

WATSON PHARMACEUTICALS INC

Form 10-Q

November 06, 2007

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

or

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

For the transition period from to

Commission file number 001-13305

WATSON PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

311 Bonnie Circle

Corona, CA 92880-2882

95-3872914
(I.R.S. Employer

Identification No.)

Edgar Filing: WATSON PHARMACEUTICALS INC - Form 10-Q

(Address of principal executive offices, including zip code)

(951) 493-5300

(Registrant's telephone number, including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of shares outstanding of the Registrant's only class of common stock as of November 1, 2007 was approximately 103,629,000.

Table of Contents

WATSON PHARMACEUTICALS, INC.

TABLE OF CONTENTS

FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

| | PAGE |
|--|-------------|
| Part I. FINANCIAL INFORMATION | |
| Item 1. Condensed Consolidated Financial Statements (Unaudited): | |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2007 and 2006</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2007 and 2006</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 23 |
| Item 3. <u>Quantitative and Qualitative Disclosure about Market Risk</u> | 41 |
| Item 4. <u>Controls and Procedures</u> | 42 |
| Part II. OTHER INFORMATION AND SIGNATURES | |
| Item 1. <u>Legal Proceedings</u> | 44 |
| Item 1A. <u>Risk Factors</u> | 44 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 44 |
| Item 6. <u>Exhibits</u> | 44 |
| <u>Signatures</u> | 45 |

Table of Contents

WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited; in thousands)

| | September 30, 2007 | December 31, 2006 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 133,348 | \$ 154,171 |
| Marketable securities | 11,721 | 6,649 |
| Accounts receivable, net | 275,840 | 384,692 |
| Inventories, net | 524,107 | 517,236 |
| Prepaid expenses and other current assets | 81,759 | 86,115 |
| Deferred tax assets | 97,226 | 112,813 |
| Total current assets | 1,124,001 | 1,261,676 |
| Property and equipment, net | 683,441 | 697,415 |
| Investments and other assets | 70,261 | 76,377 |
| Deferred tax assets | 54,603 | 55,348 |
| Product rights and other intangibles, net | 647,526 | 779,284 |
| Goodwill | 875,443 | 890,477 |
| Total assets | \$ 3,455,275 | \$ 3,760,577 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 371,431 | \$ 516,875 |
| Income taxes payable | | 46,773 |
| Current portion of long-term debt | 6,587 | 107,059 |
| Deferred revenue | 16,925 | 19,222 |
| Total current liabilities | 394,943 | 689,929 |
| Long-term debt | 974,342 | 1,124,145 |
| Deferred revenue | 46,362 | 58,086 |
| Other long-term liabilities | 8,107 | 4,169 |
| Other taxes payable | 51,639 | |
| Deferred tax liabilities | 172,886 | 203,860 |
| Total liabilities | 1,648,279 | 2,080,189 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock | | |
| Common stock | 373 | 369 |
| Additional paid-in capital | 963,830 | 937,308 |
| Retained earnings | 1,141,334 | 1,041,638 |
| Accumulated other comprehensive income | 3,190 | 1,073 |
| Treasury stock, at cost | (301,731) | (300,000) |
| Total stockholders' equity | 1,806,996 | 1,680,388 |

Edgar Filing: WATSON PHARMACEUTICALS INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Total liabilities and stockholders' equity | \$ 3,455,275 | \$ 3,760,577 |
|--|--------------|--------------|

See accompanying Notes to Condensed Consolidated Financial Statements.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------------------------|------------------------------------|------------------------------|
| | 2007 | 2006 Restated (Note 1) | 2007 | 2006 Restated (Note 1) |
| Net revenues | \$ 594,706 | \$ 440,493 | \$ 1,869,316 | \$ 1,358,082 |
| Cost of sales (excluding amortization, presented below) | 346,420 | 257,896 | 1,131,578 | 823,510 |
| Gross profit | 248,286 | 182,597 | 737,738 | 534,572 |
| Operating expenses: | | | | |
| Research and development | 35,657 | 29,447 | 108,968 | 90,409 |
| Selling, general and administrative | 112,491 | 64,467 | 312,867 | 201,991 |
| Amortization | 44,159 | 39,392 | 132,251 | 121,593 |
| Net (gain) loss on asset sales and impairments | (6,118) | | (6,118) | 66,981 |
| Total operating expenses | 186,189 | 133,306 | 547,968 | 480,974 |
| Operating income | 62,097 | 49,291 | 189,770 | 53,598 |
| Non-operating (expense) income, net: | | | | |
| Loss on early extinguishment of debt | | | (4,410) | (525) |
| Interest income | 1,964 | 9,601 | 6,696 | 22,766 |
| Interest expense | (10,125) | (3,814) | (35,476) | (10,437) |
| Other income (expense) | 1,449 | (225) | 7,886 | 4,851 |
| Total non-operating (expense) income, net | (6,712) | 5,562 | (25,304) | 16,655 |
| Income before income taxes | 55,385 | 54,853 | 164,466 | 70,253 |
| Provision for income taxes | 20,779 | 20,460 | 61,839 | 26,297 |
| Net income | \$ 34,606 | \$ 34,393 | \$ 102,627 | \$ 43,956 |
| Earnings per share: | | | | |
| Basic | \$ 0.34 | \$ 0.34 | \$ 1.00 | \$ 0.43 |
| Diluted | \$ 0.31 | \$ 0.31 | \$ 0.93 | \$ 0.43 |
| Weighted average shares outstanding: | | | | |
| Basic | 102,453 | 101,865 | 102,266 | 101,760 |
| Diluted | 117,421 | 116,353 | 117,042 | 116,356 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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

| | Nine Months Ended | |
|---|--------------------------|------------------------------|
| | September 30, | 2006 |
| | 2007 | Restated (Note 1) |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 102,627 | \$ 43,956 |
| Reconciliation to net cash provided by operating activities: | | |
| Depreciation | 56,935 | 37,027 |
| Amortization | 132,250 | 121,593 |
| Charge for asset impairment | 4,499 | 66,981 |
| Deferred income tax benefit | (15,509) | (54,134) |
| Provision for inventory reserve | 36,908 | 18,126 |
| Restricted stock and stock option compensation | 10,337 | 9,731 |
| Earnings on equity method investments | (5,409) | (1,576) |
| Gain on sale of securities | (2,131) | (3,695) |
| Loss on early extinguishment of debt | 4,410 | 525 |
| (Gain) loss on sale of property and equipment | (10,221) | 329 |
| Tax benefits from employee stock plans | 994 | 932 |
| Mark to market on derivative | 15 | (651) |
| Other | 3,532 | (3,179) |
| Changes in assets and liabilities (net of acquisition of business): | | |
| Accounts receivable, net | 111,852 | 69,931 |
| Inventories | (48,654) | (53,712) |
| Prepaid expenses and other current assets | 20,945 | (2,369) |
| Accounts payable and accrued expenses | (142,957) | 40,445 |
| Deferred revenue | (10,712) | 2,796 |
| Income taxes payable | 2,967 | 48,183 |
| Other assets | 3,047 | (3,472) |
| Total adjustments | 153,098 | 293,811 |
| Net cash provided by operating activities | 255,725 | 337,767 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Additions to property and equipment | (49,812) | (25,468) |
| Acquisition of product rights | (492) | (440) |
| Acquisition of business, net of cash acquired | | (29,574) |
| Proceeds from sale of marketable equity securities | 3,223 | 3,693 |
| Proceeds from sale of investments | | 4,695 |
| Proceeds from sale of property and equipment | 14,385 | |
| Additions to marketable securities | (5,624) | (5,164) |
| Additions to long-term investments | (1,152) | (12,682) |
| Distribution from joint venture | 715 | 5,942 |
| Net cash used in investing activities | (38,757) | (58,998) |

CASH FLOWS FROM FINANCING ACTIVITIES:

| | | |
|---|------------------|-----------------|
| Payments on term loan, current debt and other long-term liabilities | (252,910) | (18,926) |
| Proceeds from issuance of short-term debt | 1,655 | |
| Proceeds from stock plans | 15,195 | 7,928 |
| Repurchase of common stock | (1,731) | |
| Net cash used in financing activities | (237,791) | (10,998) |
| Net (decrease) increase in cash and cash equivalents | (20,823) | 267,771 |
| Cash and cash equivalents at beginning of period | 154,171 | 467,451 |
| Cash and cash equivalents at end of period | \$ 133,348 | \$ 735,222 |

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

WATSON PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 GENERAL

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

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

Acquisition of Andrx Corporation

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx Corporation (Andrx) for \$1.9 billion (the Andrx Acquisition). Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders equity, net of any related tax effect. As required by Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements (ARB 51), earnings (loss) on equity method investments has been restated for the three and nine months ended September 30, 2006 to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18). Comprehensive income has also been restated for the three and nine months ended September 30, 2006 to reflect these changes.

Table of Contents*Comprehensive Income*

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company's stockholders. Other comprehensive income refers to revenues, expenses, gains and losses that, under generally accepted accounting principles, are included in comprehensive income, but excluded from net income as these amounts are recorded directly as an adjustment to stockholders' equity. Watson's other comprehensive income is composed of unrealized gains (losses) on its holdings of publicly traded debt and equity securities, foreign currency translation adjustments and unrealized gains (losses) on cash flow hedges. The components of comprehensive income, including attributable income taxes, consisted of the following (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|------------------|------------------------------------|------------------|
| | 2007 | 2006 Restated | 2007 | 2006 Restated |
| Net income | \$ 34,606 | \$ 34,393 | \$ 102,627 | \$ 43,956 |
| Other comprehensive income (loss): | | | | |
| Unrealized gain (loss) on securities, net of tax | 122 | 608 | (395) | 1,297 |
| Translation gain (loss) | 1,676 | (199) | 2,761 | (629) |
| Unrealized loss on cash flow hedge, net of tax | (249) | | (249) | |
| Total other comprehensive income | 1,549 | 409 | 2,117 | 668 |
| Total comprehensive income | \$ 36,155 | \$ 34,802 | \$ 104,744 | \$ 44,624 |

Preferred and Common Stock

As of September 30, 2007 and December 31, 2006, 2,500,000 shares of no par value per share preferred stock were authorized, with none issued. As of September 30, 2007 and December 31, 2006, 500,000,000 shares of \$0.0033 par value per share common stock were authorized, with 113,003,000 and 111,867,000 shares issued and 103,604,000 and 102,467,000 outstanding, respectively. Of the issued shares, 9,455,000 and 9,400,000 shares were held as treasury shares as of September 30, 2007 and December 31, 2006, respectively.

Provisions for Sales Returns and Allowances

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

The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to the Company by our wholesale customer for a particular product and the negotiated contract price that the wholesaler's customer pays for that product. The Company's chargeback provision and related reserve vary with changes in product mix, changes in customer pricing and changes to estimated wholesaler inventory. The provision for chargebacks also takes into account an estimate of the expected wholesaler sell-through levels to indirect customers at contract prices. The Company principally validates the chargeback accrual quarterly through a review of the inventory

Table of Contents

reports obtained from its largest wholesale customers. This customer inventory information is used to verify the estimated liability for future chargeback claims based on historical chargeback and contract rates. These large wholesalers represent 85% 90% of the Company's chargeback payments. The Company continually monitors current pricing trends and wholesaler inventory levels to ensure the liability for future chargebacks is fairly stated. The following table summarizes the activity in the Company's major categories of SRA (in thousands):

| | Chargebacks | Rebates | Returns and Other Allowances | Cash Discounts | Total |
|--|--------------------|----------------|---|---------------------------|--------------|
| Balance at December 31, 2005 | \$ 139,605 | \$ 128,293 | \$ 45,293 | \$ 12,094 | \$ 325,285 |
| Provision related to sales in nine months ended September 30, 2006 | 876,450 | 306,016 | 141,136 | 52,224 | 1,375,826 |
| Credits and payments | (852,695) | (294,088) | (132,733) | (51,762) | (1,331,278) |
| Balance at September 30, 2006 | 163,360 | 140,221 | 53,696 | 12,556 | 369,833 |
| Provision related to sales in three months ended December 31, 2006 | 314,004 | 115,384 | 32,073 | 18,461 | 479,922 |
| Add: Andrx Acquisition | 15,911 | 27,667 | 8,992 | 1,601 | 54,171 |
| Credits and payments | (328,795) | (102,734) | (52,272) | (18,546) | (502,347) |
| Balance at December 31, 2006 | 164,480 | 180,538 | 42,489 | 14,072 | 401,579 |
| Provision related to sales in nine months ended September 30, 2007 | 909,497 | 296,333 | 122,717 | 51,001 | 1,379,548 |
| Credits and payments | (925,744) | (323,243) | (114,244) | (51,968) | (1,415,199) |
| Balance at September 30, 2007 | \$ 148,233 | \$ 153,628 | \$ 50,962 | \$ 13,105 | \$ 365,928 |

Earnings Per Share

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

Table of Contents

| | Three months ended September 30, 2007 | | Nine months ended September 30, 2006 | |
|--|---|------------------|--|------------------|
| | 2007 | 2006 Restated | 2007 | 2006 Restated |
| Earnings per share - basic | | | | |
| Net income | \$ 34,606 | \$ 34,393 | \$ 102,627 | \$ 43,956 |
| Basic weighted average common shares outstanding | 102,453 | 101,865 | 102,266 | 101,760 |
| Earnings per share - basic | \$ 0.34 | \$ 0.34 | \$ 1.00 | \$ 0.43 |
| Earnings per share - assuming dilution | | | | |
| Net income | \$ 34,606 | \$ 34,393 | \$ 102,627 | \$ 43,956 |
| Add: Interest expense on CODES, net of tax | 1,905 | 2,026 | 5,906 | 5,486 |
| Net income, adjusted | \$ 36,511 | \$ 36,419 | \$ 108,533 | \$ 49,442 |
| Basic weighted average common shares outstanding | 102,453 | 101,865 | 102,266 | 101,760 |
| Effect of dilutive securities: | | | | |
| Conversion of CODES | 14,357 | 14,357 | 14,357 | 14,357 |
| Dilutive stock options | 611 | 131 | 419 | 239 |
| Diluted weighted average common shares outstanding | 117,421 | 116,353 | 117,042 | 116,356 |
| Earnings per share - diluted | \$ 0.31 | \$ 0.31 | \$ 0.93 | \$ 0.43 |

Stock awards to purchase 5.9 million and 10.8 million common shares for the three months ended September 30, 2007 and 2006, respectively, were outstanding but were not included in the computation of diluted earnings per share because the stock awards were antidilutive. Stock awards to purchase 7.9 million and 10.1 million common shares for the nine months ended September 30, 2007 and 2006, respectively, were outstanding but were not included in the computation of diluted earnings per share because the stock awards were antidilutive.

Derivatives

During the quarter ended September 30, 2007, the Company entered into an interest rate swap derivative to convert floating-rate debt to fixed-rate debt. The Company accounts for derivatives in accordance with Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). The Company's interest rate swap agreements involve agreements to pay a fixed rate and receive a floating rate, at specified intervals, calculated on an agreed upon notional amount. The debt and amounts that the Company hedges are determined based on our current business plan, prevailing market conditions and the current shape of the yield curve. The Company's objective in entering into these interest rate financial instruments is to mitigate its exposure to significant unplanned fluctuations in earnings caused by volatility in interest rates. As of September 30, 2007, all of the derivative instruments entered into are designated as hedges of underlying exposures. The Company does not use any of these instruments for trading or speculative purposes.

Derivative instruments used by Watson involve, to varying degrees, elements of credit risk, in the event a counterparty should default, and market risk, as the instruments are subject to interest rate fluctuations. Credit risk is managed through the use of counterparty diversification and monitoring of counterparty financial condition. All derivative financial instruments are with firms rated by national rating agencies.

All derivatives are recognized on the balance sheet at their fair value. To date, all derivatives entered into by the Company qualify for and are designated as cash flow hedges. Changes in the fair value of a derivative that is highly effective, and that is designated and qualifies as a cash flow hedge to the extent that the hedge is effective, are recorded in other comprehensive income (loss) until earnings are affected by the variability of cash flows of the hedged transaction (e.g. until periodic settlements of a variable asset or liability are recorded in earnings). Any hedge ineffectiveness (which represents the amount by which the changes in the fair value of the derivative

Table of Contents

exceed the variability in the cash flows of the forecasted transaction) is recorded in current-period earnings. There was no net gain or loss recognized in earnings related to our derivative instruments for any of the periods presented.

At September 30, 2007, the notional amount of interest rate swaps entered into by the Company was \$200 million. The fair value of the interest rate swap at September 30, 2007 was a liability of \$0.4 million and is presented within other long-term liabilities on the balance sheet. These interest swap agreements were entered into on September 17, 2007 and expire in January 2009.

Recent Accounting Pronouncements

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

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, (SFAS 159) which is effective for fiscal years beginning after November 15, 2007. SFAS 159 permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The Company is currently reviewing SFAS 159 and has not yet determined the impact, if any, on its consolidated financial statements.

NOTE 2 SHARE-BASED COMPENSATION

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

Stock Option Plans

A summary of the changes in the Company's stock option plans during the nine months ended September 30, 2007 is presented below (in thousands, except per share amounts):

| | | | Weighted | |
|---|---------|----------|--------------|-----------|
| | | Weighted | Average | |
| | Average | Exercise | Remaining | Aggregate |
| | | | Contractual | Intrinsic |
| | Shares | Price | Term (Years) | Value |
| Outstanding at December 31, 2006 | 10,985 | \$ 36.39 | | |
| Granted | 596 | 30.60 | | |
| Exercised | (580) | 26.19 | | |
| Cancelled | (956) | 36.56 | | |
| Outstanding at September 30, 2007 | 10,045 | \$ 36.61 | 5.2 | \$ 20,361 |
| Vested and expected to vest at September 30, 2007 | 9,366 | \$ 37.15 | 5.0 | \$ 18,054 |
| Options exercisable at September 30, 2007 | 7,839 | \$ 38.71 | 4.3 | \$ 12,616 |

Table of Contents

As of September 30, 2007, the Company had \$9.1 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 2.0 years. Total intrinsic value of stock options exercised for the three months ended September 30, 2007 and 2006 was \$0.6 million and \$0.4 million, respectively. Total intrinsic value of stock options exercised for the nine months ended September 30, 2007 and 2006 was \$2.9 million and \$2.3 million, respectively.

Restricted Stock

A summary of the changes in restricted stock grants during the nine months ended September 30, 2007 is presented below (in thousands, except per share amounts):

| | Shares | Fair Value | Weighted Average Grant Date | Weighted Average Remaining Contractual | Aggregate Intrinsic Value |
|---|--------|------------|-----------------------------------|---|---------------------------------|
| Restricted shares outstanding at December 31, 2006 | 569 | \$ 30.26 | 1.9 | | \$ 17,211 |
| Granted | 678 | 32.12 | | | 21,804 |
| Vested | (159) | 34.20 | | | (5,444) |
| Cancelled | (67) | 31.38 | | | (2,109) |
| Restricted shares outstanding at September 30, 2007 | 1,021 | \$ 30.81 | 2.2 | | \$ 31,462 |

As of September 30, 2007, the Company had \$17.1 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 2.2 years.

Share-Based Compensation

The impact of share-based compensation on the Company's results of operations for the three and nine months ended September 30, 2007 and 2006, respectively, was as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|----------|---------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Total share-based compensation expense | \$ 3,347 | \$ 2,940 | \$ 9,901 | \$ 8,712 |
| Tax benefit | (1,255) | (1,097) | (3,723) | (3,284) |
| Share-based compensation expense, net of tax | \$ 2,092 | \$ 1,843 | \$ 6,178 | \$ 5,428 |
| Share-based compensation capitalized to inventory | \$ 924 | \$ 628 | \$ 2,707 | \$ 1,708 |

NOTE 3 ACQUISITIONS*Acquisition of Andrx Corporation*

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx in an all-cash transaction for \$25 per share, or total consideration of approximately \$1.9 billion. Andrx, whose capabilities both augment and complement those of Watson, distributes pharmaceutical products primarily to independent and chain pharmacies and physicians' offices through its Anda distribution business. In addition, the acquisition augmented our existing formulation development capability by providing technology for difficult-to-replicate

Edgar Filing: WATSON PHARMACEUTICALS INC - Form 10-Q

controlled-release pharmaceutical products and selective immediate-release products. As a result of the Andrx Acquisition, Watson now has three operating segments: Generic, Brand and Distribution.

Table of Contents*Acquisition of Sekhsaria Chemicals Ltd.*

On March 16, 2006, the Company acquired Sekhsaria Chemicals Ltd. (Sekhsaria), a private company located in Mumbai, India that provides active pharmaceutical ingredient and finished dosage formulation expertise to the global pharmaceutical industry. The Company acquired all the outstanding shares of Sekhsaria for approximately \$29.5 million plus acquisition costs. The assets acquired and liabilities assumed were recorded at fair value on the acquisition date.

Additional Investment in Scinopharm

The Company holds an equity interest in Scinopharm Taiwan Ltd. (Scinopharm). In January 2006, the Company made an additional investment in Scinopharm of approximately \$12.0 million which increased its ownership interest to approximately 31%. The Company's option to acquire an additional 44% interest in Scinopharm at a cost of approximately \$80 million expired in October 2007 without exercise.

NOTE 4 OTHER INCOME (EXPENSE)

Other income consisted of the following (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|----------|---------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Earnings on equity method investments - restated | \$ 1,686 | \$ 203 | \$ 5,409 | \$ 1,576 |
| Gain on sale of securities | | | 2,472 | 3,695 |
| Other income (expense) | (237) | (428) | 5 | (420) |
| | \$ 1,449 | \$ (225) | \$ 7,886 | \$ 4,851 |

As discussed in NOTE 1 GENERAL, earnings on equity method investments has been restated to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with APB 18.

NOTE 5 OPERATING SEGMENTS

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

Other revenue consists primarily of co-promotional revenue, royalties, commissions and the recognition of deferred revenue associated with manufacturing, development and licensing arrangements.

Table of Contents

Net revenues and segment contribution information for the Company's Generic, Brand and Distribution segments, consisted of the following:

| | Three Months Ended September 30, 2007 | | | | Three Months Ended September 30, 2006 | | |
|--|---------------------------------------|------------|--------------|--------------|---------------------------------------|------------|--------------|
| | Generic | Brand | Distribution | Total | Generic | Brand | Total |
| Product sales | \$ 326,231 | \$ 93,534 | \$ 129,875 | \$ 549,640 | \$ 347,635 | \$ 85,543 | \$ 433,178 |
| Other | 31,489 | 13,577 | | 45,066 | 5,436 | 1,879 | 7,315 |
| Net revenues | 357,720 | 107,111 | 129,875 | 594,706 | 353,071 | 87,422 | 440,493 |
| Cost of sales (1) | 210,931 | 22,089 | 113,400 | 346,420 | 234,973 | 22,923 | 257,896 |
| Gross profit | 146,789 | 85,022 | 16,475 | 248,286 | 118,098 | 64,499 | 182,597 |
| Gross margin | 41% | 79% | 13% | 42% | 33% | 74% | 41% |
| Research and development | 26,555 | 9,102 | | 35,657 | 18,339 | 11,108 | 29,447 |
| Selling and marketing | 14,018 | 26,613 | 12,716 | 53,347 | 12,656 | 26,447 | 39,103 |
| Contribution | 106,216 | 49,307 | 3,759 | 159,282 | 87,103 | 26,944 | 114,047 |
| Contribution margin | 30% | 46% | 3% | 27% | 25% | 31% | 26% |
| General and administrative | | | 59,144 | | | | 25,364 |
| Amortization | | | 44,159 | | | | 39,392 |
| Net (gain) loss on asset sales and impairments | | | (6,118) | | | | |
| Operating income | | | \$ 62,097 | | | | \$ 49,291 |
| Operating margin | | | 10% | | | | 11% |
| | Nine Months Ended September 30, 2007 | | | | Nine Months Ended September 30, 2006 | | |
| | Generic | Brand | Distribution | Total | Generic | Brand | Total |
| Product sales | \$ 1,065,152 | \$ 281,096 | \$ 421,946 | \$ 1,768,194 | \$ 1,088,491 | \$ 256,831 | \$ 1,345,322 |
| Other | 62,834 | 38,288 | | 101,122 | 7,101 | 5,659 | 12,760 |
| Net revenues | 1,127,986 | 319,384 | 421,946 | 1,869,316 | 1,095,592 | 262,490 | 1,358,082 |
| Cost of sales (1) | 693,896 | 74,099 | 363,583 | 1,131,578 | 758,921 | 64,589 | 823,510 |
| Gross profit | 434,090 | 245,285 | 58,363 | 737,738 | 336,671 | 197,901 | 534,572 |
| Gross margin | 38% | 77% | 14% | 39% | 31% | 75% | 39% |
| Research and development | 77,036 | 31,932 | | 108,968 | 56,958 | 33,451 | 90,409 |
| Selling and marketing | 41,764 | 79,397 | 39,246 | 160,407 | 39,120 | 85,187 | 124,307 |
| Contribution | \$ 315,290 | \$ 133,956 | \$ 19,117 | 468,363 | \$ 240,593 | \$ 79,263 | 319,856 |
| Contribution margin | 28% | 42% | 5% | 25% | 22% | 30% | 24% |
| General and administrative | | | | 152,460 | | | 77,684 |
| Amortization | | | | 132,251 | | | 121,593 |
| Net (gain) loss on asset sales and impairments | | | | (6,118) | | | 66,981 |
| Operating income (loss) | | | \$ 189,770 | | | | \$ 53,598 |

| | | |
|------------------|-----|----|
| Operating margin | 10% | 4% |
|------------------|-----|----|

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

NOTE 6 INVENTORIES

Inventories consist of finished goods held for sale and distribution, raw materials and work-in-process. Included in inventory at September 30, 2007 and December 31, 2006 is approximately \$17.6 million and \$34.2 million, respectively, of inventory that is pending approval by the U.S. Food and Drug Administration (FDA) or has not been launched due to contractual restrictions. This inventory consists of generic pharmaceutical products that are capitalized only when the bioequivalence of the product is demonstrated or the product is already FDA approved and is awaiting a contractual triggering event to enter the marketplace.

Table of Contents

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

| | September 30, | December 31, |
|------------------------|---------------|--------------|
| | 2007 | 2006 |
| Raw materials | \$ 105,320 | \$ 113,603 |
| Work-in-process | 67,015 | 69,621 |
| Finished goods | 351,772 | 334,012 |
| Total inventories, net | \$ 524,107 | \$ 517,236 |

NOTE 7 GOODWILL

Goodwill for the Company's reporting units consisted of the following (in thousands):

| | September 30, | December 31, |
|----------------------|---------------|--------------|
| | 2007 | 2006 |
| Brand segment | \$ 356,998 | \$ 368,105 |
| Generic segment | 432,662 | 433,774 |
| Distribution segment | 85,783 | 88,598 |
| Total goodwill | \$ 875,443 | \$ 890,477 |

The \$15 million decrease in goodwill during 2007 primarily relates to an adjustment to acquired income tax contingencies.

NOTE 8 LONG-TERM DEBT

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

| | September 30, | December 31, |
|---|---------------|--------------|
| | 2007 | 2006 |
| Senior Credit Facility, due 2011, bearing interest at LIBOR plus 0.75% (2006 Credit Facility) | \$ 400,000 | \$ 650,000 |
| CODES, face amount of \$575 million, due 2023, net of unamortized discount | 574,333 | 574,125 |
| Other notes payable | 6,596 | 7,079 |
| | 980,929 | 1,231,204 |
| Less: Current portion | 6,587 | 107,059 |
| Total long-term debt | \$ 974,342 | \$ 1,124,145 |

Senior Credit Facility

During the nine months ended September 30, 2007, the Company made prepayments of the 2006 Credit Facility totalling \$250 million. As a result of these pre-payments, the Company's results for the nine months ended September 30, 2007 reflect a \$4.4 million non-cash charge for debt repurchases. As of September 30, 2007, \$400 million is outstanding under the 2006 Credit Facility.

Table of Contents

Interest Rate Swaps

During the quarter ended September 30, 2007, the Company entered into an interest rate swap agreement to convert floating-rate debt to fixed rate debt on a notional amount of \$200 million. The interest rate swap instruments involve agreements to receive a floating rate and pay a fixed rate, at specified intervals, calculated on the agreed-upon notional amount. The differentials paid or received on interest rate swap agreements are recognized as adjustments to interest expense in the period. These interest swap agreements were entered into on September 17, 2007 and expire in January 2009. For additional information on our interest rate swap derivatives, refer to NOTE 1 GENERAL.

NOTE 9 INCOME TAXES

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* An Interpretation of FASB Statement No. 109 (FIN 48). On January 1, 2007, the Company adopted the provisions of FIN 48. Differences between the amount recognized in the consolidated financial statements prior to the adoption of FIN 48 and the amounts reported as a result of adoption have been accounted for as a cumulative effect adjustment recorded to the January 1, 2007 retained earnings balance. The adoption of FIN 48 decreased the January 1, 2007, balance of retained earnings by \$2.9 million. In addition, the Company reclassified tax reserves for which a cash tax payment is not expected in the next twelve months from current to non-current liabilities.

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

As of September 30, 2007, the liability for income tax associated with uncertain tax positions was \$50.3 million. This amount is reduced for timing differences and amounts primarily arising from business combinations which, if recognized, would be recorded to goodwill. The net amount of \$29.2 million, if recognized, would favorably affect the Company's effective tax rate.

The Company's continuing practice is to recognize interest and penalties related to uncertain tax positions in tax expense. At adoption, the Company had accrued \$6.5 million of interest and penalties (net of tax benefit) related to uncertain tax positions and, as of September 30, 2007, the Company had accrued \$7.0 million of interest and penalties (net of tax benefit) related to uncertain tax positions.

The Company conducts business globally and, as a result, it files federal, state and foreign tax returns. In the normal course of business the Company is subject to examination by taxing authorities. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2000. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, the Company believes its reserves for income taxes represent the most probable outcome. The Company adjusts these reserves, as well as the related interest, in light of changing facts and circumstances.

The Company anticipates that the total amount of liability for unrecognized tax benefits may change due to the settlement of audits and the expiration of statute of limitations in the next 12 months. Through September 30, 2007, the Company paid \$4.8 million (net of tax benefit) in settlement of uncertain tax benefits, accrued interest and penalties and recognized a current receivable for income tax and interest of \$1.2 million.

Table of Contents**NOTE 10 STOCKHOLDERS EQUITY**

A summary of the changes in stockholders' equity for the nine months ended September 30, 2007 consisted of the following (in thousands):

| | |
|---|--------------|
| Stockholders' equity, December 31, 2006 | \$ 1,680,388 |
| Adoption of FIN 48 | (2,931) |
| | 1,677,457 |
| Common stock issued under employee plans | 15,196 |
| Increase in additional paid-in capital for restricted stock and stock option compensation | 10,338 |
| Net income | 102,626 |
| Other comprehensive income | 2,117 |
| Tax benefit from employee stock plans | 993 |
| Repurchase of common stock | (1,731) |
| Stockholders' equity, September 30, 2007 | \$ 1,806,996 |

NOTE 11 NET (GAIN) LOSS ON ASSET SALES AND IMPAIRMENTS

For the three months ended September 30, 2007, we recorded a gain on sale of our Phoenix facility in the amount of \$10.6 million and also recorded an additional impairment of our Puerto Rico facility in the amount of \$4.5 million.

Gain on Sale of Phoenix Facility

The Company received cash consideration of \$13.5 million from the sale of our Phoenix facility. The carrying amount of net assets included in the Phoenix sale was \$1.5 million and transaction and other costs of disposal were \$1.4 million.

Impairment of Puerto Rico Facility

During the third quarter of 2007, the Company recognized an additional impairment charge in the amount of \$4.5 million to reduce the fair value of its solid dosage manufacturing facility in Puerto Rico to its estimated current market value. Fair value of \$2.0 million was based on discussions with potential buyers of the property and market values for comparable properties.

NOTE 12 CONTINGENCIES*Legal Matters*

Watson and its affiliates are involved in various other disputes, governmental and/or regulatory inspections, inquires, investigations and proceedings, and litigation matters that arise from time to time in the ordinary course of business. The process of resolving matters through litigation or other means is inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows. The Company's regular practice is to expense legal fees as they are incurred in connection with legal matters, and to accrue for potential liabilities in accordance with SFAS No. 5 Accounting for Contingencies.

Phen-fen litigation. Beginning in late 1997, a number of product liability suits were filed against Watson, The Rugby Group (Rugby) and certain other Watson affiliates, as well as numerous other manufacturing defendants, for personal injuries allegedly arising out of the use of phentermine hydrochloride. The plaintiffs allege various injuries, ranging from minor injuries and anxiety to heart damage and death. There are approximately 12 cases, with a total of approximately 39 plaintiffs, pending against Watson and its affiliates in numerous state and federal courts. Most of the cases involve multiple plaintiffs, and several were filed or certified

Table of Contents

as class actions. The Company believes it will be fully indemnified by Rugby's former owner, Aventis Pharmaceuticals (Aventis, formerly known as Hoechst Marion Roussel, Inc., and now known as Sanofi Aventis) for the defense of all such cases and for any liability that may arise out of these cases. Aventis is currently controlling the defense of all these matters as the indemnifying party under its agreements with the Company. Additionally, Watson may have recourse against the manufacturing defendants in these cases.

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

Governmental Reimbursement Investigations and Drug Pricing Litigation In November 1999, Schein Pharmaceutical, Inc., now known as Watson Pharma, Inc. (Watson Pharma) was informed by the U.S. Department of Justice that Watson Pharma, along with numerous other pharmaceutical companies, is a defendant in a qui tam action brought in 1995 under the U.S. False Claims Act currently pending in the U.S. District Court for the Southern District of Florida. Watson Pharma has not been served in the qui tam action. A qui tam action is a civil lawsuit brought by an individual for an alleged violation of a federal statute, in which the U.S. Department of Justice has the right to intervene and take over the prosecution of the lawsuit at its option. Pursuant to applicable federal law, the qui tam action is under seal and, at this time, no details are available.

Table of Contents

concerning, among other things, the various theories of liability against Watson Pharma or the amount of damages sought from it. A qui tam action filed in the same court in 1995 has been partially unsealed, after the U.S. Department of Justice intervened, against three other pharmaceutical companies (*In re Pharmaceutical Industry Average Wholesale Price Litigation, United States of America ex rel. Ven-a-Care of the Florida Keys, Inc., v. Abbott Laboratories, et al., U.S. District Court for the District of Massachusetts, Civil Action No. 01-12257-PBS*). That action may be the same qui tam action as the one pending against Watson Pharma. The judge to whom that case has been assigned recently issued opinions denying certain defendants' Motions to Dismiss.

The Company believes that the qui tam action against the Company, which is still under seal, relates to whether allegedly improper price reporting by pharmaceutical manufacturers led to increased payments by Medicare and/or Medicaid. The qui tam action may seek to recover damages from Watson Pharma based on its price reporting practices. Watson Pharma subsequently also received and responded to notices or subpoenas from the Attorneys General of various states, including Florida, Nevada, New York, California and Texas, relating to pharmaceutical pricing issues and whether allegedly improper actions by pharmaceutical manufacturers led to excessive payments by Medicare and/or Medicaid.

On June 26, 2003, the Company received a request for records and information from the U.S. House Committee on Energy and Commerce in connection with that committee's investigation into pharmaceutical reimbursements and rebates under Medicaid. The Company produced documents in response to the request. Other state and federal inquiries regarding pricing and reimbursement issues are anticipated.

Beginning in July 2002, the Company and certain of its subsidiaries, as well as numerous other pharmaceutical companies, were named as defendants in various state and federal court actions alleging improper or fraudulent reporting practices related to the reporting of average wholesale prices and wholesale acquisition costs of certain products, and that the defendants committed other improper acts in order to increase prices and market shares. Some of these actions have been consolidated in the U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 1456*). The consolidated amended complaint in that case alleges that the defendants' acts improperly inflated the reimbursement amounts paid by various public and private plans and programs. The amended complaint alleges claims on behalf of a purported class of plaintiffs that paid any portion of the price of certain drugs, which price was calculated based on its average wholesale price, or contracted with a pharmacy benefit manager to provide others with such drugs. The Company has filed Answers to the various amended consolidated class action complaints, and has opposed, with other defendants, the plaintiffs' Motion for Leave to File a Fifth Amended Master Consolidated Class Action Complaint. Defendants in the consolidated litigation have been divided into two groups. The Company and its named subsidiaries are contained in a large group of defendants (the Track Two Defendants) that is currently awaiting a ruling on the plaintiffs' request for certification of classes of plaintiffs to maintain a class action against the drug company defendants. Certain other defendants, referred to as the Track One defendants, have proceeded on a more expedited basis. The presiding judge in the matter granted class certification with respect to certain companies and individuals in the group of Track One Defendants. A trial was held with respect to some of the claims against this group of defendants, and the judge ruled in favor of the Plaintiffs as to some defendants and awarded damages. The Track One Defendants agreed to settle some of the claims filed on behalf of one of the classes certified in that case, and one of the Track One Defendants has agreed to settle with all of the classes certified in that case. The presiding judge has ordered the Company and other Track Two Defendants to enter mediation proceedings to explore the possibility of settling some or all of the claims pending in that case. These mediation proceedings are ongoing, and the Company is participating.

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

Table of Contents

Circuit Court for Franklin County; State of Alabama v. Abbott Laboratories, Inc. et al., Civil Action No. CV05-219, Alabama Circuit Court for Montgomery County; State of Illinois v. Abbott Laboratories, Inc. et al., Civil Action No. 05-CH-02474, Illinois Circuit Court for Cook County; State of Mississippi v. Abbott Laboratories, Inc. et al., Civil Action No. G2005-2021 S/2, Mississippi Chancery Court of Hinds County; State of Florida ex rel. Ven-A-Care, Civil Action No 98-3032G, Florida Circuit Court in Leon County; State of Arizona ex rel. Terry Goddard, No. CV 2005-18711, Arizona Superior Court for Maricopa County; State of Missouri ex rel. Jeremiah W. (Jay) Nixon v. Mylan Laboratories, et al, Case no. 054-2486, Missouri Circuit Court of St. Louis. State of Alaska v. Alharma Branded Products Division Inc., et al., In the Superior Court for the State of Alaska Third Judicial District at Anchorage, C.A. No. 3AN-06-12026 CI. State of Idaho v. Alharma USPD Inc. et al., In the District Court of the Fourth Judicial District of the State of Idaho, in and for the County of Ada, C.A. No. CV-0C-0701847; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7152; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7155; State of Hawaii v. Abbott Laboratories, Inc. et al., In the Circuit Court of the First Circuit, State of Hawaii, C.A. No. 06-1-0720-04 EEH), State of Utah vs. Actavis U.S., Inc., et al., In the Third Judicial District Court of Salt Lake County, Civil No. unknown; State of Iowa v. Abbott Laboratories, Inc., et al., In the U.S. District Court for the Southern District of Iowa, Central Division, Case No. 07-CV-00461).

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

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

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

FDA Matters. In May 2002, Watson reached an agreement with the FDA on the terms of a consent decree with respect to its Corona, California manufacturing facility. The court approved the consent decree on May 13, 2002 (*United States of America v. Watson Laboratories, Inc., and Allen Y. Chao*, United States District Court for the Central District of California, EDCV-02-412-VAP). The consent decree with the FDA does not require any fine, a facility shutdown, product recalls or any reduction in production or service at the Company's Corona facility. The consent decree applies only to the Corona facility and not other manufacturing sites. The decree requires Watson to ensure that its Corona, California facility complies with the FDA's current Good Manufacturing Practices (cGMP) regulations.

Table of Contents

Pursuant to the agreement, Watson hired an independent expert to conduct inspections of the Corona facility at least once each year. In February 2003, February 2004, January 2005, January 2006 and January 2007, respectively, the first, second, third, fourth and fifth annual inspections were completed and the independent expert submitted its report of the inspection to the FDA. In each instance, the independent expert reported its opinion that, based on the findings of the audit of the facility, the FDA's applicable cGMP requirements, applicable FDA regulatory guidance, and the collective knowledge, education, qualifications and experience of the expert's auditors and reviewers, the systems at Watson's Corona facility audited and evaluated by the expert are in compliance with the FDA's cGMP regulations. However, the FDA is not required to accept or agree with the independent expert's opinion. The FDA conducted an inspection of that facility from March 31, 2004 until May 6, 2004. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection, including observations related to certain laboratory test methods and other procedures in place at the facility. In June 2004 the Company submitted its response to the FDA Form 483 inspectional observations and met with FDA officials to discuss its response, including the corrective actions the Company had taken, and intended to take, to address the inspectional observations. The FDA conducted another inspection of the facility from April 5, 2005 through April 13, 2005. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. The FDA conducted another inspection of the facility from July 9, 2006 through July 21, 2006. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. From February 20, 2007 through March 9, 2007, the FDA conducted another inspection of the facility. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection. In April 2007 the Company submitted its response to the FDA Form 483 inspectional observations, including the corrective actions the Company has taken to address the inspectional observations. The FDA conducted another inspection of the facility from October 18, 2007 through October 26, 2007. At the conclusion of the inspection, the FDA issued a Form 483 listing two observations made during the pre-approval portion of the inspection related to two pending abbreviated new drug applications. No formal observations were made concerning the Company's compliance with cGMP. However, if in the future, the FDA determines that, with respect to its Corona facility, Watson has failed to comply with the consent decree or FDA regulations, including cGMPs, or has failed to adequately address the observations in the Form 483, the consent decree allows the FDA to order Watson to take a variety of actions to remedy the deficiencies. These actions could include ceasing manufacturing and related operations at the Corona facility, and recalling affected products. Such actions, if taken by the FDA, could adversely affect the Company, its results of operations, financial position and/or cash flows.

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

Table of Contents

appeal. As of August 1, 2007, the appellate court had not ruled on the matter. On August 16, 2007, the Court of Appeals affirmed the District Court's judgment of dismissal and on October 15, 2007, the Court of Appeals denied the appellants' petition for rehearing and petition for rehearing en banc. The Company believes that it has substantial meritorious defenses and intends to defend the matters vigorously. However, these actions, if successful, could adversely affect the Company and could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

Securities Litigation Against Andrx Corporation. On October 11, 2005, Jerry Lowry filed a class action complaint on behalf of purchasers of the Andrx's common stock during the class period (March 9, 2005 through September 5, 2005) in the U.S. District Court for the Southern District of Florida against Andrx Corporation and its then Chief Executive Officer, Thomas Rice (*Jerry Lowry v. Andrx Corporation, et al.*, Case No. 05-61640). The complaint seeks damages under the Securities Exchange Act of 1934, and alleges that during the class period, Andrx failed to disclose that its manufacturing facilities were not in compliance with cGMP. The complaint further alleges that Andrx's failure to be cGMP compliant led to the FDA placing Andrx on Official Action Indicated status, which resulted in not being eligible for approvals of Andrx's Abbreviated New Drug Applications. On July 24, 2006, the defendants moved to dismiss the action. On December 8, 2006, the court granted in part and denied in part the defendants' motion to dismiss. On April 18, 2007, plaintiffs filed a motion seeking class certification. On October 2, 2007, the parties entered into an agreement in principle settling all outstanding claims. The terms of the agreement are confidential and are subject to the execution of definitive documentation and approval of the U.S. District Court for the Southern District of Florida. The settlement is not expected to materially adversely affect the Company's business, results of operations, financial condition and cash flows.

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

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

Department of Health and Human Services Subpoena. In December 2003, the Company's subsidiary, Watson Pharma, received a subpoena from the Office of the Inspector General (OIG) of the Department of Health and Human Services. The subpoena requested documents relating to physician meetings conducted during 2002 and 2003 related to Watson Pharma's Ferrlecit® intravenous iron product. Watson Pharma provided the requested documents and has not been contacted again by the OIG for several years. However, the Company cannot predict what additional actions, if any, may be taken by the OIG, Department of Health and Human Services, or other governmental entities.

Table of Contents

Hormone Replacement Therapy Litigation. Beginning in early 2004, a number of product liability suits were filed against the Company and certain Company affiliates, for personal injuries allegedly arising out of the use of hormone replacement therapy products, including but not limited to estropipate and estradiol. These complaints also name numerous other pharmaceutical companies as defendants, and allege various injuries, including ovarian cancer, breast cancer and blood clots. Approximately ninety cases are pending against Watson and/or its affiliates in state and federal courts representing claims by approximately 142 plaintiffs. Many of the cases involve multiple plaintiffs. The majority of the cases have been transferred to and consolidated in the United States District Court for the Eastern District of Arkansas (*In re: Prempro Products Liability Litigation, MDL Docket No. 1507*). Discovery in these cases is ongoing. The Company maintains product liability insurance against such claims. However, these actions, if successful, or if insurance does not provide sufficient coverage against the claims, could adversely affect the Company and could have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

Watson and its affiliates are involved in various other disputes, governmental and/or regulatory inspections, inquires, investigations and proceedings that could result in litigation, and other litigation matters that arise from time to time. For example, the Company has received Civil Investigative Demands from the Federal Trade Commission seeking information and documents related to the terms on which the Company has settled lawsuits initiated by patentees under the Hatch-Waxman Act. These investigations include the Company's August 2006 settlement with Cephalon related to the Company's generic version of Provigil (modafinil) and its September 2006 settlement with Unimed and Besins related to the Company's generic version of AndroGel (testosterone gel).

The process of resolving matters through litigation or other means is inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows.

NOTE 13 SUBSEQUENT EVENT

On November 5, 2007, the Company prepaid an additional \$75 million outstanding under the 2006 Credit Facility. As of November 5, 2007, \$325 million is outstanding under the 2006 Credit Facility.

Table of Contents

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

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

Overview

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

Acquisition of Andrx Corporation

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx Corporation (*Andrx*) in an all-cash transaction for \$25 per share, or total consideration of approximately \$1.9 billion (the *Andrx Acquisition*). Andrx distributes pharmaceutical products primarily to independent and chain pharmacies and physicians' offices through its *Anda* distribution business. In addition, the acquisition augmented our existing formulation development capability by providing technology for difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products.

In conjunction with the *Andrx Acquisition*, the Company recorded a \$497.8 million charge to operations in the year ended December 31, 2006, in accordance with Statement of Financial Accounting Standards (*SFAS*) No. 141, *Business Combinations* (*SFAS 141*), for in-process research and development (*IPR&D*) assets acquired that the Company determined had no alternative future use in their current state. The Company's valuation of *IPR&D* projects included over thirty controlled or immediate release products at various stages of research and development. These *IPR&D* projects were valued through discounted cash flow analysis utilizing the *income* approach at rates commensurate with their perceived risks, which for these *IPR&D* projects ranged between 19%-20%. A partial list of cash flow considerations utilized for each of the *IPR&D* projects included an evaluation of a project's estimated cost to complete, future product prospects and competition, product lifecycles, expected date of market introduction and expected pricing and cost structure. The major risks and uncertainties associated with the timely and successful completion of these *IPR&D* projects include delays caused by legal actions brought by the Company's competitors and the timing of the receipt of necessary regulatory approvals. No assurances can be given that the underlying assumptions used to prepare the discounted cash flow analysis will not change or the timely completion of each project to commercial success will occur. For these and other reasons, actual results may vary significantly from estimated results.

The charge for *IPR&D* in the year ended December 31, 2006 related primarily to the acquisition of the following six *IPR&D* projects:

Actos® and Extended-Release Metformin Combination Product

In December 2003, Andrx entered into an agreement with Takeda Chemical Industries, Ltd. (*Takeda*) to develop and market a combination product consisting of Andrx's approved 505(b)(2) New Drug Application (*NDA*) extended-release metformin and Takeda's *Actos®* (pioglitazone), each of which is administered once a day for the treatment of type 2 diabetes. The Company is responsible for obtaining regulatory approval of its extended-release metformin in countries that Takeda determines it will market the combination product. In addition, the Company is responsible for the formulation and manufacture of the combination product and Takeda is responsible for obtaining regulatory approval of and marketing the combination product, both in the U.S. and in certain other countries.

Table of Contents

In March 2006, Takeda filed an NDA for this combination product and the NDA is under review by the U.S. Food and Drug Administration (FDA). Final approval and launch of the product is dependent, among other things, upon favorable resolution of the Official Action Indicated (OAI) status at the Company's Davie, Florida manufacturing facility. If approved and launched, the Company is eligible to receive future milestone payments and royalties from Takeda's sale of this product.

The Company's valuation of this IPR&D project at the Andrx Acquisition date was \$133 million.

Enoxaparin Sodium (generic version of Lovenox®)

On May 2, 2005, Andrx entered into an agreement to obtain certain exclusive marketing rights for Amphastar Pharmaceuticals, Inc.'s (Amphastar's) generic version of Aventis Pharmaceuticals, Inc.'s (Aventis') Lovenox® injectable product. Amphastar submitted its Abbreviated New Drug Application (ANDA) for generic Lovenox® to the FDA in March 2003. Amphastar's ANDA is the subject of a patent infringement lawsuit filed by Aventis. Amphastar has not obtained FDA approval for its product and the product continues to be delayed by a Citizen Petition, including two supplements, and possibly other factors. Amphastar has submitted comments to Aventis' Citizen Petition and supplements. Our marketing rights for this product generally extend to the U.S. retail pharmacy market, and we will receive up to 50% of the net profits, as defined, generated from such sales.

The launch of this product is dependent upon Amphastar obtaining FDA approval.

The Company's valuation of this IPR&D project at the Andrx Acquisition date was \$33 million.

Metoprolol Succinate (generic version of Toprol-XL®)

In 2003 and 2004, Andrx filed ANDAs seeking FDA approval to market metoprolol succinate extended-release tablets in the 25mg, 50mg, 100mg and 200mg strengths. Andrx was awarded 180-days of market exclusivity for the 50mg strength. During the second quarter of this year, the Company announced that pursuant to an agreement with Sandoz, a subsidiary of Novartis AG (Sandoz), the Company relinquished its rights to a 180-day period of marketing exclusivity for its 50mg strength product. As a result of Watson's agreement to relinquish its marketing exclusivity, Sandoz obtained final approval of its ANDA for metoprolol succinate extended-release 50 mg tablets. Watson is entitled to a share of Sandoz's profits on sales of the product, which began in the third quarter of this year.

Andrx continues to pursue approval of its own pending ANDAs for metoprolol succinate extended-release tablets. Watson believes that under current FDA policy, Andrx will be barred from obtaining final approval until March 18, 2008, when AstraZeneca's pediatric study market exclusivity expires. Final approval and launch of the product is also dependent upon satisfactorily resolving certain questions from the FDA regarding the ANDAs as well as favorable resolution of the OAI status at the Company's Davie, Florida manufacturing facility.

The Company's valuation of this IPR&D project at the Andrx Acquisition date was \$85 million.

Methylphenidate Hydrochloride (generic version of Concerta®)

Andrx has pending ANDAs for the generic versions of Concerta® (methylphenidate hydrochloride extended-release tablets) in the 18mg, 27mg, 36mg and 54mg strengths.

In September 2005, ALZA Corporation and McNeil-PPC, Inc. sued Andrx for patent infringement related to the generic version of Concerta®. The ANDAs remain under review by the FDA and McNeil-PPC, Inc. has filed a Citizen Petition relating to approval criteria for Concerta® generics. Final approval and launch of the product is also dependent upon favorable resolution of the OAI status at the Company's Davie, Florida manufacturing facility and may also be subject to obtaining a waiver or expiration of a third party's 180 days of market exclusivity.

Table of Contents

The Company's valuation of this IPR&D project at the Andrx Acquisition date was \$94 million.

Omeprazole (generic version of Prilosec®)

Andrx has pending ANDAs for omeprazole delayed-release capsules, 10mg, 20mg and 40 mg strengths, which is bioequivalent to Prilosec®. In 2001, AstraZeneca filed suit against Andrx alleging infringement of a patent (patent no. 6,013,281) (the '281 patent') directed to a process for making an omeprazole formulation. Andrx filed counterclaims of non-infringement, invalidity and unenforceability. In May 2004, the district court ruled that the '281 patent was invalid due to obviousness. In April 2007, the U.S. Court of Appeals for the Federal Circuit affirmed the 2004 District Court decision that the '281 patent is invalid.

The ANDAs remain under review by the FDA. Final approval and launch of the product is dependent upon favorable resolution of the OAI status at the Company's Davie, Florida manufacturing facility. Upon approval and launch, we believe that we are entitled to the 180-day period of market exclusivity with respect to the generic version of the 40mg strength of Prilosec®.

The Company's valuation of this IPR&D project at the acquisition date was \$57 million.

Diltiazem HCl ER (Cardizem® LA)

Andrx Corporation has pending ANDAs with the FDA for generic versions of Cardizem® LA (diltiazem HCl extended-release tablets), 120mg, 180mg, 240mg, 300mg, 360mg and 420mg strengths. Andrx initially filed its ANDA for the 420mg strength on April 25, 2005, with a Paragraph IV certification and notification to the patent holder. On August 10, 2005, Biovail Laboratories International SRL (Biovail), which is the holder of the NDA for Cardizem® LA, initiated a patent infringement lawsuit against the Company for the 420mg strength in the U.S. District Court for the District of Delaware. Andrx subsequently amended its initial ANDA submission to include the 120mg, 180mg, 240mg, 300mg and 360mg strengths, along with a related Paragraph IV certification and notice letter. On October 14, 2005, Biovail initiated a patent infringement lawsuit on the remaining strengths.

The ANDAs remain under review by the FDA. Final approval and launch of the product is dependent upon favorable resolution of the OAI status at the Company's Davie, Florida manufacturing facility, satisfactorily resolving certain questions from the FDA regarding the ANDAs, and expiration or early termination of the statutory 30-month stay of approval. The Company believes that Andrx is the first ANDA applicant with a Paragraph IV certification for each of the six strengths, and accordingly may be entitled to 180 days of market exclusivity under the Hatch-Waxman Act.

The Company's valuation of this IPR&D project at the Andrx Acquisition date was \$12 million.

Restatement of 2006 Results

Prior to the Andrx Acquisition, the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders' equity, net of any related tax effect. As required by Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements (ARB 51), earnings (loss) on equity method investments has been restated for the three and nine months ended September 30, 2006 to account for our investment in common shares of Andrx using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18). Other comprehensive income has also been restated for the three and nine months ended September 30, 2006 to reflect these changes.

Table of Contents**Results of Operations**

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

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

Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006

| | Three Months Ended September 30, 2007 | | | | Three Months Ended September 30, 2006 | | |
|--|---------------------------------------|-----------|--------------|------------|---------------------------------------|-----------|------------|
| | Generic | Brand | Distribution | Total | Generic | Brand | Total |
| Product sales | \$ 326,231 | \$ 93,534 | \$ 129,875 | \$ 549,640 | \$ 347,635 | \$ 85,543 | \$ 433,178 |
| Other | 31,489 | 13,577 | | 45,066 | 5,436 | 1,879 | 7,315 |
| Net revenues | 357,720 | 107,111 | 129,875 | 594,706 | 353,071 | 87,422 | 440,493 |
| Cost of sales (1) | 210,931 | 22,089 | 113,400 | 346,420 | 234,973 | 22,923 | 257,896 |
| Gross profit | 146,789 | 85,022 | 16,475 | 248,286 | 118,098 | 64,499 | 182,597 |
| Gross margin | 41.0% | 79.4% | 12.7% | 41.7% | 33.4% | 73.8% | 41.5% |
| Research and development | 26,555 | 9,102 | | 35,657 | 18,339 | 11,108 | 29,447 |
| Selling and marketing | 14,018 | 26,613 | 12,716 | 53,347 | 12,656 | 26,447 | 39,103 |
| Contribution | \$ 106,216 | \$ 49,307 | \$ 3,759 | 159,282 | \$ 87,103 | \$ 26,944 | 114,047 |
| Contribution margin | 29.7% | 46.0% | 2.9% | 26.8% | 24.7% | 30.8% | 25.9% |
| General and administrative | | | | 59,144 | | | 25,364 |
| Amortization | | | | 44,159 | | | 39,392 |
| Net (gain) loss on asset sales and impairments | | | | (6,118) | | | |
| Operating income | | | | \$ 62,097 | | | \$ 49,291 |
| Operating margin | | | | 10.4% | | | 11.2% |

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

Generic Segment*Net Revenues*

Our generic pharmaceutical business develops, manufactures, markets, sells and distributes generic products that are the therapeutic equivalent to their brand name counterparts and are generally sold at prices significantly less than the brand product. As such, generic products provide an effective and cost-efficient alternative to brand products. When patents or other regulatory exclusivity no longer protect a brand product,

opportunities exist to

Table of Contents

introduce off-patent or generic counterparts to the brand product. Our portfolio of generic products includes products we have internally developed, products we have licensed from third parties, and products we distribute for third parties.

Other revenues consist primarily of royalties and commission revenue.

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

Net revenues from our Generic segment for the three months ended September 30, 2007 increased 1.0% or \$4.6 million to \$357.7 million compared to net revenues of \$353.1 million from the prior year period. The increase in net revenues included an increase in other revenues (\$26.1 million), revenue generated from the addition of products from the Andrx Acquisition (\$25.4 million) and an increase in net product sales from recent product launches (\$14.3 million from the second quarter launch of bupropion hydrochloride extended-release tablets and the third quarter launch of fentanyl transdermal patch) and increased business from certain existing products. This increase in net revenues was offset in part by a \$68.8 million decline in sales of certain authorized generic products including oxycodone HCl controlled-release tablets and pravastatin sodium tablets. Generic segment sales of oxycodone HCl controlled-release tablets ended in the first quarter of 2007 as the distribution agreement to sell this product terminated during the quarter.

The \$26.1 million increase in other revenues in the three months ended September 30, 2007 for the Generic segment compared to the year ago period was primarily related to commission revenues earned on sales of fentanyl citrate troche (which commenced during the third quarter of 2006), royalties earned on GlaxoSmithKline's (GSK's) sales of Wellbutrin 150mg (which royalty commenced during the first quarter of 2007) and royalties on sales by Sandoz of metoprolol succinate 50 mg extended release tablets (which commenced during the third quarter of 2007). Together these three items combined represented an increase in other revenue totaling \$24.7 million for the three months ended September 30, 2007 from the prior year period.

Gross Profit (Gross Margin)

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

Gross profit for our Generic segment increased \$28.7 million to \$146.8 million in the three months ended September 30, 2007 from \$118.1 million in the prior year period. This year over year increase in gross profit was due primarily to the \$26.1 million increase in other revenues.

Gross margins for our Generic segment increased 7.6 percentage points to 41.0% for the three months ended September 30, 2007 from 33.4% in the prior year period. In the prior year period, our Generic segment product gross margin was negatively impacted by 4.6 percentage points due to sales of oxycodone HCl and pravastatin sodium at lower gross margins. The year-over-year increase in gross margins was also due to the increase in other revenues. This increase in other revenues resulted in a 4.6 percentage point improvement in segment gross margin. New product launches (bupropion hydrochloride extended-release tablets, 300 mg and fentanyl transdermal patch) also contributed to higher gross margins for the three months ended September 30, 2007 which were offset by price erosion within the Generic segment.

Research and Development Expenses

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

Table of Contents

R&D expenses within our Generic segment for the three months ended September 30, 2007 increased 45% or \$8.2 million to \$26.6 million compared to \$18.3 million from the prior year period. This increase was due to R&D expenditures associated with our Florida-based development group acquired in connection with the Andrx Acquisition.

Selling and Marketing Expenses

Selling and marketing expenses consist mainly of personnel costs, facilities costs, insurance and professional services costs.

Selling and marketing expenses within our Generic segment for the three months ended September 30, 2007 increased 11% or \$1.4 million to \$14.0 million compared to \$12.7 million from the prior year period.

Brand Segment

Net Revenues

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

Our Specialty Products product line includes urology products such as Trelstar®, Oxytrol® and Androderm® and a number of non-promoted products.

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

Other revenues in the Brand segment consist of co-promotion revenue, royalties and revenue (including the amortization of deferred revenue) relating to our obligation to manufacture and supply brand products to third parties.

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

Net revenues from our Brand segment for the three months ended September 30, 2007 increased 23% or \$19.7 million to \$107.1 million compared to net revenues of \$87.4 million from the prior year period. The increase in net revenues was attributable to product sales, royalties and deferred revenue related to a contract manufacturing agreement assumed in connection with the Andrx Acquisition (\$8.5 million) and our share of profits on the AndroGel® co-promotion agreement (\$5.4 million), which commenced in the fourth quarter of 2006. Brand segment product sales also increased for certain products within our Specialty Products product line from the prior year period as the prior year period was negatively impacted by a reduction in wholesaler inventory levels.

Gross Profit (Gross Margin)

Gross profit from our Brand segment increased 32% or \$20.5 million in the current year period to \$85.0 million from \$64.5 million in the year ago period. The year-over-year increase in gross profit was primarily the result of the addition of AndroGel® co-promotional other revenue in the current year period (\$5.4 million), lower production costs (\$10.0 million) due primarily to the sale of our Phoenix facility and higher sales of certain Specialty Products as the prior year period was impacted by a reduction in wholesaler inventory levels.

Table of Contents

Gross margins for our Brand segment increased 5.6 percentage points to 79.4% for the three months ended September 30, 2007 from 73.8% in the prior year period. The increase in gross margins is primarily due to an increase in other revenue (2.5 percentage points) and lower production costs due primarily to the sale of our Phoenix facility.

Research and Development Expenses

R&D expenses within our Brand segment decreased 18% or \$2.0 million to \$9.1 million compared to \$11.1 million from the prior year period primarily due to decreased costs related to Phase III studies on the gel formulation of oxybutynin for overactive bladder as these studies near completion.

*Distribution Segment**Net Revenues*

Our Distribution segment consists primarily of sales of generic pharmaceutical products sourced from third parties. Customers include independent pharmacies, pharmacy chains, pharmacy buying groups and physicians' offices. Our Distribution segment results do not include sales of Generic and Brand products manufactured or licensed by us and sold to third parties through our distribution operations. These sales are reflected in our Generic or Brand segment. As we acquired our Distribution segment as part of the Andrx Acquisition in November, 2006, there are no comparatives for the prior year period.

Segment Contribution

| (\$ in thousands): | Three Months Ended September 30, | | Change | |
|----------------------|----------------------------------|------------|-----------|--------|
| | 2007 | 2006 | Dollars | % |
| Segment contribution | | | | |
| Generic | \$ 106,216 | \$ 87,103 | \$ 19,113 | 21.9% |
| Brand | 49,307 | 26,944 | 22,363 | 83.0% |
| Distribution | 3,759 | | 3,759 | 100.0% |
| | \$ 159,282 | \$ 114,047 | \$ 45,235 | 39.7% |

as % of net revenues

26.8% 25.9%

Generic segment contribution increased for the three months ended September 30, 2007, as compared to the same period of the prior year, due to higher other revenues partially offset by higher R&D costs as a result of our Andrx Acquisition.

Brand segment contribution increased for the three months ended September 30, 2007, as compared to the same period of the prior year, primarily due to an increase in other revenues and a decrease in manufacturing costs as compared to the prior year period.

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

Table of Contents**Corporate General and Administrative Expenses**

| (\$ in thousands): | Three Months Ended September 30, | | Change | |
|---|----------------------------------|-----------|-----------|--------|
| | 2007 | 2006 | Dollars | % |
| Corporate general and administrative expenses | \$ 59,144 | \$ 25,364 | \$ 33,780 | 133.2% |
| <i>as a % of net revenues</i> | 9.9% | 5.8% | | |

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

Corporate general and administrative expenses increased 133% or \$33.8 million to \$59.1 million compared to \$25.4 million from the prior year period due primarily to the inclusion of corporate general and administrative costs related to the Andrx Acquisition (\$12.6 million), severance costs incurred in the current period (\$4.5 million) and higher litigation costs (\$14.3 million) relating to various litigation matters.

Amortization

| (\$ in thousands): | Three Months Ended September 30, | | Change | |
|-------------------------------|----------------------------------|-----------|----------|-------|
| | 2007 | 2006 | Dollars | % |
| Amortization | \$ 44,159 | \$ 39,392 | \$ 4,767 | 12.1% |
| <i>as a % of net revenues</i> | 7.4% | 8.9% | | |

The Company's amortizable assets consist primarily of acquired product rights. For the three months ended September 30, 2007 amortization expense includes charges related to intangible assets from the Andrx Acquisition.

Net (Gain) Loss on Asset Sales and Impairments

| (\$ in thousands): | Three Months Ended September 30, | | Change | |
|--|----------------------------------|------|------------|--------|
| | 2007 | 2006 | Dollars | % |
| Net (gain) loss on asset sales and impairments | \$ (6,118) | \$ | \$ (6,118) | 100.0% |
| <i>as a % of net revenues</i> | (1.0)% | 0.0% | | |

For the three months ended September 30, 2007, we recorded a gain on sale of our Phoenix facility in the amount of \$10.6 million and also recorded an additional impairment of our Puerto Rico facility in the amount of \$4.5 million.

The Company received cash consideration of \$13.5 million from the sale of our Phoenix facility. The carrying amount of net assets included in the Phoenix sale was \$1.5 million and transaction and other costs of disposal were \$1.4 million.

During the third quarter of 2007, the Company recognized an additional impairment of its solid dosage manufacturing facility in Puerto Rico. Fair value of \$2.0 million was based on discussions with potential buyers of the property and market values for comparable properties.

Table of Contents**Interest Income**

| (\$ in thousands): | Three Months Ended September 30, | | Change | |
|-------------------------------|----------------------------------|-------------|------------|---------|
| | 2007 | 2006 | Dollars | % |
| Interest income | \$ 1,964 | \$ 9,601 | \$ (7,637) | (79.5)% |
| <i>as a % of net revenues</i> | <i>0.3%</i> | <i>2.2%</i> | | |

Interest income decreased during the three months ended September 30, 2007, as compared to the prior year period due to the use of available cash, cash equivalents and marketable securities to finance the Andrx Acquisition.

Interest Expense

| (\$ in thousands): | Three Months Ended September 30, | | Change | |
|--|----------------------------------|-------------|----------|--------|
| | 2007 | 2006 | Dollars | % |
| Interest expense - 2006 Credit Facility | \$ 6,889 | \$ 3,151 | \$ 6,889 | |
| Interest expense - convertible contingent senior debentures due 2023 (CODES) | 3,151 | 3,151 | | |
| Interest and fees on credit facility | | 248 | (248) | |
| Change in derivative value | (103) | 81 | (184) | |
| Interest expense - other | 188 | 334 | (146) | |
| | \$ 10,125 | \$ 3,814 | \$ 6,311 | 165.5% |
| <i>as a % of net revenues</i> | <i>1.7%</i> | <i>0.9%</i> | | |

Interest expense increased for the three months ended September 30, 2007 due to interest expense incurred on borrowings used to finance the Andrx Acquisition.

Other Income (Expense)

| (\$ in thousands): | Three Months Ended September 30, | | Change | |
|--|----------------------------------|---------------|----------|----------|
| | 2007 | 2006 | Dollars | % |
| Earnings on equity method investments - restated | \$ 1,686 | \$ 203 | \$ 1,483 | |
| Other income (expense) | (237) | (428) | 191 | |
| | \$ 1,449 | \$ (225) | \$ 1,674 | (744.0)% |
| <i>as a % of net revenues</i> | <i>0.2%</i> | <i>(0.1)%</i> | | |
| <i>Earnings on Equity Method Investments</i> | | | | |

The Company's equity investments are accounted for under the equity method when the Company's ownership does not exceed 50% and when the Company can exert significant influence over the management of the investee. As required by ARB 51, earnings (losses) on equity method investments have been restated for the three months ended September 30, 2006 to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with APB 18.

The earnings recorded during the three months ended September 30, 2007 primarily represent our share of earnings in Scinopharm Taiwan Ltd. (Scinopharm).

Table of Contents**Provision for Income Taxes**

| (\$ in thousands): | Three Months Ended September 30, | | % Change |
|----------------------------|----------------------------------|-----------|----------|
| | 2007 | 2006 | |
| Provision for income taxes | \$ 20,779 | \$ 20,460 | |
| as a % of net revenues | 3.5% | 4.6% | |
| Effective tax rate | 37.5% | 37.3% | 0.2% |

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

Results of Operations**Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006**

| | Nine Months Ended September 30, 2007 | | | | Nine Months Ended September 30, 2006 | | |
|--|--------------------------------------|------------|--------------|--------------|--------------------------------------|------------|--------------|
| | Generic | Brand | Distribution | Total | Generic | Brand | Total |
| Product sales | \$ 1,065,152 | \$ 281,096 | \$ 421,946 | \$ 1,768,194 | \$ 1,088,491 | \$ 256,831 | \$ 1,345,322 |
| Other | 62,834 | 38,288 | | 101,122 | 7,101 | 5,659 | 12,760 |
| Net revenues | 1,127,986 | 319,384 | 421,946 | 1,869,316 | 1,095,592 | 262,490 | 1,358,082 |
| Cost of sales (1) | 693,896 | 74,099 | 363,583 | 1,131,578 | 758,921 | 64,589 | 823,510 |
| Gross profit | 434,090 | 245,285 | 58,363 | 737,738 | 336,671 | 197,901 | 534,572 |
| Gross margin | 38.5% | 76.8% | 13.8% | 39.5% | 30.7% | 75.4% | 39.4% |
| Research and development | 77,036 | 31,932 | | 108,968 | 56,958 | 33,451 | 90,409 |
| Selling and marketing | 41,764 | 79,397 | 39,246 | 160,407 | 39,120 | 85,187 | 124,307 |
| Contribution | \$ 315,290 | \$ 133,956 | \$ 19,117 | 468,363 | \$ 240,593 | \$ 79,263 | 319,856 |
| Contribution margin | 28.0% | 41.9% | 4.5% | 25.1% | 22.0% | 30.2% | 23.6% |
| General and administrative | | | | 152,460 | | | 77,684 |
| Amortization | | | | 132,251 | | | 121,593 |
| Net (gain) loss on asset sales and impairments | | | | (6,118) | | | 66,981 |
| Operating income | | | | \$ 189,770 | | | \$ 53,598 |
| Operating margin | | | | 10.2% | | | 3.9% |

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

Generic Segment**Net Revenues**

Net revenues from our Generic segment for the nine months ended September 30, 2007 increased 3% or \$32.4 million to \$1,128.0 million compared to net revenues of \$1,095.6 million from the prior year period. The increase in net revenues was attributable to an increase in other revenue (\$55.7 million), revenue generated from the addition of products from the Andrx Acquisition (\$83.7 million) and an increase in net product sales from recent product launches (\$29.2 million from the third quarter 2006 launch of Quasense™, the second quarter 2007 launch of bupropion hydrochloride extended-release tablets and the third quarter 2007 launch of fentanyl transdermal patch). This increase in net revenues was offset in part by a decline in sales of certain authorized generic products including oxycodone HCl controlled-release tablets and pravastatin

Edgar Filing: WATSON PHARMACEUTICALS INC - Form 10-Q

sodium tablets (\$118.0 million). The decline in sales of oxycodone HCl controlled-release tablets was due to the termination of the distribution agreement in the first quarter of 2007.

Table of Contents

The \$55.7 million increase in other revenues for the nine months ended September 30, 2007 compared to the year ago period was primarily related to commission revenues earned on sales of fentanyl citrate troche, royalties earned on GSK's sales of Wellbutrin XL® 150mg and royalties on sales by Sandoz of metoprolol succinate 50 mg extended release tablets. Together these three items combined represented an increase in other revenue totaling \$50.3 million for the nine months ended September 30, 2007 from the prior year period.

Gross Profit (Gross Margin)

Gross profit for our Generic segment increased \$97.4 million to \$434.1 million in the nine months ended September 30, 2007 from \$336.7 million in the prior year period. This year-over-year increase in gross profit was due to the following factors:

Other revenue increased \$55.7 million primarily as a result of commission revenue earned from the sale of fentanyl citrate troche, royalties earned in connection with the licensing of a patent to GSK and royalties on sales by Sandoz of metoprolol succinate 50 mg extended release tablets.

Gross profit from new product launches including Quasense™, bupropion hydrochloride extended-release tablets 300 mg and fentanyl transdermal patch contributed \$19.3 million to the increase in Generic segment gross profit.

Production cost improvements and facility closures also contributed to the year-over-year gross profit increase.

Gross margins for our Generic segment increased 7.8 percentage points to 38.5% for the nine months ended September 30, 2007 from 30.7% in the prior year period. The increase in gross margins is primarily due to an increase in other revenue (3.2 percentage points) and higher gross margins for oxycodone HCl and pravastatin sodium in the current year period. Gross margins were negatively impacted by 5.5 percentage points in the prior year period and 1.7 percentage points in the current year period due to the inclusion of these authorized generic products.

Research and Development Expenses

R&D expenses within our Generic segment increased 35% or \$20.1 million to \$77.0 million compared to \$57.0 million from the prior year period, due to the inclusion of R&D expenditures from the Andrx Acquisition.

Selling and Marketing Expenses

Generic segment selling and marketing expenses increased slightly during the nine months ended September 30, 2007 as compared to the same period of the prior year.

Brand Segment

Net Revenues

Net revenues from our Brand segment for the nine months ended September 30, 2007 increased 22% or \$56.9 million to \$319.4 million compared to net revenues of \$262.5 million from the prior year period. The increase in net revenues was attributable to product sales, royalties and deferred revenues recognized from a contract manufacturing agreement assumed from the Andrx Acquisition (\$21.3 million) and our share of profits on the AndroGel® co-promotion agreement (\$17.1 million). Brand segment product sales also increased for certain products within our Specialty Products product line from the prior year period as the prior year period was impacted by a reduction in wholesaler inventory levels.

Table of Contents*Gross Profit*

Gross profit from our Brand segment increased 24% or \$47.4 million in the nine months ended September 30, 2007 to \$245.3 million compared to \$197.9 million in the year ago period. The year-over-year increase in gross profit was primarily the result of an increase in other revenues (\$32.6 million), including the addition of Androgel® co-promotional revenue in the current year period (\$17.1 million) and the addition of royalties and deferred revenue (\$15.1 million) related to a contract manufacturing agreement assumed in connection with the Andrx Acquisition. Higher sales of certain Specialty Products also contributed to higher gross profit in the current year period as the prior year period was negatively impacted by a reduction in wholesaler inventory levels.

Research and Development Expenses

R&D expenses within our Brand segment in the nine months ended September 30, 2007 decreased 5% or \$1.5 million to \$31.9 million compared to \$33.5 million from the prior year period primarily due to decreased costs in the second and third quarters of 2007 related to Phase III studies on the gel formulation of oxybutynin for overactive bladder as these studies near completion.

Selling and Marketing Expenses

Brand segment selling and marketing expenses in the nine months ended September 30, 2007 decreased 7% or \$5.8 million to \$79.4 million compared to \$85.2 million from the prior year period primarily due to lower field sales force costs (\$3.7 million) and lower product spending for Oxytrol®, Trelstar® and Ferrlecit® during the current period (\$1.9 million).

Distribution Segment

Net revenues of our Distribution segment consists primarily of sales of generic pharmaceutical products sourced from third parties. Customers include independent pharmacies, pharmacy chains, pharmacy buying groups and physicians' offices. Our Distribution segment results do not include sales of generic and brand products manufactured or licensed by Watson and sold to third parties through our distribution operations. These sales are reflected in our generic or brand segment. As we acquired our Distribution segment as part of the Andrx Acquisition in November, 2006, there are no comparatives for the prior year period.

Segment Contribution

| (\$ in thousands): | Nine Months Ended September 30, | | Change | |
|----------------------|---------------------------------|------------|------------|--------|
| | 2007 | 2006 | Dollars | % |
| Segment contribution | | | | |
| Generic | \$ 315,290 | \$ 240,593 | \$ 74,697 | 31.0% |
| Brand | 133,956 | 79,263 | 54,693 | 69.0% |
| Distribution | 19,117 | | 19,117 | 100.0% |
| | \$ 468,363 | \$ 319,856 | \$ 148,507 | 46.4% |

as % of net revenues

25.1% 23.6%

Generic segment contribution increased for the nine months ended September 30, 2007, as compared to the same period of the prior year, due to new product launches in the current year period, higher levels of other revenues and gross profit partially offset by higher R&D costs as a result of the Andrx Acquisition.

Brand segment contribution increased for the nine months ended September 30, 2007, as compared to the same period of the prior year, primarily due to an increase in other revenues and an increase in net product revenues related to certain products within our Specialty Products product line as well as lower selling and marketing expenses.

Table of Contents

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

Corporate General and Administrative Expenses

| (\$ in thousands): | Nine Months Ended September 30, | | Change | |
|---|---------------------------------|-----------|-----------|-------|
| | 2007 | 2006 | Dollars | % |
| Corporate general and administrative expenses | \$ 152,460 | \$ 77,684 | \$ 74,776 | 96.3% |
| as a % of net revenues | 8.2% | 5.7% | | |

Corporate general and administrative expenses in the nine months ended September 30, 2007 increased 96% or \$74.8 million to \$152.5 million compared to \$77.7 million from the prior year period primarily due to the inclusion of corporate general and administrative costs related to the Andrx Acquisition (\$40.9 million), higher litigation costs (\$20.6 million) relating to various matters, higher acquisition and integration costs (\$6.6 million) and severance costs incurred in the current period (\$4.5 million).

Amortization

| (\$ in thousands): | Nine Months Ended September 30, | | Change | |
|------------------------|---------------------------------|------------|-----------|------|
| | 2007 | 2006 | Dollars | % |
| Amortization | \$ 132,251 | \$ 121,593 | \$ 10,658 | 8.8% |
| as a % of net revenues | 7.1% | 9.0% | | |

The Company's amortizable assets consist primarily of acquired product rights. For the nine months ended September 30, 2007 amortization expense includes charges related to intangible assets from the Andrx Acquisition.

Net (Gain) Loss on Asset Sales and Impairments

| (\$ in thousands): | Nine Months Ended September 30, | | Change | |
|---|---------------------------------|-----------|-------------|----------|
| | 2007 | 2006 | Dollars | % |
| Net (gains) loss on asset sales and impairments | \$ (6,118) | \$ 66,981 | \$ (73,099) | (109.1)% |
| as a % of net revenues | (0.3)% | 4.9% | | |

For the nine months ended September 30, 2007, we recorded a gain on sale of our Phoenix facility in the amount of \$10.6 million and also recorded an additional impairment of our Puerto Rico facility in the amount of \$4.5 million.

The Company received cash consideration of \$13.5 million from the sale of our Phoenix facility. The carrying amount of net assets included in the Phoenix sale was \$1.5 million and transaction and other costs of disposal were \$1.4 million.

During the third quarter of 2007, the Company recognized an additional impairment of its solid dosage manufacturing facility in Puerto Rico. Fair value of \$2.0 million was based on discussions with potential buyers of the property and market values for comparable properties.

Table of Contents

During the nine months ended September 30, 2006, the Company recognized a \$67.0 million loss on impairment of product rights resulting from a downward revision of long range product sales predominantly relating to Alora® and Actigall®.

Loss on Early Extinguishment of Debt

| (\$ in thousands): | Nine Months Ended September 30, | | Change | |
|--------------------------------------|---------------------------------|-------------|----------|--------|
| | 2007 | 2006 | Dollars | % |
| Loss on early extinguishment of debt | \$ 4,410 | \$ 525 | \$ 3,885 | 740.0% |
| <i>as a % of net revenues</i> | <i>0.2%</i> | <i>0.0%</i> | | |

During the nine months ended September 30, 2007, the Company pre-paid \$250 million of the Term Facility under the terms of the 2006 Credit Facility. As a result of this pre-payment, our results for the nine months ended September 30, 2007 reflect a \$4.4 million debt repurchase charge.

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

Interest Income

| (\$ in thousands): | Nine Months Ended September 30, | | Change | |
|-------------------------------|---------------------------------|-------------|-------------|---------|
| | 2007 | 2006 | Dollars | % |
| Interest income | \$ 6,696 | \$ 22,766 | \$ (16,070) | (70.6)% |
| <i>as a % of net revenues</i> | <i>0.4%</i> | <i>1.7%</i> | | |

Interest income decreased during the nine months ended September 30, 2007, as compared to the prior year period due to the use of available cash, cash equivalents and marketable securities to finance the Andrx Acquisition.

Interest Expense

| (\$ in thousands): | Nine Months Ended September 30, | | Change | % |
|---|---------------------------------|-----------|-----------|--------|
| | 2007 | 2006 | | |
| Interest expense - 2006 Credit Facility | \$ 25,339 | \$ 9,453 | \$ 25,339 | |
| Interest expense - CODES | 9,453 | 9,453 | | |
| Interest expense - 1998 Senior Notes | | 406 | (406) | |
| Interest and fees on credit facility | | 744 | (744) | |
| Change in derivative value | 15 | (651) | 666 | |
| Interest expense - other | 669 | 485 | 184 | |
| | \$ 35,476 | \$ 10,437 | \$ 25,039 | 239.9% |

as a % of net revenues *1.9%* *0.8%*

Interest expense increased for the nine months ended September 30, 2007 due to interest expense incurred on borrowings used to finance the Andrx Acquisition.

Table of Contents**Other Income (Expense)**

| (\$ in thousands): | Nine Months Ended September 30, | | Change | % |
|--|---------------------------------|-------------|----------|-------|
| | 2007 | 2006 | | |
| Earnings on equity method investments restated | \$ 5,409 | \$ 1,576 | \$ 3,833 | |
| Gain on sale of securities | 2,472 | 3,695 | (1,223) | |
| Other income (expense) | 5 | (420) | 425 | |
| | \$ 7,886 | \$ 4,851 | \$ 3,035 | 62.6% |
| <i>as a % of net revenues</i> | <i>0.4%</i> | <i>0.4%</i> | | |
| <i>Earnings on Equity Method Investments</i> | | | | |

The earnings recorded during the nine months ended September 30, 2007 primarily represent our share of earnings in Somerset Pharmaceuticals, Inc. (Somerset), our joint venture with Mylan Laboratories, Inc.

Gain on Sale of Securities

The 2006 and 2007 gain on sale of securities resulted from the sale of our investment in Adheris, Inc. to inVentiv Health, Inc. During the nine months ended September 30, 2006, we received cash proceeds of \$4.7 million and certain contingent consideration from our sale of our investment in Adheris, Inc. During the nine months ended September 30, 2007, all contingencies were removed relating to the contingent consideration received on the sale of our investment in Adheris, Inc. Accordingly, the Company received cash and common shares of inVentiv Health, Inc. during the period as additional proceeds on our sale of our investment in Adheris, Inc., resulting in a gain on sale of securities.

Provision for Income Taxes

| (\$ in thousands): | Nine Months Ended September 30, | | Change | |
|-------------------------------|---------------------------------|--------------|-----------|--------|
| | 2007 | 2006 | Dollars | % |
| Provision for income taxes | \$ 61,839 | \$ 26,297 | \$ 35,542 | 135.2% |
| <i>as a % of net revenues</i> | <i>3.3%</i> | <i>1.9%</i> | | |
| <i>Effective tax rate</i> | <i>37.6%</i> | <i>37.4%</i> | | |

The provision for income taxes increased in the nine months ended September 30, 2007 due to higher levels of income before income taxes.

Table of Contents**Liquidity and Capital Resources****Working Capital Position**

Working capital at September 30, 2007 and December 31, 2006 is summarized as follows:

| (\$ in thousands): | September 30, 2007 | December 31, 2006 | Increase (Decrease) |
|--|-----------------------|----------------------|------------------------|
| Current Assets: | | | |
| Cash and cash equivalents | \$ 133,348 | \$ 154,171 | \$ (20,823) |
| Marketable securities | 11,721 | 6,649 | 5,072 |
| Accounts receivable, net of allowances | 275,840 | 384,692 | (108,852) |
| Inventories | 524,107 | 517,236 | 6,871 |
| Other | 178,985 | 198,928 | (19,943) |
| Total current assets | 1,124,001 | 1,261,676 | (137,675) |
| Current liabilities: | | | |
| Accounts payable and accrued expenses | 371,431 | 516,875 | (145,444) |
| Current portion of long-term debt | 6,587 | 107,059 | (100,472) |
| Other | 16,925 | 65,995 | (49,070) |
| Total current liabilities | 394,943 | 689,929 | (294,986) |
| Working Capital | \$ 729,058 | \$ 571,747 | \$ 157,311 |
| Current Ratio | 2.85 | 1.83 | |

Watson's primary source of liquidity is cash from operations. Net working capital at September 30, 2007 was \$729.1 million compared to \$571.7 million at December 31, 2006 and \$1.26 billion at September 30, 2006.

During the nine months ended September 30, 2007, our working capital increased by \$157.3 million primarily due to net cash provided by operating activities. The decrease in accounts receivable at September 30, 2007 was due primarily to reduced levels of generic sales during the third quarter of 2007 compared to the fourth quarter of 2006 as well as improved collections due to favorable changes in terms. Accounts payable and accrued liabilities decreased during the period due primarily to payments of trade payables (\$53.3 million), accrued royalties (\$45.7 million), accrued severance and retention (\$14.4 million) and accrued Medicaid rebates (\$7.1 million). Current portion of long-term debt decreased at September 30, 2007 as we pre-paid \$250 million of debt incurred to finance the Andrx Acquisition. Other current liabilities decreased \$49.1 million primarily due to a reclassification of \$46.7 million of income tax payable from current to long term as a result of the implementation of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48).

We expect that 2007 cash flows from operating activities will continue to exceed net income. In addition, management expects that cash flows from operating activities and available cash balances will be sufficient to fund our operating liquidity needs over the next 12 months.

Cash Flows from Operations

Net cash flows from operating activities are summarized as follows:

| (\$ in thousands): | Nine months ended September 30, | |
|---|---------------------------------|------------|
| | 2007 | 2006 |
| Net cash provided by operating activities | \$ 255,725 | \$ 337,767 |

Table of Contents

Net cash flows provided by operating activities represents net income adjusted for certain operating-related non-cash items and changes in assets and liabilities. For the nine months ended September 30, 2007, net cash provided by operating activities was \$255.7 million, compared to \$337.8 million in the nine months ended September 30, 2006. Net cash provided by operating activities was higher in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2007 primarily due to higher reductions in accounts payable and accrued liabilities during 2007 which were partially offset by higher reductions in accounts receivable balances during 2007 and higher net income during 2007.

Investing Cash Flows

Net cash flows used in investing activities are summarized as follows:

| (\$ in thousands): | Nine months ended September 30, | |
|---------------------------------------|---------------------------------|-----------|
| | 2007 | 2006 |
| Net cash used in investing activities | \$ 38,757 | \$ 58,998 |

Investing cash flows consist of expenditures related to acquisitions, capital expenditures, investment and marketable security additions as well as proceeds from investment and marketable security sales. We used \$38.8 million in net cash for investing activities during the nine months ended September 30, 2007 compared to \$59.0 million used in investing activities during the nine months ended September 30, 2006. The higher net cash used in investing activities during the nine months ended September 30, 2006 reflected our \$29.7 million acquisition of Sekhsaria Chemicals Ltd. during 2006. During the nine months ended September 30, 2007, we incurred higher capital expenditures on property and equipment (\$49.8 million) than the comparable period in 2006 (\$25.5 million).

Financing Cash Flows

Net cash flows used in financing activities are summarized as follows:

| (\$ in thousands): | Nine months ended September 30, | |
|---------------------------------------|---------------------------------|-----------|
| | 2007 | 2006 |
| Net cash used in financing activities | \$ 237,791 | \$ 10,998 |

Financing cash flows consist primarily of borrowings and repayments of debt and proceeds from the exercise of stock options. For the nine months ended September 30, 2007, net cash used in financing activities was \$237.8 million compared to \$11.0 million during the nine months ended September 30, 2006. As indicated above we pre-paid \$250 million of debt originally incurred to finance the Andrx Acquisition during the nine months ended September 30, 2007.

Table of Contents**Debt and Borrowing Capacity**

Our debt at September 30, 2007 and December 31, 2006 is summarized as follows:

| (\$ in thousands): | September 30, 2007 | December 31, 2006 | Increase (Decrease) |
|-----------------------------------|-----------------------|----------------------|------------------------|
| Current portion of long-term debt | \$ 6,587 | \$ 107,059 | \$ (100,472) |
| Long-term debt | 974,342 | 1,124,145 | (149,803) |
| Total debt | \$ 980,929 | \$ 1,231,204 | \$ (250,275) |

| | | |
|-----------------------|-------|-------|
| Debt to capital ratio | 35.2% | 42.3% |
|-----------------------|-------|-------|

In March 2003, we issued \$575 million of our CODES. As of September 30, 2007, the entire amount of the CODES remained outstanding at an effective annual interest rate of approximately 2.1%.

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

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

The 2006 Credit Facility has a five-year term and will bear interest equal to LIBOR plus 0.75% (subject to certain adjustments). The indebtedness under the 2006 Credit Facility is guaranteed by Watson's material domestic subsidiaries. The Revolving Facility is available for working capital and other general corporate requirements subject to the satisfaction of certain conditions. Indebtedness under the 2006 Credit Facility may be pre-payable, and commitments reduced at the election of Watson without premium (subject to certain conditions). As of September 30, 2007, the Company had not drawn any funds from the Revolving Facility.

During the quarter ended September 30, 2007, the Company entered into an interest rate swap derivative to convert floating-rate debt to fixed-rate debt on a notional amount of \$200 million of the 2006 Credit Facility. The interest rate swap instruments involve agreements to receive a floating rate based on LIBOR and pay a fixed rate of 4.79%, at specified intervals, calculated on the agreed-upon notional amount. The differentials paid or received on interest rate swap agreements are recognized as adjustments to interest expense in the period. These interest swap agreements are set to expire in January of 2009. For additional information on our interest rate swap derivatives, refer to NOTE 1 GENERAL.

During the nine months ended September 30, 2007, the Company prepaid \$250 million of the amount outstanding under the Term Facility. As of September 30, 2007, \$400 million is outstanding under the Term Facility. As a result of this pre-payment, our results for the nine months ended September 30, 2007 reflect a \$4.4 million non-cash charge for debt repurchase charges.

Under the terms of the 2006 Credit Facility, each of our subsidiaries, other than minor subsidiaries, entered into a full and unconditional guarantee on a joint and several basis. We are subject to, and, as of September 30, 2007, were in compliance with financial and operation covenants under the terms of the 2006 Credit Facility. The agreement currently contains the following financial covenants:

maintenance of a minimum net worth of at least \$1.37 billion;

maintenance of a maximum leverage ratio not greater than 3.25 to 1.0; and

maintenance of a minimum interest coverage ratio of at least 5.0 to 1.0.

Table of Contents

At September 30, 2007, our net worth was \$1.81 billion, and our leverage ratio was 1.89 to 1.0. Our interest coverage ratio for the trailing twelve months ended September 30, 2007 was 10.4 to 1.0.

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

Long-term Obligations

At September 30, 2007, there have been no material changes in the Company's significant contractual obligations and commitments from those disclosed in our Quarterly Report on Form 10-Q for the period ended June 30, 2007.

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

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

Recent accounting pronouncements

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

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, (SFAS 159) which is effective for fiscal years beginning after November 15, 2007. SFAS 159 permits an entity to choose to measure many financial instruments and certain other items beginning at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The Company is currently reviewing SFAS 159 and has not yet determined the impact, if any, on its consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

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

Table of Contents

Investment Risk

As of September 30, 2007, our total holdings in equity securities of other companies, including equity-method investments and available-for-sale securities, were \$52.6 million. Of this amount, we had equity-method investments of \$49.4 million and publicly traded equity securities (available-for-sale securities) at fair value totaling \$3.0 million (\$2.6 million that was included in Marketable securities and \$0.4 million that was included in Investments and other assets). The fair values of these investments are subject to significant fluctuations due to volatility of the stock market and changes in general economic conditions. Based on the fair value of the publicly traded equity securities we held at September 30, 2007, an assumed 25%, 40% and 50% adverse change in the market prices of these securities would result in a corresponding decline in total fair value of approximately \$0.7 million, \$1.2 million and \$1.5 million, respectively.

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

Interest Rate Risk

Our exposure to interest rate risk relates primarily to our non-equity investment portfolio and our floating rate debt. Our cash is invested in A-rated money market mutual funds, short-term commercial paper and short-term certificates of deposit. Consequently, our interest rate and principal risk are minimal on our non-equity investment portfolio.

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

Based on quoted market rates of interest and maturity schedules for similar debt issues, we estimate that the fair values of our CODES, our 2006 Credit Facility and our other notes payable approximated their carrying values on September 30, 2007. While changes in market interest rates may affect the fair value of our fixed-rate debt, we believe the effect, if any, of reasonably possible near-term changes in the fair value of such debt on our financial condition, results of operations or cash flows will not be material.

During the quarter ended September 30, 2007, the Company entered into an interest rate swap derivative to convert floating-rate debt to fixed rate debt on a notional amount of \$200 million. The interest rate swap instruments involve agreements to receive a floating rate and pay a fixed rate, at specified intervals, calculated on the agreed-upon notional amount. The differentials paid or received on interest rate swap agreements are recognized as adjustments to interest expense in the period. These interest swap agreements are set to expire in January 2009. For additional information on our interest rate swap derivatives, refer to NOTE 1 GENERAL in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

At this time, we have no material foreign exchange or commodity price risks.

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

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission's (SEC's) rules and forms, and that such information is accumulated and communicated to the Company's management, including its Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its

Table of Contents

judgment in evaluating the cost-benefit relationship of possible controls and procedures. Also, the Company has investments in certain unconsolidated entities. As the Company does not control or manage these entities, its disclosure controls and procedures with respect to such entities are necessarily substantially more limited than those it maintains with respect to its consolidated subsidiaries.

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

There have been no changes in the Company's internal control over financial reporting, during the three months ended September 30, 2007, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION AND SIGNATURES

ITEM 1. LEGAL PROCEEDINGS

For information regarding legal proceedings, refer to PART I, ITEM 3. LEGAL PROCEEDINGS, of our Annual Report on Form 10-K for the year ended December 31, 2006 and *Legal Matters* in NOTE 12 CONTINGENCIES in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the risk factors previously disclosed in Item 1A. to Part 1 of our Annual Report on Form 10-K for the year ended December 31, 2006. There were no material changes from these risk factors during the nine months ended September 30, 2007.

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

(a) Recent Sales of Unregistered Securities

There were no unregistered sales of equity securities.

(b) Use of Proceeds

N/A.

(c) Issuer Purchases of Equity Securities

During the quarter ended September 30, 2007, the Company repurchased 55,400 shares surrendered to the Company to satisfy tax withholding obligations in connection with the vesting of restricted stock issued to employees for total consideration of \$1.7 million or an average of \$31.25 per share.

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

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

ITEM 6. EXHIBITS

(a) Exhibits:

Reference is hereby made to the Exhibit Index on page 46.

Table of Contents

SIGNATURES

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

WATSON PHARMACEUTICALS, INC.
(Registrant)

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

Date: November 6, 2007

Table of Contents

WATSON PHARMACEUTICALS, INC.

EXHIBIT INDEX TO FORM 10-Q

For the Quarterly Period Ended September 30, 2007

| Exhibit No. | Description |
|--------------------|--|
| 10.1 | Second Amendment to Key Employee Agreement with Allen Chao, Ph.D., dated August 1, 2007, is incorporated by reference to Exhibit 10.1 to the Company's August 1, 2007 Form 8-K. |
| 10.2 | Key Employee Agreement between Watson Pharmaceuticals, Inc. and Paul M. Bisaro, dated as of August 1, 2007, is incorporated by reference to Exhibit 10.2 to the Company's August 1, 2007 Form 8-K. |
| 31.1 | Certification of President and Chief Executive Officer pursuant to Rule 13a-14a of the Securities Exchange Act of 1934. |
| 31.2 | Certification of Principal Financial Officer pursuant to Rule 13a-14a of the Securities Exchange Act of 1934. |
| 32.1 | Certification of President and Chief Executive Officer pursuant to Rule 13a-14(d) of the Securities Exchange Act of 1934. |
| 32.2 | Certification of Principal Financial Officer pursuant to Rule 13a-14(d) of the Securities Exchange Act of 1934. |