed Rule on Consultant Pharmacists

In October 2011, CMS issued a proposed rule entitled Medicare Program; Proposed Changes to the Medicare Advantage and the Medicare Prescription Drug Benefit Programs for Contract Year 2013 and Other Proposed Changes; Considering Changes to the Conditions of Participation for Long Term Care Facilities (the Proposed Rule). In the Proposed Rule, CMS outlined its concerns, and requests comments, regarding certain contractual arrangements between Long Term Care (LTC) facilities, LTC pharmacies, consultant pharmacies, and pharmaceutical manufacturers. In April 2012, after reviewing the comments, CMS declined to finalize the portion of the Proposed Rule requiring the independence of consultant pharmacists from LTC pharmacies. CMS further noted that the [independent consultant pharmacist] requirement would be highly disruptive to both LTC facilities and consultant pharmacists, and without additional regulation of facility staff and providers, any benefits would not outweigh the costs of industry disruption. However, CMS solicited additional comments and acknowledged the possibility of future regulations if there fails to be improvement in inappropriate utilization throughout the industry. The Corporation believes that a future rule, which could require the independence of consultant pharmacists, may increase overall costs for payers and customers and reduce the quality of care and service to long-term care patients and residents. However, until CMS provides additional guidance, the

Corporation is unable to fully evaluate the impact future regulations in consultant pharmacist services to its business.

Acquisitions

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

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

Prime Vendor Agreement

On January 4, 2011, the Corporation entered into an Amended and Restated Prime Vendor Agreement for Long-Term Care Pharmacies by and between AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen Corporation, the Corporation, Pharmacy Corporation of America and Chem Rx Pharmacy Services, LLC (the Amended Prime Vendor Agreement). The Amended Prime Vendor Agreement became effective on January 1, 2011 and, upon its effectiveness, superseded in its entirety the Prime Vendor Agreement for Long-Term Care Pharmacies entered into as of August 1, 2007 between the Corporation and ABDC.

The Amended Prime Vendor Agreement incorporates Chem Rx and is otherwise substantially the same in scope except for modifications to select sourcing and rebate terms. The term of the Amended Prime Vendor Agreement was extended until September 30, 2013, with one-year automatic renewal periods unless either party provides prior notice of its intent not to renew. The Amended Prime Vendor Agreement requires the Corporation to purchase substantially all brand and non-injectable generic drugs from ABDC. The Amended Prime Vendor Agreement does provide the flexibility for the Corporation to contract directly with the manufacturer with these purchases being considered in the contractual requirements as long as ABDC is the distributor. If the Corporation fails to adhere to this contractual provision ABDC has the ability to increase the Corporation s drug pricing under the terms of the Amended Prime Vendor Agreement.

Employment Agreements

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

The type of compensation due to each of the executive officers in the event of the termination of their employment period varies depending on the nature of the termination. The employment agreements generally do not entitle the executive officers to any additional payment or benefits solely upon the occurrence of a change in control but do provide additional payments or benefits or both upon a termination of employment in connection with a change in control. Additionally, the vesting of certain equity based grants made to certain executive officers accelerate upon the occurrence of a change in control.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Leases

The Corporation leases real estate properties, buildings, vehicles, and equipment under cancelable and non-cancelable leases. The leases expire at various times and have various renewal options. Certain leases that meet the lease capitalization criteria have been recorded as an asset and liability at the net present value of the minimum lease payments at the inception of the lease. Interest rates used in computing the net present value of the lease payments are based on the Corporation s incremental borrowing rate at the inception of the lease. The Corporation recorded the following lease expense for the periods presented (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Pharmacy locations and administrative offices lease expense	$ 3.6	$ 3.7	$ 10.8	$ 10.8
Office equipment lease expense	0.6	0.6	1.9	1.8
Total lease expense	$ 4.2	$ 4.3	$ 12.7	$ 12.6

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

Year Ending December 31,	Operating Leases
2012	$ 14.7 *
2013	13.3
2014	8.5
2015	6.3
2016	5.3
Thereafter	13.2
Total	$ 61.3

* The 2012 amount shown includes lease expense for the nine months ended September 30, 2012 of $10.8 million.

NOTE 7 REVENUES

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

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

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

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 REVENUES (Continued)

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

A summary of revenues by payer type follows (dollars in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2011		2012		2011		2012	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Medicare Part D	$ 250.4	48.3 %	$ 209.5	47.4 %	$ 759.0	47.9 %	$ 670.1	47.9 %
Institutional healthcare providers	154.2	29.7	138.1	31.3	474.7	29.9	426.6	30.5
Medicaid	54.1	10.4	38.4	8.7	167.2	10.5	128.4	9.2
Private and other	23.6	4.6	19.9	4.4	69.7	4.4	65.0	4.6
Insured	19.6	3.8	19.3	4.4	64.6	4.1	58.4	4.2
Medicare	1.1	0.2	1.0	0.2	3.4	0.2	2.8	0.2
Hospital management fees	15.7	3.0	15.8	3.6	46.9	3.0	48.1	3.4
Total	$ 518.7	100.0 %	$ 442.0	100.0 %	$ 1,585.5	100.0 %	$ 1,399.4	100.0 %

Co-payments for the Corporation s services can be applicable under Medicare Part D, the state Medicaid programs, and certain third party payers and are typically not collected at the time products are delivered or services are provided. Co-payments under the Medicaid programs and third party plans are generally billed to the responsible party as part of the Corporation s normal billing procedures and are subject to the Corporation s normal collection procedures.

Under Medicare Part D, co-payments related to institutional residents who are both Medicare and Medicaid eligible (dual eligible) are due from the responsible party for up to the first thirty days of a beneficiary s stay in a skilled nursing facility, subsequent to which the PDPs are responsible for reimbursement.

Under certain circumstances, including state-mandated return policies under various Medicaid programs, the Corporation accepts returns of medications and issues a credit memorandum to the applicable payer. Product returns are processed in the period in which the return is accepted by the Corporation. A reserve has been established for such returns based on historical trends.

NOTE 8 MERGER, ACQUISITION, INTEGRATION COSTS AND OTHER CHARGES

The Corporation began, in 2007, the integration of its pharmacy operating systems and the Corporation expects to continue to incur costs related to the integration of its pharmacy operating systems, as well as transitional related costs associated with the expiration and non-renewal of the Information Technology Services Agreement with Kindred Healthcare Operating Inc., a wholly owned subsidiary of Kindred Healthcare during 2012. In addition, the Corporation also incurs and will continue to incur costs related to acquisitions.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 MERGER, ACQUISITION, INTEGRATION COSTS AND OTHER CHARGES (Continued)

The following is a summary of merger, acquisition, integration costs and other charges incurred by the Corporation (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Merger, integration costs and other charges:				
Pre-Pharmacy transaction litigation matters	$ (2.0)	$ -	$ (2.0)	$ -
Tender offer costs	1.1	-	1.1	1.9
Professional and advisory fees	0.2	1.2	0.6	2.2
General and administrative	-	-	0.1	-
Employee costs	-	0.2	0.2	0.2
Severance costs	-	-	0.2	-
Facility costs	0.3	-	0.2	0.4
Other	0.1	0.8	-	0.9
	(0.3)	2.2	0.4	5.6
Acquisition related costs:				
Professional and advisory fees	0.9	2.8	4.1	5.4
General and administrative	0.1	-	0.7	0.1
Employee costs	0.5	0.6	2.5	2.1
Severance costs	0.2	0.2	1.6	0.5
Facility costs	0.3	0.1	1.5	0.5
Other	0.1	0.2	0.8	0.1
	2.1	3.9	11.2	8.7
Total merger, acquisition, integration costs and other charges	$ 1.8	$ 6.1	$ 11.6	$ 14.3
Negative effect on diluted earnings per share	$ (0.04)	$ (0.13)	$ (0.25)	$ (0.29)

The Corporation has incurred various expenses as a result of Omnicare s unsolicited tender offer including legal, investment banking and other fees. Tender offer costs of $1.1 million and $1.9 million, were incurred during the nine months ended September 30, 2011 and 2012, respectively. In addition, the Corporation incurred costs and other charges related to the transition of the information technology services being provided by the Corporation s current vendor to another vendor (IT Transition) during the three months and nine months ended September 30, 2012 of $0.8 million and $0.9 million, respectively.

During the second quarter of 2010, the Corporation recorded an estimated liability of $5.0 million related to certain claims arising from time periods prior to July 31, 2007. During the third quarter of 2011, the Corporation was informed that one claim would not be pursued. Therefore, the Corporation reversed $2.0 million of the estimated liability recorded in 2010.

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS

Common Stock

Holders of the Corporation s common stock are entitled to one vote for each share held of record on all matters on which stockholders may vote. There are no preemptive, conversion, redemption or sinking fund provisions applicable to the Corporation s common stock. In the event of liquidation, dissolution or winding up, holders of common stock are entitled to share ratably in the assets available for distribution, subject to any prior rights of any holders of preferred stock then outstanding. In addition, the Corporation s Credit Agreement imposes restrictions on its ability to pay dividends.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

Preferred Stock

The certificate of incorporation authorizes the issuance of an aggregate of 1.0 million shares of preferred stock. On August 25, 2011, the Board of Directors designated 175,000 shares of preferred stock as Series A Junior Participating Preferred Stock (Series A Junior Preferred Stock). As of September 30, 2012, there were no shares of preferred stock outstanding.

The Series A Junior Preferred Stock is entitled to receive quarterly cumulative dividends in an amount per whole share equal to the greater of $10.00 or 1,000 times the dividends declared on the Common Stock since the preceding quarterly dividend payment date, or with respect to the first quarterly dividend payment date, since the date of issuance, and a liquidation preference of a minimum of $10.00 per whole share, plus an amount equal to any accrued dividends and distributions thereon, whether or not declared, to the date of payment, and will be entitled to an aggregate payment per whole share equal to 1,000 times the amount per share distributed to the holders of Common Stock. Holders of Series A Junior Preferred Stock are entitled to vote on each matter on which holders of Common Stock are entitled to vote, and have 1,000 votes per whole share. The preferred stockholders also are entitled to certain corporate governance and special voting rights, as defined in the certificate of designation.

The Corporation s Board of Directors may, from time to time, direct the issuance of shares of preferred stock in series and may, at the time of issuance, determine the designation, powers, rights, preferences and limitations of each series. Satisfaction of any dividend preferences of outstanding preferred stock would reduce the amount of funds available for the payment of dividends on our shares of common stock. Holders of preferred stock may be entitled to receive a preference payment in the event of any liquidation, dissolution or winding-up of the Corporation before any payment is made to the holders of our common stock. Under certain circumstances, the issuance of preferred stock may render more difficult or tend to discourage a merger, tender offer or proxy contest, the assumption of control by a holder of a large block of the Corporation s securities or the removal of incumbent management. The Board of Directors may issue shares of preferred stock with voting and conversion rights that could adversely affect the holders of common stock. Specifically, the Corporation s certificate of incorporation authorizes the Corporation s Board of Directors to adopt a rights plan without stockholder approval. This could delay or prevent a change in control of the Corporation or the removal of existing management.

On August 25, 2011, the Board of Directors adopted a rights plan (the Rights Agreement), providing for the distribution of one right for each share of common stock outstanding (a Right). Each right entitled the holder to purchase one one-thousandth (1/1000th) of a share of Series A Junior Preferred Stock, par value $0.01 per share, of the Corporation at a price of $45.00 per one one-thousandth (1/1000th) of a share, subject to adjustment. The rights were to become exercisable at the discretion of the Board of Directors following a public announcement that 15% or more of the Corporation s common stock has been acquired or an intent to acquire has become apparent.

On March 28, 2012, the Corporation amended the Rights Agreement (the Amendment). The Amendment amends the final expiration date of the Corporation s Series A Junior Participating Preferred Stock purchase rights issued pursuant to the Rights Agreement from August 25, 2011 to March 28, 2012. Accordingly, the Rights expired at the close of business on March 28, 2012, and the Rights Agreement has been terminated and is of no further force and effect.

Treasury Stock Purchases

In August 2010, the Board of Directors authorized a share repurchase of up to $25.0 million of the Corporation s common stock, of which $10.5 million was used. On July 2, 2012 the Board of Directors authorized an increase to the remaining portion of the existing stock repurchase program that will allow the Corporation to again purchase back up to a maximum of $25.0 million of the Corporation s common stock. Share repurchases under this authorization may be made in the open market through unsolicited or solicited privately negotiated transactions, or in

such other appropriate manner, and will be funded from available cash. The amount and timing of the repurchases, if any, will be determined by the Corporation s management and will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. Common stock acquired through the share repurchase program will be held as treasury shares and may be used for general corporate purposes, including reissuances in connection with acquisitions, employee stock option exercises or other employee stock plans. The stock repurchase program does not have an expiration date and may be limited, terminated or extended at any time without prior notice. During the three months ended September 30, 2012, the Corporation repurchased 82,801 shares of common stock for an aggregate purchase price, including commissions, of $1.0 million at an average purchase price of $11.96 per share.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

The Corporation may redeem shares from employees upon the vesting of the Corporation s stock awards for minimum statutory tax withholding purposes. The Corporation redeemed 22,418 shares of certain vested awards for an aggregate price of approximately $0.2 million during the nine months ended September 30, 2012. These shares have also been designated by the Corporation as treasury stock.

As of September 30, 2012, the Corporation had a total of 1,455,347 shares held as treasury stock.

Amended and Restated 2007 Omnibus Incentive Plan

The Corporation has adopted the Amended and Restated PharMerica Corporation 2007 Omnibus Incentive Plan (as amended and restated, the Omnibus Plan) under which the Corporation is authorized to grant equity-based and other awards to its employees, officers, directors, and consultants.

The Corporation has reserved 7,237,000 shares of its common stock for awards to be granted under the Omnibus Plan plus 534,642 shares reserved for substitute equity awards. Under the fungible share pool, one share of stock will be subtracted from the share limit for each share of stock covered by a stock option or stock appreciation right award and 1.65 shares of stock will be subtracted from the share limit for each share of stock covered by any full-value award, including restricted share awards, restricted stock units and performance share awards at target. The following shares are not available for re-grant under the Omnibus Plan: (i) shares tendered by a participant or withheld by the Corporation to pay the purchase price of a stock option award or to satisfy taxes owed with respect to an award, (ii) shares subject to a stock appreciation right that are not issued in connection with such award s settlement upon the exercise thereof, and (iii) shares reacquired by the Corporation using cash proceeds received by the Corporation from the exercise of stock options. Effective January 1, 2010, shares subject to an award that is forfeited, expired or settled for cash, are available for re-grant under the Omnibus Plan as one share of stock for each share of stock covered by a stock option or appreciation right and 1.65 shares of stock for each share of stock covered by any other type of award.

The Corporation s Compensation Committee administers the Omnibus Plan and has the authority to determine the recipient of the awards, the types of awards, the number of shares covered, and the terms and conditions of the awards. The Omnibus Plan allows for grants of incentive stock options, non-qualified stock options, stock appreciation rights, restricted share and restricted stock units, deferred shares, performance awards, including cash bonus awards, and other stock-based awards.

Stock options granted to officers and employees under the Omnibus Plan generally vest in four equal annual installments and have a term of seven years. The restricted share awards granted to officers and employees generally vest in full upon the three-year anniversary of the date of grant. The restricted stock units granted to officers generally vest in two or three equal annual installments. The restricted share awards granted to members of the Board of Directors vest in three equal annual installments. The restricted stock units granted to members of the Board of Directors vest in one annual installment. The performance share units granted under the Omnibus Plan vest based upon the achievement of a target amount of the Corporation s earnings before interest, income taxes, depreciation and amortization, merger, acquisition, integration costs and other charges, impairment of intangible assets, and any changes in accounting principles, which reinforces the importance of achieving the Corporation s profitability objectives. The performance is generally measured over a three-year period.

As of September 30, 2012, total shares available for grants of stock-based awards pursuant to the Omnibus Plan were 2,912,920 shares. The 2,912,920 shares do not take into consideration the dilution of 1.65 shares of stock for any full-value award, including restricted stock awards, restricted stock units and performance share awards at target. The number of shares remaining available for future issuance calculated under the fungible share pool would be 2,216,568.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

Stock-Based Compensation Expense

The following is a summary of stock-based compensation incurred by the Corporation (dollars in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Stock option compensation expense	$ 0.4	$ 0.5	$ 1.8	$ 1.5
Nonvested stock compensation expense	0.9	1.8	2.7	3.7
Total Stock Compensation Expense	$ 1.3	$ 2.3	$ 4.5	$ 5.2
Negative effect on diluted earnings per share	$ (0.03)	$ (0.05)	$ (0.10)	$ (0.10)

As of September 30, 2012, there was $11.6 million of total unrecognized compensation cost related to the Corporation s stock compensation arrangements. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Total estimated stock-based compensation expense for the Corporation s stock options and nonvested stock awards for the current year and the next four years and thereafter are as follows (dollars in millions):

Year Ending December 31,	Stock Options	Nonvested Restricted Shares	Nonvested Restricted Stock Units	Performance Share Units	Total
2012	$ 2.0	$ 0.1	$ 3.5	$ 1.9	$ 7.5 *
2013	1.6	-	3.2	0.9	5.7
2014	0.8	-	1.7	0.7	3.2
2015	0.2	-	0.1	0.1	0.4
2016	-	-	-	-	-
Thereafter	-	-	-	-	-
Total	$ 4.6	$ 0.1	$ 8.5	$ 3.6	$ 16.8

*The 2012 amount shown includes stock based compensation expense for the nine months ended September 30, 2012 of $5.2 million.

The following weighted average assumptions were used to estimate the fair value of options granted for the year ended December 31, 2011, using the Black-Scholes-Merton option valuation model:

	2011
Expected volatility (range)	42.23 - 46.34%
Risk free interest rate (range)	0.19 - 2.20%
Expected dividends	-
Average expected term (years)	2.0 - 5.0
Average fair value per share of stock options granted based on the Black-Scholes-Merton model (dollars)	$3.61
Weighted average fair value of options granted (in millions)	$2.4

The Corporation did not issue stock options during the nine months ended September 30, 2012.

Expected Volatility

Volatility is a measure of the tendency of investment returns to vary around a long-term average rate. Historical volatility is an appropriate starting point for setting this assumption. The Corporation also considers how future experience may differ from the past. This may require using other factors to adjust historical volatility, such as implied volatility, peer-group volatility and the range and mean-reversion of volatility estimates over various historical periods. The peer-group utilized consisted of twelve companies in 2011, in the same or similar industries as the Corporation. The Corporation estimates the volatility of its common stock in conjunction with the Corporation s annual grant and volatility is calculated utilizing the historical volatility of the Corporation and its peer-group. To the extent material grants are made subsequent to the Corporation s annual grant, the volatility calculation is updated through the most recent grant date of the awards.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

Risk-Free Interest Rate

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option.

Expected Dividends

The Corporation has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, it uses an expected dividend yield of zero.

Expected Term

The Corporation calculated an expected term using management s estimate and expectation of option exercises. The majority of the Corporation s stock options are on a graded-vesting schedule. The Corporation estimates the value of awards with graded-vesting by treating each vesting tranche as a separate award. Management has determined to value each tranche of the awards separately utilizing a multiple fair value method.

Stock Option Activity

The following table summarizes option activity for the periods presented:

	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Term	Aggregate Instrinsic Value (in millions)
Outstanding shares at December 31, 2010	2,223,743	$ 16.28	4.7 years	$ 0.1
Granted	657,576	10.89		
Exercised	(18,713)	12.34		
Canceled	(118,595)	15.00		
Outstanding shares at December 31, 2011	2,744,011	$ 15.07	4.2 years	$ 3.1
Exercised	(39,295)	10.77		
Canceled	(185,467)	14.39		
Outstanding shares at September 30, 2012	2,519,249	$ 15.19	3.4 years	$ 1.0
Exercisable shares at September 30, 2012	1,801,430	$ 15.79	2.8 years	$ 0.3
Expired shares during 2012	61,340	$ 15.71		

The total intrinsic value of stock options exercised for the nine months ended September 30, 2011 and 2012 was $0.1 million and $0.2 million, respectively. Cash received from stock option exercises during the nine months ended September 30, 2012 was $0.4 million. The total fair value of options vested for the nine months ended September 30, 2011 and 2012 was $2.3 million and $2.0 million, respectively. The Corporation expects to recognize stock based compensation expense for stock options over a remaining weighted average period of 1.7 years.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

Nonvested Shares

The following table summarizes nonvested share activity for the periods presented:

	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding shares at December 31, 2010	489,855	$ 16.72
Granted-Restricted Stock Units	498,333	11.34
Granted-Performance Share Units	186,533	10.78
Forfeited	(207,204)	14.27
Vested	(151,028)	16.50
Outstanding shares at December 31, 2011	816,489	$ 12.69
Granted-Restricted Stock Units	388,398	12.80
Granted-Performance Share Units	213,861	13.53
Forfeited	(155,839)	13.25
Vested	(114,758)	11.52
Outstanding shares at September 30, 2012	1,148,151	$ 13.01

The total fair value of shares vested for the nine months ended September 30, 2011 and 2012 was $1.7 million and $1.3 million, respectively. The Corporation expects to recognize stock based compensation expense for nonvested shares over a weighted average period of less than one year to 2.1 years.

Based upon the achievement of the performance criteria at the end of the performance cycle for the performance share units issued to date, the Corporation may issue no shares or a maximum of 790,821 shares.

401(k) Plan

The Corporation sponsors a salary reduction plan under Section 401(k) of the Internal Revenue Code with a safe harbor matching contribution which is also a defined contribution retirement plan under Section 401(a) for all eligible employees, as defined in the plan document. The plan is qualified under Section 401(k). Contributions to the plan are based upon employee contributions and the Corporation s matching contributions. For the three months ended September 30, 2011 and 2012, the Corporation s matching contributions to the plan were $1.5 million and for the nine months ended September 30, 2011 and 2012, the Corporation s matching contributions to the plan were $4.5 million and $4.6 million, respectively.

Deferred Compensation Plans

The Corporation maintains an unfunded deferred compensation plan for certain management and highly compensated employees. Under the plan, a participant may elect to defer up to 50% of such participant s annual base salary and up to 100% of such participant s annual short-term incentive program cash bonus into the plan during each plan year. In addition, the Corporation may, in its sole discretion, make discretionary contributions to a participant s account.

The Corporation also maintains a deferred compensation plan for the directors of the Corporation. The directors of the Corporation may elect to defer up to 100% of their cash fees and their stock fees in any one year. If a director elects to defer his/her restricted share grant, the shares will be deferred as they vest until the participant elects for the deferred compensation to be a taxable event.

As of December 31, 2011 and September 30, 2012, the Corporation had $3.9 million and $4.7 million, respectively, recognized as a long-term liability related to the deferred compensation plans in the accompanying condensed consolidated balance sheets.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 INCOME TAXES

The provision for income taxes is based upon the Corporation s estimate of annual taxable income or loss for each respective accounting period. The following table summarizes our provision for income taxes for the periods presented (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Provision for income taxes	$ 3.3	$ 3.9	$ 9.1	$ 12.7
Total provision as a percentage of pre-tax income	40.9 %	39.5 %	37.0 %	39.9 %

The increase in our provision for income taxes as a percentage of taxable income for the nine months ended September 30, 2012 compared to the comparable 2011 period was primarily due to the release of a $1.2 million tax liability in 2011 upon completion of an Internal Revenue Service (IRS) audit for the 2007 and 2008 calendar years. The effective tax rates in 2011 and 2012 are higher than the federal statutory rate largely as a result of the combined impact of state and local taxes and various non-deductible expenses.

The Corporation derives a current federal and state income tax benefit from the impact of deductions associated with the amortization of tax deductible goodwill acquired through business combinations. The tax basis of the Corporation s tax deductible goodwill was approximately $122.3 million (as adjusted) and $110.3 million at December 31, 2011 and September 30, 2012, respectively. The future tax benefits of the tax-deductible goodwill are included in the Corporation s deferred tax assets.

The Corporation recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Corporation also recognizes as deferred tax assets, the future tax benefits from net operating and capital loss carryforwards. As of September 30, 2012, the Corporation has utilized all tax benefits from federal net operating loss carryforwards and tax benefits from state net operating loss carryforwards are $8.2 million, net of federal impact. The net operating losses have carryforward periods ranging from 1 to 20 years depending on the taxing jurisdiction.

A valuation allowance is provided for the Corporation s deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized. The Corporation recognized deferred tax assets totaling $37.1 million at December 31, 2011 and $33.2 million at September 30, 2012, net of valuation allowances of $1.0 million.

As of December 31, 2011 and September 30, 2012, the Corporation had no reserves recorded as a liability for unrecognized tax benefits for U.S. federal and state tax jurisdictions.

The federal statute of limitations remains open for tax years 2009 through 2011. The Corporation s consolidated U.S. income tax returns for 2010 are scheduled to be under examination by the IRS.

State tax jurisdictions generally have statutes of limitation ranging from three to five years. The Corporation is generally no longer subject to state and local income tax examinations by tax authorities for years before 2006. The state income tax impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification of IRS settlement to the states. Kindred Healthcare, Inc. (Kindred) and AmerisourceBergen are responsible for any taxes that relate to periods prior to July 31, 2007.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share (dollars in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Numerator:				
Numerator for basic and diluted earnings per share-net income	$ 4.8	$ 6.0	$ 15.5	$ 19.2
Denominator:				
Denominator for basic earnings per share-weighted average shares	29,366,998	29,491,234	29,324,094	29,470,473
Effect of dilutive securities:				
Employee stock options	10,279	3,600	7,630	4,037
Employee restricted shares	7,981	8,530	6,604	9,487
Employee restricted stock units	145,837	184,435	85,002	160,165
Employee performance share units	-	158,880	-	185,007
Denominator for diluted earnings per share-adjusted weighted average shares	29,531,095	29,846,679	29,423,330	29,829,169
Basic earnings per share	$ 0.16	$ 0.20	$ 0.53	$ 0.65
Diluted earnings per share	$ 0.16	$ 0.20	$ 0.53	$ 0.64
Unexercised employee stock options and unvested restricted shares excluded from the effect of dilutive securities above (a)	2,740,257	2,788,800	2,562,749	3,103,047

(a) These unexercised employee stock options and nonvested restricted shares were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented.

Stock options and restricted shares and units granted by the Corporation are treated as potential common shares outstanding in computing earnings per diluted share. Performance share units are treated as potential common shares outstanding in computing earnings per diluted share only when the performance conditions are met.

Common shares repurchased by the Corporation reduce the number of basic shares used in the denominator for basic and diluted earnings per share.

NOTE 12 BUSINESS SEGMENT DATA

The Corporation operates in two reportable business segments: institutional pharmacies and hospital pharmacy management. Institutional pharmacies provide pharmacy services to nursing centers and other healthcare providers and the hospital pharmacy management business provides management services to the majority of Kindred s hospitals. For business segment reporting purposes, the Corporation defines segment operating income as earnings before interest, income taxes, depreciation, amortization, impairment of intangible assets, merger, acquisition,

integration costs and other charges, and rent. Segment operating income reported for each of the Corporation s business segments excludes the allocation of corporate overhead.

The following table sets forth the assets and goodwill amounts by reportable segment (dollars in millions):

	(As adjusted) December 31, 2011	September 30, 2012
Assets:		
Institutional pharmacies	$ 823.1	$ 788.1
Hospital pharmacy management	10.9	10.1
	$ 834.0	$ 798.2
Goodwill:		
Institutional pharmacies	$ 214.9	$ 214.9
Hospital pharmacy management	-	-
	$ 214.9	$ 214.9

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 BUSINESS SEGMENT DATA (Continued)

The following table sets forth income statement information by reportable segment (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Revenues:				
Institutional pharmacies	$ 503.0	$ 426.2	$ 1,538.6	$ 1,351.3
Hospital pharmacy management	15.7	15.8	46.9	48.1
	$ 518.7	$ 442.0	$ 1,585.5	$ 1,399.4
Net income:				
Segment operating income:				
Institutional pharmacies	$ 28.1	$ 29.3	$ 79.0	$ 86.0
Hospital pharmacy management	1.5	1.2	4.6	3.3
Segment operating income	29.6	30.5	83.6	89.3
Rent	4.2	4.3	12.7	12.6
Depreciation and amortization	7.8	7.8	23.3	22.9
Impairment of intangible assets	5.1	-	5.1	-
Merger, acquisition, intregation cost and other charges	1.8	6.1	11.6	14.3
Interest expense, net	2.6	2.4	6.3	7.6
Income before income taxes	8.1	9.9	24.6	31.9
Provision for income taxes	3.3	3.9	9.1	12.7
Net income	$ 4.8	$ 6.0	$ 15.5	$ 19.2
Rent:				
Institutional pharmacies	$ 4.2	$ 4.3	$ 12.7	$ 12.6
Hospital pharmacy management	-	-	-	-
	$ 4.2	$ 4.3	$ 12.7	$ 12.6
Depreciation and amortization:				
Institutional pharmacies	$ 7.8	$ 7.8	$ 23.3	$ 22.9
Hospital pharmacy management	-	-	-	-
	$ 7.8	$ 7.8	$ 23.3	$ 22.9
Capital expenditures:				
Institutional pharmacies	$ 3.2	$ 6.6	$ 9.4	$ 13.5
Hospital pharmacy management	-	-	-	-

	$ 3.2	$ 6.6	$ 9.4	$ 13.5

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which reflect the Corporation s current estimates, expectations and projections about the Corporation s future results, performance, prospects and opportunities. Forward looking statements include, among other things, the information concerning the Corporation s possible future results of operations including revenues, costs of goods sold, and gross margin, business and growth strategies, financing plans, the Corporation s competitive position and the effects of competition, the projected growth of the industries in which we operate, and the Corporation s ability to consummate strategic acquisitions. Forward-looking statements include statements that are not historical facts and can be identified by forward-looking words such as anticipate, believe, could, estimate, expect, intend, plan, may, should, will, would, project, and similar expressions. These forward-looking statements are based upon in currently available to the Corporation and are subject to a number of risks, uncertainties and other factors that could cause the Corporation s actual results, performance, prospects or opportunities to differ materially from those expressed in, or implied by, these forward-looking statements. Important factors that could cause the Corporation s actual results to differ materially from the results referred to in the forward-looking statements the Corporation makes in this report include:

the Corporation s access to capital, credit ratings, indebtedness, and ability to raise additional financings and operate under the terms of the Corporation s debt obligations;

anti-takeover provisions of the Delaware General Corporation Law, which in concert with our certificate of incorporation and our by-laws could delay or deter a change in control;

the effects of adverse economic trends or intense competition in the markets in which we operate;

the Corporation s risk of loss of revenues due to a customer or owner of skilled nursing facility entering the institutional pharmacy business;

the demand for the Corporation s products and services;

the risk of retaining existing customers and service contracts and the Corporation s ability to attract new customers for growth of the Corporation s business;

the effects of renegotiating contract pricing relating to significant customers and suppliers, including the hospital pharmacy segment which is substantially dependent on service provided to one customer;

the Corporation s ability to successfully transition information technology services being provided by its current vendor to another vendor effectively;

the effects of an increase in credit risk, loss or bankruptcy of or default by any significant customer, supplier, or other entity relevant to the Corporation s operations;

the Corporation s ability to successfully pursue the Corporation s development and acquisition activities and successfully integrate new operations and systems, including the realization of anticipated revenues, economies of scale, cost savings, and productivity gains associated with such operations;

the Corporation s ability to control costs, particularly labor and employee benefit costs, rising pharmaceutical costs, and regulatory compliance costs;

the effects of healthcare reform and government regulations, including, interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare and institutional pharmacy services industries, including, the dispensing of antipsychotic prescriptions;

changes in the reimbursement rates or methods of payment from Medicare and Medicaid and other third party payers to both us and our customers;

the potential impact of state government budget shortfalls and their ability to pay the Corporation and its customers for services provided;

the Corporation s ability, and the ability of the Corporation s customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;

the effects of changes in the interest rate on the Corporation s outstanding floating rate debt instrument and the increases in interest expense, including increases in interest rate terms on any new debt financing;

the Corporation s ability to implement the short cycle dispensing requirements of the 2010 Health Care Legislation without incurring significant additional operating costs;

further consolidation of managed care organizations and other third party payers;

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political and economic conditions nationally, regionally, and in the markets in which the Corporation operates;

natural disasters, war, civil unrest, terrorism, fire, floods, tornadoes, earthquakes, hurricanes, epidemic, pandemic, catastrophic event or other matters beyond the Corporation s control;

increases in energy costs, including state and federal taxes, and the impact on the costs of delivery expenses and utility expenses;

elimination of, changes in, or the Corporation s failure to satisfy pharmaceutical manufacturers rebate programs;

the Corporation s ability to attract and retain key executives, pharmacists, and other healthcare personnel;

the Corporation s risk of loss not covered by insurance;

the outcome of litigation to which the Corporation is a party from time to time, including adverse results in material litigation or governmental inquiries;

changes in accounting rules and standards, audits, compliance with the Sarbanes-Oxley Act, and regulatory investigations;

changes in market conditions that would result in the impairment of goodwill or other assets of the Corporation;

changes in market conditions in which we operate that would influence the value of the Corporation s stock;

changes in volatility of the Corporation s stock price and the risk of litigation following a decline in the price of the Corporation s stock price;

the Corporation s ability to anticipate a shift in demand for generic drug equivalents and the impact on the financial results including the negative impact on brand drug rebates;

prescription volumes may decline, and our net revenues and profitability may be negatively impacted, if the safety risk profiles of drugs increase or if drugs are withdrawn from the market, including as a result of manufacturing issues, or if prescription drugs transition to over-the-counter products;

the effects on the Corporation s results of operations related to interpretations of accounting principles by the SEC staff that may differ from those of management;

changes in tax laws and regulations;

the effects of changes to critical accounting estimates; and

other factors, risks and uncertainties referenced in the Corporation s filings with the Commission, including the Risk Factors set forth in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2011.

YOU ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON ANY FORWARD-LOOKING STATEMENTS, ALL OF WHICH SPEAK ONLY AS OF THE DATE OF THIS QUARTERLY REPORT. EXCEPT AS REQUIRED BY LAW, WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR RELEASE ANY REVISIONS TO THESE FORWARD-LOOKING STATEMENTS TO REFLECT ANY EVENTS OR CIRCUMSTANCES AFTER THE DATE OF THIS QUARTERLY REPORT OR TO REFLECT THE OCCURRENCE OF UNANTICIPATED EVENTS. ALL SUBSEQUENT WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS ATTRIBUTABLE TO US OR ANY PERSON ACTING ON THE CORPORATION S BEHALF ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THE CAUTIONARY STATEMENTS CONTAINED OR REFERRED TO IN THIS SECTION AND IN OUR RISK FACTORS SET FORTH IN PART I, ITEM 1A OF THE CORPORATION S ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2011 AND IN OTHER REPORTS FILED WITH THE SEC BY THE CORPORATION.

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General

The condensed consolidated financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this quarterly report on Form 10-Q as of and for the three months and nine months ended September 30, 2012, reflect the financial position, results of operations, and cash flows of the Corporation.

Unless the context otherwise requires, all references to we, us, our, and Corporation refer to PharMerica Corporation and its subsidiaries.

The Corporation s Business and Industry Trends

Unsolicited Takeover by Omnicare

On August 23, 2011, Omnicare, Inc. (Omnicare) made public an unsolicited proposal to acquire all of the outstanding shares of the Corporation s common stock for $15.00 per share in cash. On January 27, 2012, the Federal Trade Commission (FTC) issued an administrative complaint to block Omnicare s proposed acquisition of the Corporation. The complaint alleged that the proposed acquisition would be illegal and in violation of Section 15 of the FTC Act and Section 7 of the Clayton Act because it would harm competition and enable Omnicare to raise the price of drugs for Medicare Part D consumers and others. On February 21, 2012 the unsolicited tender offer expired and Omnicare did not extend the offer.

In connection with these matters, in the nine months ended September 30, 2011 and September 30, 2012, we expensed $1.1 and $1.9 million, respectively, of legal and advisory fees, which are included in merger, acquisition, integration costs and other charges in the condensed consolidated income statements. The Corporation does not expect to incur significant additional costs in the future in connection with Omnicare s unsolicited tender offer.

Institutional Pharmacy Business

The Corporation is the second largest institutional pharmacy services company in the United States based on revenues. We service healthcare facilities and also provide management pharmacy services to hospitals. The Corporation operates 94 institutional pharmacies in 44 states. The Corporation s customers are typically institutional healthcare providers, such as skilled nursing facilities, nursing centers, assisted living facilities, hospitals, and other long-term alternative care settings. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 89 hospitals in the United States.

Our core business provides pharmacy products and services to residents and patients in skilled nursing facilities, nursing centers, assisted living facilities, hospitals, and other long-term alternative care settings. We purchase, repackage, and dispense prescription and non-prescription pharmaceuticals in accordance with physician orders and deliver such medication to healthcare facilities for administration to individual patients and residents. Depending on the specific location, we service healthcare facilities typically within a radius of 120 miles or less of our pharmacy locations at least once each day. We provide 24-hour, seven-day per week on-call pharmacist services for emergency dispensing, delivery, and/or consultation with the facility s staff or the resident s attending physician. We also provide various supplemental healthcare services that complement our institutional pharmacy services.

We offer prescription and non-prescription pharmaceuticals to our customers through unit dose or modified unit dose packaging, dispensing, and delivery systems, typically in a 15 to 30 day supply. Unit dose medications are packaged for dispensing in individual doses as compared to bulk packaging used by most retail pharmacies. The customers we serve prefer the unit dose delivery system over the bulk delivery system employed by retail pharmacies because it improves control over the storage and ordering of drugs and reduces errors in drug administration in healthcare facilities. Nursing staff in our customers facilities administer the pharmaceuticals to individual patients and residents.

Our computerized dispensing and delivery systems are designed to improve efficiency and control over distribution of medications to patients and residents. We provide computerized physician orders and medication administration records for patients or residents on a monthly basis as requested. Data from these records are formulated into monthly management reports on patient and resident care and quality assurance. This system improves efficiencies in nursing time, reduces drug waste, and helps to improve patient outcomes.

Consultant Pharmacist Services

Federal and state regulations mandate that long-term care facilities, in addition to providing a source of pharmaceuticals, retain consultant pharmacist services to monitor and report on prescription drug therapy in order to maintain and improve the quality of resident care. On September 30, 2008, the United States Department of Health and Human Services Office of Inspector General (OIG) published OIG

Supplemental Compliance Program Guidance for Nursing Homes. With quality of care being the first risk

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area identified, the supplemental guidance is part of a series of recent government efforts focused on improving quality of care at skilled nursing and long-term care facilities. The guidance contains compliance recommendations and an expanded discussion of risk areas. The guidance stressed that facilities must provide pharmaceutical services to meet the needs of each resident and should be mindful of potential quality of care problems when implementing policies and procedures on proper medication management. It further stated that facilities can reduce risk by educating staff on medication management and improper pharmacy kickbacks for consultant pharmacists and that facilities should review the total compensation paid to consultant pharmacists to ensure it is not structured in a way that reflects the volume or value of particular drugs prescribed or administered to residents.

In October 2011, Centers for Medicare and Medicaid Services (CMS) issued a proposed rule entitled Medicare Program; Proposed Changes to the Medicare Advantage and the Medicare Prescription Drug Benefit Programs for Contract Year 2013 and Other Proposed Changes; Considering Changes to the Conditions of Participation for Long Term Care Facilities (the Proposed Rule). In the Proposed Rule, CMS outlined its concerns, and requested comments, regarding certain contractual arrangements between Long Term Care (LTC) facilities, LTC pharmacies, consultant pharmacies, and pharmaceutical manufacturers. After reviewing the comments, CMS declined to finalize the portion of the Proposed Rule requiring the independence of consultant pharmacists from LTC pharmacies. CMS further noted that the independent consultant pharmacist requirement would be highly disruptive to both LTC facilities and consultant pharmacists, and without additional regulation of facility staff and providers, any benefits would not outweigh the costs of industry disruption. However, CMS solicited additional comments and acknowledged the possibility of future regulations if there fails to be improvement in inappropriate utilization throughout the industry. The Corporation believes that a future rule, which could require the independence of consultant pharmacists, may increase overall costs for payers and customers and reduce the quality of care and service to long-term care patients and residents. However, until CMS provides additional guidance, the Corporation is unable to fully evaluate the impact of future regulations in consultant pharmacist services.

We provide consultant pharmacist services that help our customers comply with the federal and state regulations applicable to nursing homes. Currently, we provide consultant services to approximately 70% of our patients serviced. The services offered by our consultant pharmacists include:

- Monthly reviews of each resident s drug regimen to assess the appropriateness and efficacy of drug therapies, including the review of medical records, monitoring drug interactions with other drugs or food, monitoring laboratory test results, and recommending alternative therapies;
- Participation on quality assurance and other committees of our customers, as required or requested by such customers;
- Monitoring and reporting on facility-wide drug utilization;
- Development and maintenance of pharmaceutical policy and procedure manuals; and
- Assistance with federal and state regulatory compliance pertaining to resident care.

Medical Records

The Corporation provides medical records services, which includes the completion and maintenance of medical record information for patients in the Corporation s customer s facilities. The medical records services include:

- Real-time access to medication and treatment administration records, physician order sheets and psychotropic drug monitoring sheets;
- Online ordering to save time and resources;

A customized database with the medication profiles of each resident s medication safety, efficiency and regulatory compliance;

Web-based individual patient records detailing each prescribed medicine; and

Electronic medical records to improve information to make it more legible and instantaneous.

Ancillary Services

The Corporation provides intravenous (IV) drug therapy products and services to its customers. We provide IV products and services to client facilities as well as hospice and home care patients.

We prepare the product to be administered using proper equipment in an aseptic environment and then deliver the product to the facilities for administration by the nursing staff. Proper administration of IV drug therapy requires a highly trained nursing staff. Upon request, we arrange for consultants to provide an education and certification program on IV therapy to assure proper staff training and compliance with regulatory requirements in client facilities offering an IV therapy program.

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Hospital Pharmacy Management Services

We also provide hospital pharmacy management services. These services generally entail the overall management of the hospital pharmacy operations, including the ordering, receipt, storage, and dispensing of pharmaceuticals to the hospital s patients pursuant to the clinical guidelines established by the hospital. We offer the hospitals a wide range of regulatory and financial management services, including inventory control, budgetary analysis, staffing optimization, and assistance with obtaining and maintaining applicable regulatory licenses, certifications, and accreditations. We work with the hospitals to develop and implement pharmacy policies and procedures, including drug formulary development and utilization management. We also offer clinical pharmacy programs that encompass a wide range of drug therapy and disease management protocols, including protocols for anemia treatment, infectious diseases, wound care, nutritional support, renal dosing, and therapeutic substitution. The hospital pharmacy management services segment is comprised of a few customers, of which, our largest service is to the majority of the Kindred Healthcare, Inc. (Kindred) hospitals.

Additional business segment information is set forth in Part I, Item 1 Financial Statements and Note 12 Business Segment Data to the Condensed Consolidated Financial Statements of this quarterly report on Form 10-Q.

Customers

Institutional Care Settings. Our customers are typically institutional healthcare providers, such as skilled nursing facilities, nursing centers, assisted living facilities, hospitals and other long-term alternative care settings. We are generally the primary source of supply of pharmaceuticals for our customers.

Our customers depend on institutional pharmacies like us to provide the necessary pharmacy products and services and to play an integral role in monitoring patient medication regimens and safety. We dispense pharmaceuticals in patient specific packaging in accordance with physician instructions.

At September 30, 2012, we had contracts to provide pharmacy services to 322,633 licensed beds for patients in healthcare facilities throughout the country. We also have significant customer concentrations with facilities operated by Kindred. For the nine months ended September 30, 2012, Kindred institutional pharmacy contracts represented approximately 11.3% of the Corporation s total revenues.

Hospital Pharmacy Management Services. At September 30, 2012, the Corporation provided hospital pharmacy management services to Kindred and other customers at 89 locations. For the nine months ended September 30, 2012, revenues under the Kindred hospital pharmacy management service contracts represented approximately 3.2% of the Corporation s total revenues.

Suppliers/Inventory

On January 4, 2011, the Corporation entered into an Amended and Restated Prime Vendor Agreement for Long-Term Care Pharmacies by and between AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen Corporation, the Corporation, Pharmacy Corporation of America and Chem Rx Pharmacy Services, LLC (Chem Rx) (the Amended Prime Vendor Agreement). The Amended Prime Vendor Agreement became effective on January 1, 2011 and, upon its effectiveness, superseded in its entirety the Prime Vendor Agreement for Long-Term Care Pharmacies entered into as of August 1, 2007 between the Corporation and ABDC.

The Amended Prime Vendor Agreement incorporates Chem Rx and is otherwise substantially the same in scope except for modifications to select sourcing and rebate terms. The term of the Amended Prime Vendor Agreement was extended until September 30, 2013, with one-year automatic renewal periods unless either party provides prior notice of its intent not to renew. The Amended Prime Vendor Agreement requires the Corporation to purchase substantially all brand and non-injectable generic drugs from ABDC. The Amended Prime Vendor Agreement does provide flexibility for the Corporation to contract directly with the manufacturer with these purchases being considered in the contractual requirements as long as ABDC is the distributor. If the Corporation fails to adhere to this contractual provision ABDC has the ability to increase the Corporation s drug pricing under the terms of the Amended Prime Vendor Agreement.

We also obtain pharmaceutical and other products from contracts negotiated directly with pharmaceutical manufacturers for discounted prices. While the loss of a supplier could adversely affect our business if alternate sources of supply are unavailable, numerous sources of supply are generally available to us.

We seek to maintain an on-site inventory of pharmaceuticals and supplies to ensure prompt delivery to our customers. ABDC maintains local distribution facilities in most major geographic markets in which we operate.

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Brand versus Generic

The pharmaceutical industry has been experiencing a higher level of brand-to-generic drug conversions. We believe the generic dispensing rate will continue to increase over time as the result of a large number of patent expirations in the near future.

The following table summarizes the generic drug dispensing rate:

	2011*	2012*
March 31	79.4 %	80.9 %
June 30	79.4	83.2
September 30	79.6	84.4
December 31	80.0	N/A

*Single source generic drugs, previously classified as brand drugs, are now being classified as generics for purposes of the generic dispensing rate calculation.

The following table summarizes the material brand-to-generic conversions expected to occur in 2012 through 2016:

2012	2013	2014	2015	2016
Seroquel (1Q)	Humalog (2Q)	Nexium (2Q)	Namenda (1Q)	Crestor (3Q)
Lexapro (1Q)	Lidoderm Patch (3Q)	Celebrex (2Q)	Abilify (2Q)	
Plavix (2Q)	Niaspan (3Q)	Copaxone (2Q)	Aggrenox (3Q)	
Provigil (2Q)	Cymbalta (4Q)	Renvela (3Q)	Invanz (4Q)	
Singulair (3Q)				
Actos (3Q)				
Diovan (3Q)				
Diovan HCT (3Q)				
Xopenex (3Q)				

(Number in parentheses equals the quarter of conversion)

When a branded drug shifts to a generic, initial pricing of the generic drug in the market will vary depending on the number of manufacturers launching their generic version of the drug. Historically a shift from brand-to-generic decreased our revenue and improved our gross margin from sales of these classes of drugs during the initial time period a brand drug has a generic alternative. However, recent experience has indicated that the third-party payers may reduce their reimbursements to the Corporation faster than previously experienced. This acceleration in the reimbursement reduction has resulted in margin compression much earlier than we have historically experienced. Due to the unique nature of the brand-to-generic conversion, management cannot estimate the future financial impact of the brand-to-generic conversions on its results of operations.

Supplier and Manufacturer Rebates

We currently receive rebates from certain manufacturers and distributors of pharmaceutical products for achieving targets of market share or purchase volumes. Rebates are designed to prefer, protect, or maintain a manufacturer s products that are dispensed by the pharmacy under its formulary. Rebates for brand name products are generally based upon achieving a defined market share tier within a therapeutic class and can be based on either purchasing volumes or actual prescriptions dispensed. Rebates for generic products are more likely to be based on achieving purchasing volume requirements.

Information Technology

Computerized medical records and documentation are an integral part of our distribution system. We primarily utilize a proprietary information technology infrastructure that automates order entry of medications, dispensing of medications, invoicing, and payment processing. These systems provide consulting drug review, electronic medication management, medical records, and regulatory compliance information to help ensure patient safety. These systems also support verification of eligibility and electronic billing capabilities for the Corporation s pharmacies. They also provide order entry, shipment, billing, reimbursement and collection of service fees for medications, specialty services and other services rendered.

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Based upon our electronic records, we are able to provide reports to our customers and management on patient care and quality assurance. These reports help to improve efficiency in patient care, reduce drug waste, and improve patient outcomes. We expect to continue to invest in technologies that help critical information access and system availability.

Sources of Pharmacy Revenues

We receive payment for our services from third party payers, including Medicare Part D Plans, government reimbursement programs under Medicare and Medicaid, and non-government sources such as institutional healthcare providers, commercial insurance companies, health maintenance organizations, preferred provider organizations, and contracted providers. The sources and amounts of our revenues will be determined by a number of factors, including the mix of our customers patients, brand to generic conversions and the rates and charges of reimbursement among payers. Changes in our customers censuses, the case mix of the patients, brand and generic dispensing rates, and the payer mix among private pay, Medicare Part D and Medicaid, will affect our profitability.

A summary of revenue by payer type for the three months and nine months ended September 30, 2011 and 2012 is as follows (dollars in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2011		2012		2011		2012	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Medicare Part D	$ 250.4	48.3%	$ 209.5	47.4%	$ 759.0	47.9%	$ 670.1	47.9%
Institutional healthcare providers	154.2	29.7	138.1	31.3	474.7	29.9	426.6	30.5
Medicaid	54.1	10.4	38.4	8.7	167.2	10.5	128.4	9.2
Private and other	23.6	4.6	19.9	4.4	69.7	4.4	65.0	4.6
Insured	19.6	3.8	19.3	4.4	64.6	4.1	58.4	4.2
Medicare	1.1	0.2	1.0	0.2	3.4	0.2	2.8	0.2
Hospital management fees	15.7	3.0	15.8	3.6	46.9	3.0	48.1	3.4
Total	$ 518.7	100.0%	$ 442.0	100.0%	$ 1,585.5	100.0%	$ 1,399.4	100.0%

Competition

We face a highly competitive environment in the institutional pharmacy market. In each geographic market there are national, regional and local institutional pharmacies that provide services comparable to those offered by our pharmacies which may have greater financial and other resources than we do and may be more established in the markets they serve than we are. In addition, owners of skilled nursing facilities are also entering the institutional pharmacy market, particularly in areas of their geographic concentration. On a nationwide basis, there is one large competitor in the institutional pharmacy industry, Omnicare.

We believe that the competitive factors most important to our business are pricing, quality and the range of services offered, clinical expertise, ease of doing business with the provider and the ability to develop and maintain relationships with customers. Because relatively few barriers to entry exist in the local markets we serve, we have encountered and will continue to encounter substantial competition from local market entrants.

2010 Health Care Legislation

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act and on March 30, 2010, President Obama signed into law the reconciliation law known as Health Care and Education Affordability Reconciliation Act the Reconciliation Act and, combined we refer to both Acts as the 2010 Health Care Legislation. Three key provisions of the 2010 Health Care Legislation that are relevant to the Corporation are: (i) the gradual modification to the calculation of the Federal Upper Limit (FUL) for drug prices and the definition of Average Manufacturer s Price (AMP), (ii) the closure, over time, of the Medicare Part D coverage gap, which is otherwise known as the Donut Hole, and (iii) short cycle dispensing. The constitutionality of the 2010 Health Care Legislation was confirmed on June 28, 2012 by the Supreme Court of the United States (the Supreme Court). Specifically, the Supreme Court upheld the individual mandate and the expansion of Medicaid; however, the Supreme Court limited the expansion by making state participation in the expansion voluntary. Pending the promulgation of regulations thereunder, the Corporation is unable to fully evaluate the impact of the 2010 Health Care Legislation.

FUL and AMP Changes

The 2010 Health Care Legislation amended the Deficit Reduction Act of 2005 (the DRA) to change the definition of the Federal Upper Limit or FUL by requiring the calculation of the FUL as no less than 175% of the weighted average, based on utilization, of the most recently reported monthly Average Manufacturer s Price or AMP for pharmaceutically and therapeutically equivalent multi-source drugs available through retail community pharmacies nationally.

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In addition, the definition of AMP changed to reflect net sales only to drug wholesalers that distribute to retail community pharmacies and to retail community pharmacies that directly purchase from drug manufacturers. Further, the 2010 Health Care Legislation continues the current statutory exclusion of prompt pay discounts offered to wholesalers and adds three other exclusions to the AMP definition: i) bona fide services fees; ii) reimbursement for unsalable returned goods (recalled, expired, damaged, etc.); and iii) payments from and rebates/discounts to certain entities not conducting business as a wholesaler or retail community pharmacy. In addition to reporting monthly, the manufacturers are required to report the total number of units used to calculate each monthly AMP. CMS will use this information when it establishes FULs as a result of the new volume-weighted requirements pursuant to the 2010 Health Care Legislation.

In September 2011, CMS issued the first draft FUL reimbursement files for multiple source drugs, including the draft methodology used to calculate the FULs in accordance with the Health Care Legislation. These draft FUL prices are based on the manufacturer reported and certified July 2011 monthly AMP and AMP unit data. CMS continues to release this data monthly and is expected to do so going forward. CMS has not posted monthly AMPs for individual drugs, but only posted the weighted average of monthly AMPs in a FUL group and the calculation methodology.

On February 2, 2012, CMS issued proposed regulations further clarifying the AMP and FUL changes described above and indicated that the final rule would be issued sometime in 2013.

Until CMS provides final guidance and the industry adapts to this now public available pricing information, the Corporation is unable to fully evaluate the impact of the changes in FUL and AMP to its business.

Part D Coverage Gap

Starting on January 1, 2011, the Medicare Coverage Gap Discount Program (the Program) requires drug manufacturers to provide a 50% discount on the negotiated ingredient cost to certain Medicare Part D beneficiaries for certain drugs and biologics purchased during the coverage gap (this is exclusive of the pharmacy dispensing fee). In addition, the 2010 Health Care Legislation includes a requirement that closes or eliminates the coverage gap entirely by fiscal year 2020. The coverage gap will be eliminated by gradually reducing the coinsurance percentage for both drugs covered and not covered by the Program for each applicable beneficiary.

At this time, the Corporation is unable to fully evaluate the impact of the changes to the coverage gap to its business.

Short Cycle Dispensing

Pursuant to the 2010 Health Care Legislation, Prescription Drug Plans (PDPs) will be required, under Medicare Part D and Medicare Advantage prescription drug plans (Medicare Advantage or MAPDs) to utilize specific, uniform dispensing techniques, such as weekly, daily, or automated dose dispensing, when dispensing covered Medicare Part D drugs to beneficiaries who reside in a long-term care facility to reduce waste associated with 30 to 90 day prescriptions for such beneficiaries. This short cycle dispensing provision will take effect on January 1, 2013. On April 15, 2011, CMS issued final regulations pursuant to the 2010 Health Care Legislation requiring, beginning January 1, 2013, pharmacies dispensing to long-term care facilities to dispense no more than 14-day supplies of brand-name medications covered by Medicare Part D except in limited circumstances (i.e. solid oral doses of antibiotics and solid oral doses dispensed in original containers as indicated by the FDA or otherwise customarily dispensed in their original packaging to assist patients with compliance). The final regulations also provided clarity around what pharmacy costs should be included in the determination of the dispensing fee.

The Corporation is unable to fully evaluate the impact of the short cycle dispensing requirements on the Corporation s operations.

Overview of Reimbursement

Medicare is a federal program that provides certain hospital and medical insurance benefits to persons age 65 and over and to certain disabled persons. Medicaid is a medical assistance program administered by each state that provides healthcare benefits to certain indigent patients. Within the Medicare and Medicaid statutory framework, there are substantial areas subject to administrative rulings, interpretations, and discretion that may affect payments made under Medicare and Medicaid.

We receive payment for our services from institutional healthcare providers, commercial Medicare Part D Plans, third party payer government reimbursement programs such as Medicare and Medicaid, and other non-government sources such as commercial insurance companies, health maintenance organizations, preferred provider organizations, and contracted providers. With respect to our skilled nursing facilities customers, their residents are covered by Medicare Part A, Part B and Part D Plans, Medicaid, insurance, and other private payers (including managed care).

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Medicare

The Medicare program consists of four parts: (i) Medicare Part A, which covers, among other things, in-patient hospital, skilled nursing facilities, home healthcare, and certain other types of healthcare services; (ii) Medicare Part B, which covers physicians services, outpatient services, and certain items and services provided by medical suppliers such as intravenous therapy; (iii) Medicare Part C or Medicare Advantage, a managed care option for beneficiaries who are entitled to Medicare Part A and enrolled in Medicare Part B, and (iv) Medicare Part D, which provides coverage for prescription drugs that are not otherwise covered under Medicare Part A or Part B for those beneficiaries that enroll.

Part A

The Balanced Budget Act of 1997 (the BBA) mandated the Prospective Payment System (PPS) for Medicare-eligible enrolled residents in skilled nursing facilities. Under PPS, Medicare pays skilled nursing facilities a fixed fee per patient per day for extended care services to patients, covering substantially all items and services furnished during such enrollee s stay. Such services and items include pharmacy services and prescription drugs. We bill skilled nursing facilities based upon a negotiated fee schedule and are paid based on those contractual relationships. We do not receive direct payment from Medicare for patients covered under the Medicare Part A benefit. We classify the revenues recognized from these payers as Institutional Healthcare Providers.

Federal legislation continues to focus on reducing Medicare and Medicaid program expenditures. Such decreases may directly impact the Corporation s customers and their Medicare reimbursement. Given the changing nature of these rules, we are unable at this time to fully evaluate the impact on our business. Any evaluation of budgeting, cost-cutting, and financing of health care must also consider the new federal administration and the impact its proposed health care policies could have on any future cost considerations.

Part B

The MMA also changed the Medicare payment methodology and conditions for coverage of certain items of durable medical equipment, prosthetics, orthotics, and supplies (DMEPOS) under Medicare Part B. The Corporation provides some of these products to its customers. The changes include, among other things, a new competitive bidding program. Beginning on January 1, 2011 in selected areas and for selected supplies, only suppliers that were winning bidders are eligible to provide services, at prices established as a result of the competitive bids, to Medicare beneficiaries. Enteral nutrients, equipment and supplies, oxygen equipment, hospital beds, walkers, negative pressure wound therapy pumps and supplies are among the 10 categories of DMEPOS included in the first round of the competitive bidding process. The Corporation submitted bids in all geographic areas for the enteral nutrient category prior to the March 3, 2012 deadline set by CMS. Once the bidding and selection process is completed, proposed implementation of the contracts and pricing is July 2013. Medicare Part B is not material to the Corporation, representing 0.2% of revenues.

Part D

Medicare Part D provides coverage for prescription drugs that are not otherwise covered under Medicare Part A or Part B for those beneficiaries that enroll. Under Medicare Part D, beneficiaries may enroll in prescription drug plans offered by private commercial insurers who contract with CMS (or in a fallback plan offered on behalf of the government through a contractor, to the extent private entities fail to offer a plan in a given area), which provide coverage of outpatient prescription drugs (collectively, Part D Plans). Part D Plans include both plans providing the drug benefit on a standalone basis and Medicare Advantage plans providing drug coverage as a supplement to an existing medical benefit under that Medicare Advantage plan. Medicare beneficiaries generally have to pay a premium to enroll in a Part D Plan, with the premium amount varying from one Part D Plan to another, although CMS provides various federal subsidies to Part D Plans to reduce the cost to beneficiaries.

Part D Plans are required to make available certain drugs on their formularies. Dually-eligible residents in nursing centers generally are entitled to have their prescription drug costs covered by a Part D Plan, provided that the prescription drugs which they are taking are either on the Part D Plan s formulary or an exception to the Part D Plan s formulary is granted. CMS reviews the formularies of Part D Plans and requires these formularies to include the types of drugs most commonly used by Medicare beneficiaries. CMS also reviews the formulary exceptions criteria of the Part D Plans that provide for coverage of drugs determined by the Part D Plan to be medically appropriate for the enrollee; however there currently is not a separate formulary for long-term care residents.

We obtain reimbursement for drugs we provide to enrollees of the given Part D Plan in accordance with the terms of agreements negotiated between us and the Part D Plan. The Medicare Part D final rule prohibits Part D plans from paying for drugs and services not specifically called for by the BBA.

In addition, beginning January 2010, MIPPA required that all PDPs provide prompt payment to pharmacies. PDP and MAPDs must pay clean claims to retail pharmacies within 14 days if submitted electronically or within 30 days otherwise.

Medicare Part D does not alter federal reimbursement for residents of nursing centers whose stay at the nursing center is covered under Medicare Part A. Accordingly, Medicare s fixed per diem payments to nursing centers under PPS will continue to include a portion attributable to the expected cost of drugs provided to such residents. We will, therefore, continue to receive reimbursement for drugs provided to such residents from the nursing center in accordance with the terms of our agreements with each nursing center.

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In June 2009, CMS released a report indicating that approximately $41.0 million in Medicare Part D payments for prescription drugs, some dispensed by LTC pharmacies, were likely made incorrectly. CMS concluded many of the drugs, which were dispensed during Part A skilled nursing facility stays, should have been included in per diem payments under Medicare Part A. CMS stated it will focus on ensuring such improper payments do not occur in the future. We are unable to fully evaluate the impact of current and future federal initiatives aimed at eliminating these discrepancies.

In addition, we receive rebates from pharmaceutical manufacturers for undertaking certain activities that the manufacturers believe may increase the likelihood that we will dispense their products. CMS continues to question whether institutional pharmacies should be permitted to receive these access/performance rebates from manufacturers with respect to prescriptions covered under Medicare Part D, but has not prohibited the receipt of such rebates. CMS defines these as rebates a manufacturer provides to long-term care pharmacies that are designed to prefer, protect, or maintain that manufacturer s product selection by the long-term care pharmacy or to increase the volume of that manufacturer s products that are dispensed by the pharmacy under its formulary. CMS, in 2007, required PDPs to have policies and systems in place as part of their drug utilization management programs to protect beneficiaries and reduce costs when long-term care pharmacies receive incentives to move market share through access/performance rebates. The elimination or substantial reduction of manufacturer rebates, if not offset by other reimbursement, would have an adverse effect on our business.

Medicaid

The reimbursement rate for pharmacy services under Medicaid is determined on a state-by-state basis subject to review by CMS and applicable federal law. Although Medicaid programs vary from state to state, they generally provide for the payment of certain pharmacy services, up to established limits, at rates determined in accordance with each state s regulations. The federal Medicaid statute specifies a variety of requirements that a state plan must meet, including the requirements related to eligibility, coverage for services, payment, and admissions. For residents that are eligible for Medicaid only, and are not dual eligibles covered under Medicare Part D, we bill the individual state Medicaid program or in certain circumstances the state s designated managed care or other similar organizations. Federal regulations and the regulations of certain states establish upper limits for reimbursement of certain prescription drugs under Medicaid. In most states, pharmacy services are priced at the lower of usual and customary charges or cost, which generally is defined as a function of average wholesale price and may include a profit percentage plus a dispensing fee. Most states establish a fixed dispensing fee per prescription that is adjusted to reflect associated cost. Over the last several years, state Medicaid programs have lowered reimbursement through a variety of mechanisms, principally higher discounts off average wholesale price levels, expansion of the number of medications subject to federal upper limit pricing, and general reductions in contract payment methodology to pharmacies.

Critical Accounting Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires us to make estimates and assumptions that affect reported amounts and related disclosures. Management considers an accounting estimate to be critical if:

- It requires assumptions to be made that were uncertain at the time the estimate was made; and
- Changes in the estimate or different estimates could have a material impact on our consolidated results of operations or financial condition.

The critical accounting estimates discussed below are not intended to be a comprehensive list of all of the Corporation s accounting policies that require estimates. Management believes that of the significant accounting policies, as discussed in Note 1 of the condensed consolidated financial statements included elsewhere in this report, the estimates discussed below involve a higher degree of judgment and complexity. Management believes the current assumptions and other considerations used to estimate amounts reflected in the condensed consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts reflected in the condensed consolidated financial statements, the resulting changes could have a material adverse effect on the consolidated results of operations and financial condition of the Corporation.

Allowance for doubtful accounts and provision for doubtful accounts

Accounts receivable primarily consist of amounts due from PDP s under Medicaid Part D, long-term care institutions, the respective state Medicaid programs, private payers and third party insurance companies. Our ability to collect outstanding receivables is critical to our results of operations and cash flows. We establish an allowance for doubtful accounts to reduce the carrying value of our receivables to their estimated net

realizable value. In addition, certain drugs dispensed are subject to being returned and the responsible paying party is due a credit for such returns.

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Our allowance for doubtful accounts, included in our condensed consolidated balance sheets at December 31, 2011 and September 30, 2012, were $48.6 million and $56.1 million, respectively

Our quarterly provision for doubtful accounts included in our condensed consolidated income statements was as follows (dollars in millions):

	Amount	% of Revenues		Amount	% of Revenues
2011			**2012**		
First Quarter	$ 5.4	1.0%	First Quarter	$ 6.2	1.2%
Second Quarter	5.8	1.1	Second Quarter	6.2	1.4
Third Quarter	6.4	1.2	Third Quarter	7.3	1.7
Fourth Quarter	7.2	1.5	Fourth Quarter	N/A	N/A

Please refer to Note 1 to our condensed consolidated financial statements included elsewhere in this report for a rollforward of our allowance for doubtful accounts.

The largest components of bad debts in our accounts receivable relate to the accounts for which private payers are responsible (which we refer to as private and other), accounts which our customers from long-term care institutions are responsible under Medicare Part A and owe us for the drug component of their patients stay at their respective institution and third party, Medicare Part D, and Medicaid accounts that have been denied.

We attempt to collect the private and other accounts through various efforts. We attempt to collect payments due from long-term care institutions through billing and collecting in accordance with the terms of the contracts. We attempt to collect from third party, Medicare Part D and Medicaid accounts by obtaining the appropriate documentation and direct discussions with the payers. In all cases, the drugs have been dispensed.

In general, we perform the following steps in collecting accounts receivable:

- if possible, perform up front adjudication prior to dispensing the product;
- billing and follow-up with third party payers;
- billing and follow-up with long-term care institutions;
- utilization of collection agencies; and
- other legal processes.

The Corporation has an established process to determine the adequacy of the allowance for doubtful accounts, which relies on analytical tools, specific identification, and benchmarks to arrive at a reasonable allowance. No single statistic or measurement alone determines the allowance for doubtful accounts.

We monitor and review trends by payer classification along with the composition of our aging accounts receivable. This review is focused primarily on trends in private and other payers, PDP s, dual eligible co-payments, historic payment patterns of long-term care institutions, and monitoring respective credit risks.

In addition, we analyze other factors such as revenue days in accounts receivables, denial trends by payer types, payment patterns by payer types, subsequent cash collections, and current events that may impact payment patterns of our long-term care institution customers.

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The following table shows our institutional pharmacy revenue days outstanding reflected in our institutional pharmacy net accounts receivable as of the dates indicated:

	2011	2012
First Quarter	39.0	42.8
Second Quarter	41.6	45.3
Third Quarter	42.5	44.0
Fourth Quarter	42.8	N/A

The following table shows our summarized aging categories by quarter:

	2011				2012			
	First	Second	Third	Fourth	First	Second	Third	Fourth
0 to 60 days	63.4 %	63.9 %	63.1 %	61.2 %	61.5 %	58.0 %	58.6 %	N/A %
61 to 120 days	19.3	18.0	18.9	19.5	17.3	17.7	15.7	N/A
Over 120 Days	17.3	18.1	18.0	19.3	21.2	24.3	25.7	N/A

The following table shows our allowance for doubtful accounts as a percent of gross accounts receivable:

	2011			2012		
	Allowance	Gross Accounts Receivable	% of Gross Accounts Receivable	Allowance	Gross Accounts Receivable	% of Gross Accounts Receivable
First Quarter	$ 38.1	$ 273.9	13.9 %	$ 52.1	$ 296.4	17.6 %
Second Quarter	39.6	282.4	14.0	52.8	272.1	19.4
Third Quarter	42.9	282.8	15.2	56.1	266.0	21.1
Fourth Quarter	48.6	280.8	17.3	N/A	N/A	N/A

Revenue recognition/Allowance for contractual discounts

The following table shows our sources of revenues for the quarters presented:

	Three Months Ended March 31,		Three Months Ended June 30,	
	2011	2012	2011	2012
Medicare Part D	47.7 %	48.2 %	47.5 %	48.1 %
Institutional healthcare providers	30.7	30.0	29.8	30.2
Medicaid	10.4	9.6	10.7	9.2
Private payer and other	4.0	4.7	4.6	4.7
Insured	4.1	4.1	4.2	4.1
Medicare	0.2	0.2	0.2	0.2
Hospital management fees	2.9	3.2	3.0	3.5
Total	100.0 %	100.0 %	100.0 %	100.0 %

	Three Months Ended September 30,		Three Months Ended December 31,	
	2011	2012	2011	2012
Medicare Part D	48.3 %	47.4 %	48.3 %	N/A %
Institutional healthcare providers	29.7	31.3	28.5	N/A
Medicaid	10.4	8.7	10.2	N/A

Private payer and other	4.6	4.4	4.6	N/A
Insured	3.8	4.4	5.1	N/A
Medicare	0.2	0.2	0.2	N/A
Hospital management fees	3.0	3.6	3.1	N/A
Total	100.0 %	100.0 %	100.0 %	- %

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

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Co-payments for our services can be applicable under Medicare Part D, the state Medicaid programs, and certain third party payers and are typically not collected at the time products are delivered or services are provided. Co-payments under the Medicaid programs and third party plans are generally billed to the responsible party as part of our normal billing procedures which are subject to normal collection procedures.

Under Medicare Part D, institutional residents who are dual eligible have co-payments due from the responsible party for up to the first thirty days of a beneficiary s stay in a skilled nursing facility subsequent to which the PDP s are responsible for reimbursement.

Under certain circumstances, including state-mandated return policies under various Medicaid programs, we accept returns of medications and issue credit memorandums to the applicable payer. Product returns are processed in the period returned. We estimate an amount for expected returns based on historical trends.

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

Please refer to Note 7 to our accompanying condensed consolidated financial statements and footnotes included elsewhere in this quarterly report for a further discussion of our revenue recognition policies.

Inventory and cost of drugs dispensed

We have inventory located at each of our institutional pharmacy locations. Our inventory is maintained on a first-in, first-out lower of cost or market basis. The inventory consists of prescription drugs, over the counter products and intravenous solutions. Our inventory relating to controlled substances is maintained on a manually prepared perpetual system to the extent required by the Drug Enforcement Agency and state board of pharmacies. All other inventory is maintained on a periodic system, through the performance of quarterly physical inventories at the end of each quarter. All inventory counts are reconciled to the balance sheet account and differences are adjusted through cost of goods sold. In addition, we record an amount of potential returns of prescription drugs based on historical rates of returns.

As of December 31, 2011 and September 30, 2012, our inventories on our accompanying condensed consolidated balance sheets were $130.6 million and $98.0 million, respectively.

Our inventory turns were as follows for the periods presented:

	2011	2012
First Quarter	15.0	11.0
Second Quarter	12.0	10.6
Third Quarter	11.0	10.3
Fourth Quarter	10.3	N/A

Goodwill, other intangible assets and accounting for business combinations

Goodwill represents the excess of the purchase price over the fair value of the net assets of acquired companies. Our intangible assets are comprised primarily of trade names, customer relationship assets, and non-compete agreements.

Our goodwill included in our accompanying condensed consolidated balance sheets as of December 31, 2011 and September 30, 2012 was $214.9 million.

Our net intangible assets included in our accompanying condensed consolidated balance sheets as of December 31, 2011 and September 30, 2012 were $100.2 million and $94.0 million, respectively. The amount of accumulated amortization of intangible assets as of December 31, 2011 and September 30, 2012 was $34.2 million and $43.2 million, respectively.

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The Corporation performs an annual, and more frequent if necessary, qualitative assessment of its Institutional Pharmacy reporting unit to determine if it is necessary to proceed to the first step of the two-step goodwill impairment test. The Corporation is not required to do so unless, based on the qualitative assessment, it is determined that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If the Corporation must continue to step one, then we determine fair value using widely accepted valuation techniques, including discounted cash flow and market multiple analyses. These types of analyses require us to make assumptions and estimates regarding future cash flows, industry economic factors and the profitability of future business strategies.

The purchase prices of acquisitions are allocated to the assets acquired and liabilities assumed based upon their respective fair values. Such valuations require us to make significant estimates and assumptions, including projections of future events and operating performance.

Fair value estimates are determined by management based upon and derived from appraisals, established market values of comparable assets, or internal calculations of estimated future net cash flows. Our estimate of future cash flows is based on assumptions and projections we believe to be currently reasonable and supportable. The ultimate decision regarding purchase price allocation is that of management.

We assess for the potential impairment of intangible assets and finite-lived assets recorded on the Corporation s balance sheet whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable.

During the third quarter of 2011, the Corporation recorded a pre-tax impairment charge of $5.1 million related to finite-lived customer relationships. The impairment, which related to the Institutional Pharmacy Segment, was incurred as the result of non-renewal of certain customer contracts. The impairment was related to intangible assets acquired in an acquisition during the year ended December 31, 2005. These asset groups were assessed for recoverability and management determined the finite-lived customer relationship assets to be impaired. No other assets within the asset groups were deemed impaired. Using a discounted cash flow analysis, the Corporation determined the pre-tax impairment charge of $5.1 million was required to write the carrying value down to fair value, resulting in a loss per diluted share impact of $0.11. The Corporation recognized the impairment as a permanent write-down of the cost basis and accumulated amortization of the affected assets.

Accounting for income taxes

The provision for income taxes is based upon the Corporation s annual taxable income or loss for each respective accounting period. The Corporation recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax basis of assets and liabilities and their reported amounts in the condensed consolidated financial statements. Deferred tax assets generally represent items that will result in a tax deduction in future years for which we have already recorded the tax benefit in the accompanying condensed consolidated income statements. The Corporation also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards.

We assess the likelihood that deferred tax assets will be recovered from future taxable income. A valuation allowance is provided for deferred tax assets if it is more-likely-than-not that some portion or all of the net deferred tax assets will not be realized. Our deferred tax asset balances in our condensed consolidated balance sheets as of December 31, 2011 and September 30, 2012, were $37.1 million and $33.2 million, respectively, including the impact of valuation allowances. Our valuation allowances for deferred tax assets in our condensed consolidated balance sheets as of December 31, 2011 and September 30, 2012 were $1.0 million.

Please refer to Note 10 to our condensed consolidated financial statements included elsewhere in this report for further discussion of our accounting for income taxes.

Key Financial Statement Components

Consolidated Income Statements

Our revenues are comprised primarily of product revenues and are derived from the sale of prescription drugs through our institutional pharmacies. The majority of our product revenues are derived on a fee-for-service basis. Our revenues are recorded net of certain discounts and estimates for returns. Hospital pharmacy revenues represent management fees and pass through costs associated with managing the clients hospital pharmacy.

Cost of goods sold is comprised primarily of the cost of product and is principally attributable to the dispensing of prescription drugs. Our cost of product relating to drugs dispensed by our institutional pharmacies consists primarily of the cost of inventory dispensed and our costs incurred to process and dispense the prescriptions. Cost of goods also includes direct labor, delivery costs, rent, utilities, depreciation, travel costs, professional fees and other costs attributable to the dispensing of medications. In addition, cost of product includes a credit for rebates earned directly or indirectly from pharmaceutical manufacturers whose drugs are included in our formularies. These rebates generally take the form of

formulary rebates, which are earned based on the volume of a specific drug dispensed, or market share rebates, which are earned based on the achievement of contractually specified market share levels. The Corporation receives rebates on brand and generic drugs dispensed and other administrative rebates.

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Selling, general and administrative expenses reflect the costs of operations dedicated to executive management, the generation of new sales, maintenance of existing client relationships, management of clinical programs, enhancement of technology capabilities, direction of pharmacy operations, human resources and performance of reimbursement and collection activities, in addition to finance, legal and other staff activities.

Merger, acquisition, integration costs and other charges represent the costs associated with integrating our operations, as well as costs related to acquisitions. Also included in this category are costs related to the unsolicited tender offer by Omnicare and costs related to the transition of the information technology services being provided by the Corporation s current vendor to another vendor (IT Transition).

Interest expense, net, primarily includes interest expense relating to our senior secured credit facility, partially offset by interest income generated by cash and cash equivalents.

Consolidated Balance Sheets

Our assets include cash and cash equivalent investments, accounts receivable, inventory, fixed assets, deferred tax assets, goodwill and intangibles.

Cash reflects the accumulation of positive cash flows from our operations and financing activities, and primarily includes deposits with banks or other financial institutions. Our cash balances are at the highest on Thursday nights and at the lowest on Friday nights. Friday is usually our largest cash disbursement day as a result of payments for our drug costs and our payrolls.

Accounts receivable primarily consist of amounts due from PDPs under Medicare Part D, the respective state Medicaid programs, long-term care institutions, third party insurance companies, and private payers, net of allowances for doubtful accounts, as well as contractual allowances.

Inventory reflects the cost of prescription products held for dispensing by our institutional pharmacies, net of allocated rebates, and is recorded on a first-in, first-out basis. We perform quarterly inventory counts and record our inventory and cost of goods sold based on such quarterly inventories. We also include an estimate for returns on inventory.

Deferred tax assets primarily represent temporary differences between the financial statement basis and the tax basis of certain accrued expenses, goodwill, accounts receivable allowance, net operating loss carryforwards, and stock-based compensation.

Fixed assets include investments in our institutional pharmacies and information technology, including capitalized software development. Goodwill and intangible assets are comprised primarily of goodwill and intangibles related to our previous acquisitions.

Our primary liabilities include accounts payable, accrued salaries and wages, other current liabilities, debt, and deferred tax liabilities. Accounts payable primarily consist of amounts payable for prescription inventory purchases under our Amended Prime Vendor Agreement and other purchases made in the normal course of business. The balances in accounts payable and accrued salaries and wages are at the highest on Thursday nights and at the lowest on Friday nights, as a result of payments for drug costs and payroll being funded on Friday. Accrued expenses and other current liabilities primarily consist of employee and facility-related cost accruals incurred in the normal course of business, as well as income taxes payable.

Our debt is primarily comprised of loans under our senior secured credit facility including the revolver. We do not have any off-balance sheet arrangements, other than purchase commitments and lease obligations.

Consolidated Statements of Cash Flows

An important element of our operating cash flows is the timing of billing cycles, subsequent cash collections and payments for drug costs and labor. Due to the nature of the Corporation s cash cycle, cash flows from operations can fluctuate significantly depending on the day of the week of the respective close process. We pay for our prescription drug inventory in accordance with payment terms offered under our Amended Prime Vendor Agreement. The Corporation receives rebates from its prime vendor and suppliers each period. Rebates are allocated as reduction in inventory and also recorded as a reduction to cost of goods sold in the period earned. Outgoing cash flows include inventory purchases, employee payroll and benefits, facility operating expenses, capital expenditures including technology investments, interest and principal payments on our outstanding debt, and income taxes. The cost of acquisitions will also result in cash outflows.

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Definitions

Listed below are definitions of terms used by the Corporation in managing the business. The definitions are necessary to the understanding of the Management s Discussion and Analysis section of this document.

Bps: Represents basis points. Basis points are based on percentages. For example, 100 bps represents a change of 1.0%.

Gross profit per prescription dispensed: Represents the gross profit from the institutional pharmacy segment divided by the total prescriptions dispensed.

Institutional pharmacy gross margin: Represents the gross profit per prescription dispensed divided by the revenue per prescription dispensed.

NM: Represents not meaningful.

Prescriptions dispensed: Represents a prescription filled for an individual patient. A prescription will usually be for a 15 or 30 day period and will include only one drug type.

Revenues per prescription dispensed: Represents the revenues from the institutional pharmacy segment divided by the total prescriptions dispensed.

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Results of Operations

The following table presents selected consolidated comparative results of operations and statistical information for the periods presented (dollars in millions, except per prescription amounts and where indicated):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2011 Amount	Increase (Decrease)		2012 Amount	2011 Amount	Increase (Decrease)		2012 Amount
Net revenues								
Institutional Pharmacy	$ 503.0	$ (76.8)	(15.3) %	$ 426.2	$ 1,538.6	$ (187.3)	(12.2) %	$ 1,351.3
Hospital Management	15.7	0.1	0.6	15.8	46.9	1.2	2.6	48.1
Total net revenues	518.7	(76.7)	(14.8)	442.0	1,585.5	(186.1)	(11.7)	1,399.4
Cost of goods sold								
Institutional Pharmacy	429.2	(76.8)	(17.9)	352.4	1,325.7	(193.4)	(14.6)	1,132.3
Hospital Management	13.8	0.2	1.4	14.0	41.0	1.8	4.4	42.8
Total cost of goods sold	443.0	(76.6)	(17.3)	366.4	1,366.7	(191.6)	(14.0)	1,175.1
Gross profit								
Institutional Pharmacy	73.8	-	-	73.8	212.9	6.1	2.9	219.0
Hospital Management	1.9	(0.1)	(5.3)	1.8	5.9	(0.6)	(10.2)	5.3
Total gross profit	$ 75.7	$ (0.1)	(0.1) %	$ 75.6	$ 218.8	$ 5.5	2.5 %	$ 224.3
Institutional Pharmacy (in whole numbers except where indicated)								
Volume information								
Prescriptions dispensed (in thousands)	10,357	(646)	(6.2) %	9,711	31,733	(2,058)	(6.5) %	29,675
Revenue per prescription dispensed	$ 48.57	$ (4.68)	(9.6) %	$ 43.89	$ 48.49	$ (2.95)	(6.1) %	$ 45.54
Gross profit per prescription dispensed	$ 7.13	$ 0.47	6.6 %	$ 7.60	$ 6.71	$ 0.67	10.0 %	$ 7.38
Institutional pharmacy gross margin	14.7 %	2.6 %	18.0 %	17.3 %	13.8 %	2.4 %	17.1 %	16.2 %
Generic dispensing rate*	79.6 %	4.8 %	6.0 %	84.4 %	79.5 %	3.3 %	4.2 %	82.8 %
Customer licensed beds under contract								
Beginning of period	353,024	(26,876)	(7.6) %	326,148	362,901	(23,403)	(6.4) %	339,498
Additions-PharMerica Corporation	3,229	1,529	47.4	4,758	13,870	(112)	(0.8)	13,758
Additions-Chem Rx	905	(9)	(1.0)	896	2,295	(255)	(11.1)	2,040
Losses-PharMerica Corporation	(13,561)	5,176	(38.2)	(8,385)	(30,287)	1,606	(5.3)	(28,681)
Losses-Chem Rx	(1,498)	714	(47.7)	(784)	(6,680)	2,698	(40.4)	(3,982)
End of period	342,099	(19,466)	(5.7) %	322,633	342,099	(19,466)	(5.7) %	322,633
Hospital Management (in whole numbers except where indicated)								
Volume information								
Hospital management contracts serviced	90	(1.0)	(1.1) %	89	90	(1.0)	(1.1)%	89

* Single source generic drugs, previously classified as brand drugs, are now being classified as generics for purposes of the generic dispensing rate calculation.

Revenues

Institutional pharmacy revenues decreased $76.8 million for the three months ended September 30, 2012 compared to the three months ended September 30, 2011 due primarily to the continued wave of drugs converting from brand to generic and a net decline in customer licensed beds under contract of 19,466. The 9.6% decrease in revenue per prescription dispensed was a result of the significance of the brand to generic

conversions resu