WATSON PHARMACEUTICALS INC
Form 10-Q
August 09, 2006

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 JUNE 30, 2006

or

o 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	**95-3872914**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

311 Bonnie Circle
Corona, CA 92880-2882
(Address of principal executive offices, including zip code)

(951) 493-5300
(Registrant s telephone number, including area code)

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

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

The number of shares outstanding of the Registrant s only class of common stock as of August 2, 2006 was approximately 102,219,000.

WATSON PHARMACEUTICALS, INC.

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WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited; in thousands)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 600,411	$ 467,451
Marketable securities	169,037	162,475
Accounts receivable, net	347,813	333,832
Inventories	310,421	278,062
Prepaid expenses and other current assets	33,425	31,014
Deferred tax assets	110,950	87,596
Total current assets	1,572,057	1,360,430
Property and equipment, net	449,375	436,149
Investments and other assets	63,348	50,318
Deferred tax assets	25,550	25,733
Product rights and other intangibles, net	600,662	751,808
Goodwill	479,945	455,595
Total assets	$ 3,190,937	$ 3,080,033
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 298,639	$ 211,160
Income taxes payable	63,895	28,789
Current portion of long-term debt	10,392	
Deferred revenue	8,182	5,721
Total current liabilities	381,108	245,670
Long-term debt	574,013	587,935
Deferred revenue	13,969	13,891
Other long-term liabilities	1,772	2,504
Deferred tax liabilities	88,785	125,792
Total liabilities	1,059,647	975,792
Commitments and contingencies		
Stockholders equity:		
Preferred stock		
Common stock	368	367
Additional paid-in capital	929,014	923,619
Unearned compensation		(9,326)
Retained earnings	1,494,713	1,485,100
Accumulated other comprehensive income	7,195	4,481
Treasury stock, at cost	(300,000)	(300,000)
Total stockholders equity	2,131,290	2,104,241
Total liabilities and stockholders equity	$ 3,190,937	$ 3,080,033

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF (LOSS) INCOME

(Unaudited; in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005 Restated	2006	2005 Restated
Net revenues	$ 510,356	$ 416,266	$ 917,589	$ 817,094
Cost of sales (excludes amortization, presented below)	330,860	211,213	565,614	418,163
Gross profit	179,496	205,053	351,975	398,931
Operating expenses:				
Research and development	31,125	31,486	60,962	60,324
Selling, general and administrative	70,774	68,125	137,524	131,776
Amortization	41,101	41,101	82,201	81,739
Loss on impairment	66,981		66,981	
Total operating expenses	209,981	140,712	347,668	273,839
Operating (loss) income	(30,485)	64,341	4,307	125,092
Other income (expense):				
(Losses) earnings on equity method investments	1,646	(997)	1,454	(875)
Gain on sales of securities			3,695	
(Loss) on early extinguishment of debt	195		(525)	
Interest income	6,913	4,546	13,165	8,652
Interest (expense) income	(3,322)	(3,624)	(6,623)	(6,914)
Other expense	(97)	185	8	(39)
Total other income, net	5,335	110	11,174	824
(Loss) income before income taxes	(25,150)	64,451	15,481	125,916
(Benefit) provision for income taxes	(9,532)	24,002	5,867	46,854
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
(Loss) earnings per share:				
Basic	$ (0.15)	$ 0.38	$ 0.09	$ 0.73
Diluted	$ (0.15)	$ 0.35	$ 0.09	$ 0.67
Weighted average shares outstanding:				
Basic	101,666	106,359	101,742	107,740
Diluted	101,666	121,253	102,125	122,671

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited; in thousands)

	Six Months Ended June 30, 2006	2005 Restated
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 9,614	$ 79,062
Reconciliation to net cash provided by operating activities:		
Depreciation	24,569	19,639
Amortization	82,201	81,739
Charge for asset impairment	66,981	
Deferred income tax provision	(61,857)	(12,130)
Provision for inventory reserve	10,701	29,584
Restricted stock and stock option compensation	6,653	
(Earnings) losses on equity method investments	(1,454)	875
Gain on sale of securities	(3,695)	
Loss on early extinguishment of debt	525	
Loss on sale of fixed assets	166	620
Tax benefits from employee stock plans	785	1,606
Mark to market on derivative	(732)	(841)
Other	(1,899)	(1,006)
Changes in assets and liabilities (net of acquisition of business):		
Accounts receivable, net	(13,618)	(19,799)
Inventories	(38,542)	2,407
Prepaid expenses and other current assets	(776)	6,352
Accounts payable and accrued expenses	84,425	(5,893)
Deferred revenue	(1,485)	3,858
Income taxes payable	35,106	(8,541)
Other assets	(1,443)	1,412
Total adjustments	186,611	99,882
Net cash provided by operating activities	196,225	178,944
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property and equipment	(18,179)	(38,103)
Acquisition of product rights	(302)	(427)
Acquisition of business, net of cash acquired	(29,664)	
Proceeds from sale of marketable equity securities	2,203	220,083
Proceeds from sale of investments	4,695	
Additions to marketable securities	(3,944)	
Additions to long-term investments	(12,500)	(1,500)
Distribution from joint venture	5,942	2,500
Net cash (used in) provided by investing activities	(51,749)	182,553
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments to repurchase 1998 Senior Notes	(14,585)	
Repurchase of common stock		(182,585)
Principal payments on long-term debt and other long-term liabilities	(4,214)	(5)
Proceeds from stock plans	7,283	11,175
Net cash used in financing activities	(11,516)	(171,415)
Net increase in cash and cash equivalents	132,960	190,082
Cash and cash equivalents at beginning of period	467,451	298,653
Cash and cash equivalents at end of period	$ 600,411	$ 488,735

See accompanying Notes to Condensed Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 GENERAL

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

The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2005. 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.

In the year ended December 31, 2005 the Company acquired additional common shares in Scinopharm Taiwan, Ltd. (Scinopharm), previously accounted for under the cost method, to an ownership level in excess of 20%. Accordingly, as required by Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18), results of operations, earnings per share and cash flows from operating and investing activities have been restated for the three and six months ended June 30, 2005 to conform to current period presentation.

Merger Agreement with Andrx Corporation

On March 13, 2006, the Company announced a definitive merger agreement (the Merger Agreement) to acquire all the outstanding shares of common stock of Andrx Corporation (Nasdaq: ADRX) (Andrx) in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion. Andrx distributes pharmaceutical products primarily to independent and chain pharmacies and physicians offices and is considered a leader in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products.

In connection with the transaction, on March 31, 2006, the Company filed a Hart-Scott-Rodino (HSR) notification and report form (HSR Notification) with the Department of Justice and the Federal Trade Commission (FTC) pursuant to the HSR Antitrust Improvements Act of 1976, as amended (HSR Act). On May 1, 2006, the Company and Andrx received a request for additional documentation from the FTC related to the HSR Notification, to which responses were submitted.

Consummation of the merger, which is expected to occur in the third or fourth quarter of 2006, is subject to the satisfaction of certain customary closing conditions including, among others, (i) the expiration of the applicable waiting period under the HSR Act, and (ii) no material adverse effect, as defined in the Merger Agreement, as amended.

On July 7, 2006, Watson and Andrx amended the Merger Agreement. Under the initial terms of the Merger Agreement, either Watson or Andrx could have terminated the Merger Agreement and abandoned the merger at any time on or after September 12, 2006, subject to certain conditions. The amendment extends the September 12, 2006 date to November 13, 2006, in the event that the merger cannot be consummated solely because: (i) the waiting period applicable to the consummation of the merger under the HSR Act has not expired or been terminated, (ii) a governmental entity has enjoined or prohibited the consummation of the merger, or (iii) there is a pending antitrust proceeding that would prohibit the consummation of the merger or that would otherwise have a material adverse effect for Watson and its subsidiaries, taken as a whole on a post-merger basis.

The amendment also provides that in the event that the representations and warranties that will be made by Andrx in the Merger Agreement are true and correct on September 12, 2006, then such representations and warranties, with limited exceptions, will be deemed to be true on all dates subsequent to September 12, 2006. In addition, in the event that no material adverse effect has occurred with regard to Andrx or its ability to

consummate the merger on September 12, 2006, then no such material adverse effect will be deemed to exist on all dates subsequent to September 12, 2006. For additional information on Andrx, see the U.S. Securities and Exchange Commission s (SEC) website at www.sec.gov.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005 Restated	2006	2005 Restated
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
Other comprehensive income (loss):				
Unrealized (loss) gain on securities	(379)	(1,794)	5,063	(5,293)
Less related income taxes	144	669	(1,919)	1,974
Total unrealized (loss) gain on securities, net	(235)	(1,125)	3,144	(3,319)
Translation loss	(595)		(430)	
Total other comprehensive (loss) income	(830)	(1,125)	2,714	(3,319)
Total comprehensive (loss) income	$ (16,448)	$ 39,324	$ 12,328	$ 75,743

Preferred and Common Stock

As of June 30, 2006 and December 31, 2005 there were 2,500,000 shares of no par value per share preferred stock authorized, with none issued. As of June 30, 2006 and December 31, 2005, there were 500,000,000 shares of $0.0033 par value per share common stock authorized, with 111,568,000 and 110,205,000 shares issued, and 102,168,000 and 100,805,000 outstanding, respectively. Approximately 9,399,800 shares were held as treasury shares as of June 30, 2006 and December 31, 2005, respectively.

Stock Repurchases

During 2005, we repurchased approximately 9.4 million shares of our common stock at an aggregate cost of $300.0 million under the Company s $300.0 million stock repurchase program approved by the Board on February 10, 2005 (the 2005 Repurchase Program). This completed our stock repurchase program under the 2005 Repurchase Program.

On February 15, 2006, the Company s Board of Directors authorized the expenditure of an additional $300.0 million to repurchase shares of the Company s outstanding common stock (the 2006 Repurchase Program). Repurchases are authorized to be made in open market or privately negotiated transactions from time to time in compliance with the SEC Rule 10b-18, subject to market conditions, applicable legal requirements and other factors. Additionally, the Board has authorized that purchases may be made under Rule 10b5-1 promulgated under the Securities and Exchange Act of 1934, as amended. A Rule 10b5-1 plan allows

Watson to repurchase its shares during periods when it would normally not be active in the market due to its internal trading blackout periods. All such purchases must be made in accordance with a pre-defined plan that is established when the plan administrator is not aware of any material non-public information. At this time, the Company does not intend to repurchase common stock under the 2006 Repurchase Program given the pending acquisition of Andrx.

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 various sales returns and allowances is recorded which reduces product sales and accounts receivable. These adjustments include estimates for chargebacks, rebates, returns, and other sales allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with wholesale and indirect customers.

The Company s provision for chargebacks is the most significant and complex estimated 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 estimates take into consideration the current average chargeback rates by product and estimated wholesaler inventory levels. Watson continually monitors these assumptions giving consideration to current pricing trends and estimated wholesaler inventory levels and make adjustments to these estimates when the Company believes that the actual chargeback amounts payable in the future will differ from original estimates. The following table summarizes the activity in the Company s major categories of sales returns and allowances (in thousands):

	Chargebacks	Rebates	Returns and Other Allowances	Cash Discounts	Total
Balance at December 31, 2004	$ 129,551	$ 148,948	$ 44,483	$ 10,614	$ 333,596
Provision related to sales in six months ended June 30, 2005	434,548	165,358	60,265	28,886	689,057
Credits and payments	(456,724)	(189,162)	(65,512)	(29,240)	(740,638)
Balance at June 30, 2005	107,375	125,144	39,236	10,260	282,015
Provision related to sales in six months ended December 31, 2005	501,276	180,512	59,608	30,614	772,010
Credits and payments	(469,046)	(177,363)	(53,551)	(28,780)	(728,740)
Balance at December 31, 2005	139,605	128,293	45,293	12,094	325,285
Provision related to sales in six months ended June 30, 2006	567,776	201,959	84,287	34,570	888,292
Credits and payments	(539,685)	(191,298)	(85,478)	(33,167)	(849,328)
Balance at June 30, 2006	$ 167,696	$ 138,954	$ 44,102	$ 13,497	$ 364,249

Earnings Per Share

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

outstanding for the calculation of diluted earnings per share for all periods in which the securities were outstanding. A reconciliation of the numerators and denominators of basic and diluted earnings per share consisted of the following (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2006	2005 Restated	2006	2005 Restated
(Loss) earnings per share - basic				
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
Basic weighted average common shares outstanding	101,666	106,359	101,742	107,740
(Loss) earnings per share - basic	$ (0.15)	$ 0.38	$ 0.09	$ 0.73
(Loss) earnings per share - assuming dilution				
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
Add: Interest expense on CODES, net of tax		1,808		3,430
Net (loss) income, adjusted	$ (15,618)	$ 42,257	$ 9,614	$ 82,492
Basic weighted average common shares outstanding	101,666	106,359	101,742	107,740
Effect of dilutive securities:				
Conversion of CODES		14,357		14,357
Dilutive stock options		537	383	574
Diluted weighted average common shares outstanding	101,666	121,253	102,125	122,671
(Loss) earnings per share - diluted	$ (0.15)	$ 0.35	$ 0.09	$ 0.67

Stock awards to purchase 10.4 million and 6.5 million common shares for the three month periods ended June 30, 2006 and 2005, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive. Stock awards to purchase 8.6 million and 6.5 million common shares for the six month periods ended June 30, 2006 and 2005, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive. Common stock equivalents relating to the CODES convertible into 14.4 million common shares were not included in the computation of diluted earnings per share for the three and six month periods ended June 30, 2006 because the CODES were antidilutive.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 151, Inventory Costs-an Amendment of ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 clarifies that items such as abnormal freight, handling costs, and wasted materials (spoilage) be recognized as current period charges rather than as a portion of the inventory cost. Unallocated overheads are to be recognized as an expense in the period in which they are incurred. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The provision of this Statement shall be applied prospectively. The adoption of SFAS 151 on January 1, 2006, did not have a material effect on our Condensed Consolidated Financial Statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) as well as SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure (SFAS 148),

supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and amends SFAS No. 95, Statement of Cash Flows (SFAS 95). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The intrinsic value method as permitted under APB 25 together with the pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for attributing compensation cost to reporting periods and the transition method to be used at date of adoption. The transition methods include modified prospective and modified retrospective adoption options. Under the modified retrospective option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The modified prospective method requires that compensation expense be recorded for all unvested stock options at the beginning of the first quarter of adoption of SFAS 123R, while the modified retrospective method would record compensation expense for all unvested stock options beginning with the first period restated. SFAS 123R also requires any previously recorded unearned or deferred compensation accounts (i.e. contra-equity accounts) within stockholders equity be recorded as a reduction to additional paid-in capital balances rather than shown as contra equity accounts as was permitted prior to January 1, 2006. SFAS 95 is amended to require excess tax benefits be reported as a financing cash flow rather than as a reduction in taxes paid within the Consolidated Statement of Cash Flows. On January 1, 2006, the Company adopted SFAS 123R using the modified prospective method option.

In March 2005, the SEC issued SEC Staff Accounting Bulletin No. 107 (SAB 107) which describes the SEC staff position as well as supplemental implementation guidance on the application and adoption of SFAS 123R. The Company has applied the provisions of SAB 107 and its guidance in our adoption of SFAS 123R on January 1, 2006 (Refer to NOTE 2 SHARE-BASED COMPENSATION).

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154), which replaces APB Opinion No. 20, Accounting Changes (APB 20) and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements (SFAS 3). SFAS 154 applies t all voluntary changes in accounting principle and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 also requires retrospective application to prior period financial statements involving changes in accounting principle unless it is impracticable to determine either the period-specific or cumulative effect of the change. This statement also requires that a change in the method of depreciation, amortization or depletion of long-lived assets be accounted for as a change in accounting estimate that is accounted for prospectively. SFAS 154 also retains many provisions of APB 20 including those related to reporting a change in accounting estimate, a change in the reporting entity and a correction of an error and also carries forward provisions of SFAS 3 governing the reporting of accounting changes in interim financial statements. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 on January 1, 2006, did not have a material effect on our Consolidated Financial Statements.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for the uncertainty in recognizing income taxes in an organization in accordance with FASB Statement No. 109 by providing detailed guidance for financial statement recognition, measurement and disclosure involving uncertain tax positions. FIN 48 requires an uncertain tax position to meet a more-likely-than-not recognition threshold at the effective date to be recognized both upon the adoption of FIN 48 and in subsequent periods. FIN 48 is effective for fiscal years beginning after December 15, 2006. As the provisions of FIN 48 will be applied to all tax positions upon initial adoption, the cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. The Company is currently evaluating FIN 48 and the effect, if any, on our Condensed Consolidated Financial Statements.

NOTE 2 SHARE-BASED COMPENSATION

As indicated above, effective January 1, 2006, the Company adopted the modified prospective method of 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. SFAS 123R eliminates previously available alternatives to account for share-based compensation transactions, as the Company formerly did, using the recognition and measurement principles of APB 25 and related interpretations. Under the intrinsic value method of APB 25, no stock-based employee compensation expense had been recognized for employee options in the Company s Condensed Consolidated Statements of Income, as all employee options granted under the Company s stock option plans or employee stock purchase plan (ESPP) either had an exercise price equal to the market value of the underlying common stock on the date of grant or were deemed non-compensatory under APB 25 for common stock issued under our ESPP. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the share-based compensation impact of FAS 123R.

Stock Option Plans

The Company has adopted several stock option plans, all of which have been approved by the Company s shareholders, that authorize the granting of options to purchase the Company s common shares subject to certain conditions. At June 30, 2006, the Company had reserved 14.9 million of its common shares for issuance of share-based compensation awards under the Company s stock option and restricted stock plans. Options are granted at the fair value of the shares underlying the options at the date of the grant and generally become exercisable over periods ranging from three to five years and expire in ten years. In conjunction with certain of the Company s acquisitions, Watson assumed stock option and warrant plans from the acquired companies. The options and warrants in these plans were adjusted by the individual exchange ratios specified in each transaction. No additional options or warrants have been granted under any of the assumed plans.

The Company estimates the fair value of its stock option plans and the ESPP using the Black-Scholes option pricing model (the Option Model). The Option Model requires the use of subjective and complex assumptions, including the option s expected term and the estimated future price volatility of the underlying stock, which determine the fair value of the share-based awards. The Company s estimate of expected term in 2006 was determined based on the weighted average period of time that options granted are expected to be outstanding considering current vesting schedules and the historical exercise patterns of existing option plans. Beginning in 2005, the expected volatility assumption used in the Option Model changed from being based on historical volatility to implied volatility based on traded options on the Company s stock in accordance with guidance provided in SFAS 123R and SAB 107. Prior to 2005, the Company s measurement of expected volatility was based on the historical volatility of its stock. The risk-free interest rate used in the Option Model is based on the yield of U.S. Treasuries with a maturity closest to the expected term of the Company s stock options.

The following weighted average assumptions were used for stock options granted during the three and six months ended June 30, 2006 and 2005:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Dividend yield	None	None	None	None
Expected volatility	25 %	44 %	25 %	37 %
Risk-free interest rate	5.04 %	3.96 %	5.04 %	3.98 %
Expected term	4.4	5.3	5.2	5.4
Weighted average fair value per share at grant date	$ 8.22	$ 13.51	$ 9.50	$ 12.12

Effective January 1, 2006, in accordance with the provisions of SFAS 123R, share-based compensation expense recognized during a period is based on the value of the portion of share-based awards that are expected to vest with employees. Accordingly, the recognition of share-based compensation expense beginning January 1, 2006 has been reduced for estimated future forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant with adjustments recorded in subsequent period compensation expense if actual forfeitures differ from those estimates. Prior to 2006, we accounted for forfeitures as they occurred for the disclosure of pro forma information presented in our Notes to Condensed Consolidated Financial Statements for prior periods. Share-based compensation expense recognized under SFAS 123R includes share-based awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R as well as share-based awards granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123. In conjunction with the adoption of SFAS 123R, we changed the method of recognizing share-based compensation expense from the accelerated multiple-option approach to the ratable single-option approach.

As a result of adopting SFAS 123R on January 1, 2006, the Company s operating income and net income before income tax was reduced by $2.7 million and $4.5 million, and net income was reduced by $1.7 million ($0.02 per basic and diluted share) and $2.8 million ($0.03 per basic and diluted share) for the three and six months ended June 30, 2006, related to the Company s employee stock option plans, respectively. There was no share-based employee compensation related expense recognized in the three and six months ended June 30, 2005. Total stock option cost capitalized as part of inventory was $0.4 million and $0.7 for three and six months ended June 30, 2006, respectively. There was no stock option cost capitalized as part of inventory in the three and six months ended June 30, 2005.

On December 15, 2005 the Compensation Committee of the Board approved the accelerated vesting of certain unvested, out-of-the-money stock options having an exercise price of $38.00 or greater. The acceleration of vesting was effective December 15, 2005, for stock options previously awarded to the Company s employees, including its executive officers under the Company s equity compensation plans. In connection with the acceleration of vesting terms of these options, the Company recognized an additional $6.9 million, pre-tax non-cash compensation expense on a pro forma basis in accordance with SFAS 123 in the three months ended December 31, 2005. The acceleration action was taken in order to reduce the impact on future compensation expense of recognizing share based payment transactions within future periods consolidated statements of income upon adoption of SFAS 123R on January 1, 2006.

A summary of the changes in the Company s stock option plans during the six months ended June 30, 2006 is presented below (in thousands, except per share amounts):

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	11,194	$ 36.76		
Granted	202	28.98		
Exercised	(261)	19.23		
Cancelled	(346)	40.32		
Outstanding at June 30, 2006	10,789	$ 36.93	6.0	$ 747
Vested and expected to vest at June 30, 2006	10,256	$ 37.30	6.0	$ 742
Options exercisable at June 30, 2006	8,035	$ 39.47	5.2	$ 674

As of June 30, 2006, the Company had $9.7 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 1.6 years.

Restricted Stock

During 2005, the Compensation Committee of the Board authorized and issued restricted stock to the Company s employees, including its executive officers and certain non-employee directors (the Participants) under the Company s equity compensation plans. The restricted stock award program offers Participants the opportunity to earn shares of our common stock over time, rather than options that give Participants the right to purchase stock at a set price. Restricted stock awards are grants that entitle the holder to shares of common stock subject to certain terms. Restricted stock awards generally have restrictions eliminated over a one to four year period. Restrictions generally lapse for non-employee directors after one year. Restrictions generally lapse for employees over a two to four year period. The fair value of restricted stock grants is based on the fair market value of our common stock on the respective grant dates. Restricted stock compensation is being amortized and charged to operations over the same period as the restrictions are eliminated for the Participants.

The Company s operating income and net income before income tax provision was reduced by $0.8 and $1.3 million and net income was reduced by $0.5 million ($0.00 per basic and diluted share) and $0.8 million ($0.01 per basic and diluted share) for the three and six months ended June 30, 2006, related to the Company s restricted stock plans, respectively. There was no restricted stock expense recognized in both the three and six months ended June 30, 2005. Total restricted stock cost capitalized as part of inventory was $0.2 million and $0.4 for the three and six months ended June 30, 2006, respectively. There was no restricted stock cost capitalized as part of inventory in the three and six months ended June 30, 2005.

A summary of the changes in restricted stock grants during the six months ended June 30, 2006 is presented below (in thousands, except per share amounts):

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Restricted shares outstanding at December 31, 2005	315.5	$ 34.43	2.3	$ 10,863
Granted	83.7	29.05		2,431
Vested	(5.0)	30.04		(150)
Cancelled	(23.6)	35.08		(826)
Restricted shares outstanding at June 30, 2006	370.6	$ 33.24	2.0	$ 12,318
Restricted shares net of estimated forfeitures at June 30, 2006	251.4	33.24	2.0	$ 8,358

As of June 30, 2006, the Company had $6.4 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 1.9 years.

ESPP

An ESPP was established for eligible employees to purchase shares of the Company s common stock at 85% of the lower of the fair market value of Watson common stock on the effective date of subscription or the date of purchase. Under the ESPP, employees can authorize the Company to withhold up to 15% of their compensation during any offering period for common stock purchases, subject to certain limitations. The ESPP was implemented on January 1, 2002 and was qualified under Section 423 of the Internal Revenue Code. The Board authorized an aggregate of 700,000 shares of the Company s common stock for issuance under the ESPP. As of December 31, 2005, a total of 471,307 shares were issued under the ESPP. On June 29, 2005 the Compensation Committee of the Board terminated the ESPP effective January 1, 2006.

The following weighted average assumptions were used for the ESPP during the three and six months ended June 30, 2005:

Dividend yield	None
Expected volatility	26 %
Risk-free interest rate	4.00 %
Expected term	6 months
Weighted average fair value per share at grant date	$ 7.31

Pro Forma Information for Periods Prior to the Adoption of FAS 123R

Prior to 2006, the Company determined stock-based compensation expense using the intrinsic value method of APB 25 and we provided the disclosures required by SFAS 123, as amended by SFAS 148. The following table provides the pro forma effects on net income and earnings per share for the three and six months ended June 30, 2005 as if the fair value recognition provisions of SFAS 123R had been applied to options and ESPP

grants under the Company s employee compensation plans (in thousands, except per share amounts):

	Three Months Ended June 30, 2005 Restated	Six Months Ended June 30, 2005 Restated
Net income, as reported	$ 40,449	$ 79,062
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	2,857	5,947
Pro forma net income	37,592	73,115
Add: Interest expense on CODES	1,808	3,430
Pro forma net income, adjusted	$ 39,400	$ 76,545
Earnings per share:		
Basic - as reported	$ 0.38	$ 0.73
Basic - pro forma	$ 0.35	$ 0.68
Diluted - as reported	$ 0.35	$ 0.67
Diluted - pro forma	$ 0.33	$ 0.62

NOTE 3 ACQUISITIONS

Acquisition of Sekhsaria Chemicals Ltd.

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

The results of operations of Sekhsaria have been included in the Company s Condensed Consolidated Financial Statements subsequent to the date of acquisition. Pro forma results of operations have not been presented because the effect of the acquisition was not material.

Additional Investment in Scinopharm

The Company holds an equity interest in Scinopharm. In January 2006, we made an additional investment in Scinopharm of approximately $12.0 million which increased our ownership share to approximately 31%. Additionally, we have an option to acquire an additional 44% interest in Scinopharm by January 2008 at a cost of approximately $80 million.

Acquisition of Manufacturing Facility in Goa, India

In October 2005, the Company entered into an asset purchase agreement to purchase a manufacturing facility located in Goa, India (Goa) from Dr. Reddy s Laboratories, Ltd. (Dr. Reddy) for total cash

consideration of approximately $16.4 million plus acquisition costs. The transaction included a manufacturing facility, machinery and equipment.

NOTE 4 INVESTMENTS

The Company s equity investments in publicly traded companies are classified as available-for-sale and are recorded at fair value based on quoted market prices using the specific identification method. These investments are classified as current marketable securities, or investment and other assets, as appropriate, on the Company s Condensed Consolidated Balance Sheets.

The Company s debt investments in U.S. Treasury and agency securities are classified as available-for-sale and are recorded at fair value based on quoted market prices using the specific identification method.

The following table provides a summary of the fair value and unrealized holding gain (loss) related to Watson s available-for-sale securities (in thousands):

At June 30, 2006	Cost, Including Accrued Interest	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury and agency securities	$ 156,226	$	$ (1,274)	$ 154,952
Equity securities - current	1,575	12,510		14,085
Current	157,801	12,510	(1,274)	169,037
Equity securities - non-current	232	1,250		1,482
Total	$ 158,033	$ 13,760	$ (1,274)	$ 170,519

At December 31, 2005	Cost, Including Accrued Interest	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury and agency securities	$ 154,302	$	$ (1,835)	$ 152,467
Equity securities - current	1,572	8,436		10,008
Current	155,874	8,436	(1,835)	162,475
Equity securities - non-current	232	707		939
Total	$ 156,106	$ 9,143	$ (1,835)	$ 163,414

Gross unrealized gains at June 30, 2006 and December 31, 2005 primarily relate to our holdings in shares of Andrx common stock. The gross unrealized holding loss at June 30, 2006 and December 31, 2005 is attributable to adjustments, included in other comprehensive income, for the decline in fair value in the Company s investment in U.S. Treasury and agency securities.

The Company s net unrealized gain related to its available-for-sale securities increased $3.1 million for the six month period ended June 30, 2006. During the six month period ended June 30, 2005, the Company s net unrealized holding gain decreased $3.2 million. These changes in the Company s net unrealized holding gain are included in other comprehensive loss.

Current Investments

The Company s investment in the common stock of Andrx, publicly traded on the Nasdaq Stock Market under the symbol ADRX, is classified as a current investment on the Company s Condensed Consolidated Balance Sheets at June 30, 2006 and December 31, 2005. The Company did not sell any of its shares of Andrx during the six month periods ended June 30, 2005 and 2006. (Refer to NOTE 1 GENERAL.)

The Company s investments in U.S. Treasury and agency securities are classified as a current investment on the Company s Condensed Consolidated Balance Sheet at June 30, 2006 and December 31, 2005.

The contractual maturities of the U.S. Treasury securities at June 30, 2006 are as follows (in thousands):

	Fair value
Mature within one year	$ 153,057
Mature within two years	1,895
	$ 154,952

Non-current Investments

The Company s investments in the common stock of NovaDel Pharma Inc. and Amarin Corporation plc (Amarin) are classified as non-current investments and are included in investments and other assets on the Company s Condensed Consolidated Balance Sheets at June 30, 2006 and December 31, 2005.

NOTE 5 OPERATING SEGMENTS

Watson has two operating segments: Brand and Generic. The brand business 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 Generic business segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Company sells its Brand and Generic products primarily to pharmaceutical wholesalers, drug distributors and chain drug stores.

The Company evaluates segment performance based on segment net revenues, gross profit and contribution. Segment contribution represents segment gross profit less direct research and development expenses and selling and marketing expenses. The Company does not report depreciation expense, total assets, and capital expenditures by segment as such information is not used by management, or has not been accounted for at the segment level.

The other revenue classification for the three month period ended June 30, 2006 and 2005 consists primarily of royalties and revenues from research, development and licensing fees. Net revenues and segment contribution information for the Company s Brand and Generic segments, consisted of the following:

	Three Months Ended June 30, 2006			Three Months Ended June 30, 2005		
	Generic	Brand	Total	Generic	Brand	Total
Product sales	$ 419,441	$ 88,051	$ 507,492	$ 312,453	$ 100,746	$ 413,199
Other	990	1,874	2,864	1,149	1,918	3,067
Net revenues	420,431	89,925	510,356	313,602	102,664	416,266
Cost of revenue (excludes amortization, presented below)	306,564	24,296	330,860	188,141	23,072	211,213
Gross profit	113,867	65,629	179,496	125,461	79,592	205,053
Gross margin	27 %	73 %	35 %	40 %	78 %	49 %
Research and development	18,124	13,001	31,125	21,818	9,668	31,486
Selling and marketing	13,526	29,765	43,291	11,688	30,532	42,220
Contribution	$ 82,217	$ 22,863	105,080	$ 91,955	$ 39,392	131,347
Contibution margin	20 %	25 %	21 %	29 %	38 %	32 %
General and administrative			27,483			25,905
Amortization			41,101			41,101
Loss on impairment			66,981			
Operating income			$ (30,485)			$ 64,341
Operating margin			(6.0)%			15 %

	Six Months Ended June 30, 2006			Six Months Ended June 30, 2005		
	Generic	Brand	Total	Generic	Brand	Total
Product sales	$ 740,856	$ 171,288	$ 912,144	$ 605,616	$ 205,272	$ 810,888
Other	1,665	3,780	5,445	2,235	3,971	6,206
Net revenues	742,521	175,068	917,589	607,851	209,243	817,094
Cost of revenue (excludes amortization, presented below)	523,948	41,666	565,614	371,331	46,832	418,163
Gross profit	218,573	133,402	351,975	236,520	162,411	398,931
Gross margin	29 %	76 %	38 %	39 %	78 %	49 %
Research and development	38,619	22,343	60,962	40,962	19,362	60,324
Selling and marketing	26,464	58,740	85,204	22,948	58,000	80,948
Contribution	$ 153,490	$ 52,319	205,809	$ 172,610	$ 85,049	257,659
Contibution margin	21 %	30 %	22 %	28 %	41 %	32 %
General and administrative			52,320			50,828
Amortization			82,201			81,739
Loss on impairment			66,981			
Operating income			$ 4,307			$ 125,092
Operating margin			0 %			15 %

NOTE 6 INVENTORIES

Inventories consist of finished goods held for sale and distribution, raw materials and work-in-process. Included in inventory at June 30, 2006 and December 31, 2005 is approximately $3.9 and $6.0 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.

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

	June 30, 2006	December 31, 2005
Raw materials	$ 96,471	$ 85,983
Work-in-process	56,270	67,173
Finished goods	157,680	124,906
Total inventories	$ 310,421	$ 278,062

NOTE 7 ASSET IMPAIRMENT CHARGES

In Accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144), Watson reevaluates the carrying value of identifiable intangible and long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. SFAS 144 defines impairment as the condition that exists when the carrying amount of a long-lived asset exceeds its fair value. An impairment loss is recognized only if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value.

In the quarter ended June 30, 2006, revisions to the Company s long range product sales forecast were deemed necessary as a result of a detailed analysis of prescription trends and a review of sales and inventory data provided by our largest customers. As a result of these downward revisions to our long range product sales forecast, the Company conducted a product right impairment review. Results of our impairment review indicated future undiscounted cash flows for four product rights were less than their respective carrying values. An analysis was undertaken to determine the fair values for the four product rights and an impairment of approximately $67.0 million was recognized predominantly relating to Alora® (purchased in 1999) and Actigall® (purchased in 2002) for the three and six months ended June 30, 2006.

NOTE 8 GOODWILL AND OTHER INTANGIBLE ASSETS

Watson tests its goodwill and intangible assets with indefinite lives by comparing the fair value of each of the Company s reporting units to the respective carrying value of the reporting units. The Company performs this impairment testing annually during the second quarter and when events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The Company s two reporting units are Brand and Generic pharmaceutical products. The carrying value of each reporting unit is determined by assigning the assets employed in, and liabilities relating to, to those reporting units, including the existing goodwill and intangible assets. Goodwill is considered impaired if the carrying amount exceeds the fair value of the reporting unit. During the second quarter of 2006, Watson performed its annual assessment for the impairment of goodwill and determined there was no indication of impairment.

During the six months ended June 30, 2006, in conjunction with the acquisition of Sekhsaria, the total purchase price in excess of the fair value of net assets acquired amounted to $24.3 million (See Note 3 ACQUISITIONS). This entire amount was recorded as an addition to goodwill under the Generic pharmaceutical product segment. Goodwill for the Company s reporting units consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
Brand pharmaceutical products	$ 368,105	$ 368,105
Generic pharmaceutical products	111,840	87,490
Total goodwill	$ 479,945	$ 455,595

Other intangible assets consist primarily of product rights. The original cost and accumulated amortization of these intangible assets are as follows (in thousands):

	June 30, 2006	December 31, 2005
Product rights and related intangibles	$ 1,200,569	$ 1,269,513
Less accumulated amortization	(599,907)	(517,705)
Total product rights and related intangibles, net	$ 600,662	$ 751,808

Assuming no additions, disposals or additional adjustments are made to the carrying values and/or useful lives of the assets, annual amortization expense on product rights and related intangibles is estimated to be approximately $160.3 million in 2006, $157.7 in 2007, $46.7 million in 2008, $45.7 in 2009 and $38.6 million in 2010. The Company s current product rights and related intangibles have a weighted average useful life of approximately fourteen years.

NOTE 9 LONG-TERM DEBT

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

	June 30, 2006	December 31, 2005
CODES, face amount of $575 million, due 2023, net of unamortized discount	$ 573,987	$ 573,849
Senior unsecured notes, 7.125% (1998 Senior Notes), face amount of $14 million, due 2008, net of unamortized discount		14,054
Other notes payable	10,418	32
	584,405	587,935
Less: Current portion of long-term debt	10,392	
Total long-term debt	$ 574,013	$ 587,935

CODES

In March 2003, the Company issued $575 million of CODES. The CODES, which are convertible into shares of Watson s common stock upon the occurrence of certain events, are due in March 2023, with interest payments due semi-annually in March and September at an effective annual interest rate of 2.1%, excluding changes in fair value of the contingent interest derivative. At June 30, 2006 and December 31, 2005, the unamortized discount for the CODES for both periods was $1.0 and 1.2 million, respectively.

The CODES are convertible into Watson s common stock at a conversion price of approximately $40.05 per share (subject to certain adjustments upon certain events such as (i) stock splits or dividends, (ii) material stock distributions or reclassifications, (iii) distribution of stock purchase rights at less than current market rates or

(iv) a distribution of assets or common stock to our shareholders or subsidiaries). The CODES may be converted, at the option of the holders, prior to maturity under any of the following circumstances:

- during any quarterly conversion period (period from and including the thirtieth trading day in a fiscal quarter to, but not including, the thirtieth trading day in the immediately following fiscal quarter) if the closing sale price per share of Watson s common stock for a period of at least 20 trading days during the 30 consecutive trading-day period ending on the first day of such conversion period is more than 125% ($50.06) of the conversion price in effect on that thirtieth day;

- on or before March 15, 2018, during the five business-day period following any 10 consecutive trading-day period in which the daily average trading price for the CODES for such ten-day period was less than 105% of the average conversion value for the debentures during that period. This conversion feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at June 30, 2005;

- during any period, following the earlier of (a) the date the CODES are rated by both Standard & Poor s Rating Services and Moody s Investor Services, Inc., and (b) April 21, 2003, when the long-term credit rating assigned to the CODES by either Standard & Poor s or Moody s (or any successors to these entities) is lower than BB or Ba3 , respectively, or when either of these rating agencies does not have a rating then assigned to the CODES for any reason, including any withdrawal or suspension of a rating assigned to the CODES. This conversion feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at June 30, 2005;

- if the CODES have been called for redemption; or

- upon the occurrence of specified corporate transactions.

The Company may redeem some or all of the CODES for cash, on or after March 20, 2008, for a price equal to 100% of the principal amount of the CODES plus accrued and unpaid interest (including contingent interest) to, but excluding, the redemption date.

The CODES contain put options which may require the Company to repurchase for cash all or a portion of the CODES on March 15 of 2010, 2015 and 2018 at a repurchase price equal to 100% of the principal amount of the CODES plus any accrued and unpaid interest (including contingent interest) to, but excluding, the date of repurchase.

In addition, the holders of the CODES have the right to receive contingent interest payments during any six-month period from March 15 to September 14 and from September 15 to March 14, commencing on September 15, 2003, if the average trading price of the CODES for the five trading days ending on the second trading day immediately preceding the relevant six-month period equals 120% or more of the principal amount of the CODES. The interest rate used to calculate the contingent interest is the greater of 5% of the Company s then-current estimated per annum borrowing rate for senior non-convertible fixed-rate debt with a maturity date and other terms comparable to that of the CODES or 0.33% per annum. This contingent interest payment feature is an embedded derivative and has been bifurcated and recorded separately in the Condensed Consolidated Balance Sheets in other long-term liabilities. The initial fair value assigned to the embedded derivative was $1.9 million, which is recorded as a discount to the CODES. Changes to the fair value of this embedded derivative are reflected as an adjustment to interest expense. The current value of the embedded derivative was $ 0.2 and $0.9 million at June 30, 2006 and December 31, 2005, respectively.

1998 Senior Notes

In May 1998, Watson issued $150 million of its 1998 Senior Notes. The Company is required to make interest only payments due semi-annually in May and November at an effective annual rate of 7.2%. In February 2004, the Company initiated a tender offer to purchase all of its outstanding 1998 Senior Notes and a related consent solicitation. The Company received tenders of its 1998 Senior Notes and deliveries of related consents from holders of approximately $101.6 million of the $150 million aggregate principal amount of 1998 Senior Notes outstanding. In May 2004, the Company acquired an additional $34.3 million of its outstanding 1998 Senior Notes in an open market transaction. 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.

Credit Facility

In May 2003, we entered into an agreement with a syndicate of lenders for a five-year, $300 million senior, unsecured revolving credit facility (the Credit Facility) for working capital and other general corporate purposes. On September 8, 2005, we entered into a Second Amendment to the Credit Facility on substantially the same terms and conditions except the fee structure was reduced and certain defined terms were added or amended. On March 6, 2006, we entered into a Third Amendment to the Credit Facility which, among other things, permits the Company to repurchase up to $300.0 million of its common stock. As of June 30, 2006, the total $300 million under the Credit Facility was available to us. Watson s assets generally are held by, and its operations generally are conducted through its subsidiaries. Within the meaning of Regulation S-X, Rule 3-10, the Company has no assets or operations independent of its subsidiaries. Under the terms of the Credit Facility, each of our subsidiaries, other than minor subsidiaries, entered into a full and unconditional guarantee on a joint and several basis. In order to provide subsidiary guarantees in connection with the Credit Facility, we were required to issue similar guarantees to the 1998 Senior Note holders. The subsidiary guarantees related to both the Credit Facility and the 1998 Senior Notes are full and unconditional, on a joint and several basis, and are given by all subsidiaries other than minor subsidiaries. As of June 30, 2006 and December 31, 2005, the Company had not drawn any funds from the Credit Facility. Watson is subject to certain financial and operational covenants, all of which, as of June 30, 2006, the Company was in compliance.

NOTE 10 FINANCIAL INSTRUMENTS

Fair value of Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, marketable securities, accounts and other receivables, investments, trade accounts payable, senior subordinated notes, CODES and embedded derivatives related to the issuance of the CODES. The carrying amounts of cash and cash equivalents, marketable securities, accounts and other receivables and trade accounts payable are representative of their respective fair values due to their relatively short maturities. The fair values of investments in companies that are publicly traded are based on quoted market prices. The fair value of investments in privately held companies, or cost-method investments, are based on historical cost, adjusted for any write-down related to impairment. The Company estimates the fair value of its fixed rate long-term obligations based on quoted market rates of interest and maturity schedules for similar issues. The carrying value of these obligations approximates their fair value. The fair value of the embedded derivatives related to the CODES is based on a present value technique using discounted expected future cash flows.

Derivative Financial Instruments

The Company s derivative financial instruments consist of embedded derivatives related to its CODES. These embedded derivatives include certain conversion features and a contingent interest feature. See Note 8 for a more detailed description of these features of the CODES. Although the conversion features represent embedded derivative financial instruments, based on the de minimis value of these features at the time of issuance and at June 30, 2006, no value has been assigned to these instruments. The contingent interest feature provides unique tax treatment under the Internal Revenue Service s Contingent Debt Regulations. In essence, interest accrues, for tax purposes, on the basis of the instrument s comparable yield (the yield at which the issuer would issue a fixed rate instrument with similar terms). This embedded derivative is reported on the Company s Condensed Consolidated Balance Sheets at fair value and the changes in the fair value of the embedded derivative are reported as gains or losses in the Company s Condensed Consolidated Statements of Income.

The carrying value of the Company s derivative financial instruments, which approximates fair value, decreased $0.7 million from $0.9 million at December 31, 2005 to $0.2 million at June 30, 2006. The change in fair value was recorded as a reduction of interest expense during the respective period.

NOTE 11 COMMITMENTS AND CONTINGENCIES

Facility and Equipment Leases

The Company has entered into long-term operating leases for certain facilities and equipment. The terms of the operating leases for the Company s facilities require the Company to pay property taxes, normal maintenance expenses and maintain minimum insurance coverage. Total rental expense for operating leases for the six months ended June 30, 2006 and 2005 were $4.1 million and $5.5 million, respectively.

Future minimum lease payments under all non-cancelable operating leases consist of approximately $4.1 million remaining in 2006, $6.7 million in 2007, $4.7 million in 2008, $3.7 million in 2009, $2.4 million in 2010 and $13.8 million thereafter.

Employee Retirement Plans

The Company maintains certain defined contribution retirement plans covering substantially all employees. The Company contributes to the plans based upon the employee contributions. Watson s contributions to these retirement plans for the three and six months ended June 30, 2006 were $1.7 million and $3.6 million, respectively. Watson s contributions to these retirement plans for the three and six months ended June 30, 2005 were $1.6 million and $3.3 million, respectively. The Company does not sponsor any defined benefit retirement plans or postretirement benefit plans.

Legal Matters

The Company is party to certain lawsuits and legal proceedings, which are described in PART I, ITEM 3. LEGAL PROCEEDINGS, of our Annual Report on Form 10-K for the year ended December 31, 2005. The following is a description of material developments during the period covered by this Quarterly Report and through the filing of this Quarterly Report, and should be read in conjunction with the Annual Report referenced above.

Cipro Litigation. In the action pending in the Wisconsin Court of Appeals *(Barbara A. Meyers, et. al. v. Bayer AG, et. al., Appeal No. 2003AP2840)*, on June 8, 2006, the defendants filed a petition for review with the Wisconsin Supreme Court. On June 26, 2006, the plaintiffs opposed the petition for review. On July 26, 2006, the Wisconsin Supreme Court granted the defendants petition for review. The petition will be decided after it has been fully briefed by the parties.

Governmental Reimbursement Investigations And Drug Pricing Litigation. With respect to the Drug Pricing Litigation pending against the Company and certain subsidiaries, the plaintiffs in the Class Action case in the Multi-District Litigation in U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 1456*) have filed a motion requesting that different classes of plaintiffs (including individuals who made co-payments for drugs reimbursed by Medicare and third-party payors, such as insurance companies and union health benefit funds) be certified by the Court so that the Court can decide whether the Company and the other defendants must pay damages to members of the classes who do not choose to be excluded from the class. The Company has filed an opposition to the Motion for Class Certification, and a hearing has been scheduled for September 12, 2006. In addition, the Attorney General s Office in Idaho has requested that the Company meet to discuss whether that office should bring claims against the Company. Additional actions in other states 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. With respect to the May 13, 2002, consent decree entered in connection with the Company s Corona, California, facility (*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 U.S. Food and Drug Administration conducted an inspection of the facility from July 9 21, 2006. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. 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, 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.

Hormone Replacement Therapy Litigation. With respect to the hormone replacement therapy product liability lawsuits pending against the Company, certain of its subsidiaries, and others, additional actions raising similar issues have been filed, and some actions or claims have been dismissed. As of August 8, 2006, approximately 170 cases were pending against Watson and/or its affiliates in state and federal courts, representing claims by approximately 1,345 plaintiffs. Discovery is ongoing. 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.

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.

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

The following discussion of our financial condition and the results of operations should be read in conjunction with the Condensed Consolidated Financial Statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q (Quarterly Report). This discussion contains forward-looking statements that are subject to known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include, among others, those identified under Cautionary Note Regarding Forward-Looking Statements and elsewhere in this Quarterly Report and under Risks Related to our Business in our Annual Report on Form 10-K for the year ended December 31, 2005.

Overview

Watson Pharmaceuticals, Inc. (Watson , the Company we , us or our) was incorporated in 1985 and is engaged in the development, manufactu 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.).

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. As a result of the differences between the two types of products, we currently operate and manage our business as two segments: Generic and Brand.

The Company has announced several recent cost reduction initiatives including the closure of our Puerto Rico manufacturing facility and the planned divestiture of our Phoenix, Arizona injectable facility by early 2007. The Company is also establishing a foreign operating infrastructure to supply the U.S. market which includes a recently acquired solid dose manufacturing facility in Goa, India; an increased investment in a Chinese/Taiwanese company specializing in the development and manufacture of active pharmaceutical ingredients (API); and the acquisition of Mumbai, India-based Sekhsaria Chemicals, Ltd. that provides API and finished dosage formulation expertise to the global pharmaceutical industry.

On March 13, 2006, the Company announced a definitive merger agreement (the Merger Agreement) to acquire all the outstanding shares of common stock of Andrx Corporation (Nasdaq: ADRX) (Andrx) in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion. Andrx distributes pharmaceutical products primarily to independent and chain pharmacies and physicians offices and is considered a leader in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products. The consummation of the merger is subject to U.S. regulatory approval. Following the close of the merger, Watson will have three operating segments: Generic, Brand and Distribution. The following discussion does not include or incorporate the anticipated impact of Andrx on our business, results of operations, financial condition, cash flows or expectations for 2006. For additional information on the merger with Andrx, refer to NOTE 1 GENERAL in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

Results of Operations

Three Months Ended June 30, 2006 Compared to the Three Months Ended June 30, 2005

Net Revenues

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Generic segment				
Generics	$ 340,848	$ 234,484	$ 106,364	45.4 %
Generic oral contraceptives	78,593	77,969	624	0.8 %
Total generic product sales	419,441	312,453	106,988	34.2 %
Other	990	1,149	(159)	(13.8)%
Total generic segment net revenues	420,431	313,602	106,829	34.1 %
Brand segment				
Specialty Products	44,434	54,710	(10,276)	(18.8)%
Nephrology	43,617	46,036	(2,419)	(5.3)%
Total brand product sales	88,051	100,746	(12,695)	(12.6)%
Other	1,874	1,918	(44)	(2.3)%
Total brand segment net revenues	89,925	102,664	(12,739)	(12.4)%
Total net revenues	$ 510,356	$ 416,266	$ 94,090	22.6 %

Generic Segment

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

Other revenues include royalties and revenues earned under research and development agreements, other agreements and royalties. Revenues recognized from research, development and licensing agreements (including milestone payments) are 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.

Our Generic segment develops, manufactures, markets, sells and distributes products within two product lines: Generics and Generic Oral Contraceptives (Generic OC s).

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.

For the three months ended June 30, 2006, revenues from our Generic segment increased $106.8 million or 34% over sales from the prior year period. Sales increased due to certain recently launched authorized generic products including oxycodone HCl controlled-release tablets that were launched during the fourth quarter of 2005 and pravastatin sodium tablets that were launched during the second quarter of 2006. Sales from these authorized generic products were $115.6 million during the second quarter of 2006. Excluding these recently

launched authorized generic products, revenues in our Generic segment declined by $8.8 million or 3% compared to the same period in 2005. This decline was due primarily to lower pricing on the Company s existing products.

Brand Segment

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

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

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

For the three months ended June 30, 2006, revenues from our Specialty Products group declined approximately $10.3 million or 19%. The decrease in sales from our Specialty Products group for the three months ended June 30, 2006, as compared to the prior year period was primarily attributable to a decrease in prescription volumes for our non-promoted specialty products and a reduction in wholesaler inventory levels as a result of our entry into inventory management agreements with several of our large wholesale customers during 2005. Sales levels in the prior year period were also impacted by higher levels of wholesaler buying in anticipation of price increases prior to entering into the inventory management agreements with those wholesalers.

Gross Profit (Gross Margin)

	Three Months Ended June 30, 2006		2005		Change	
Overall Consolidated Gross Margin	35.2	%	49.3	%	(14.1	)%
Generic pharmaceutical products	26.9	%	39.8	%	(12.9	)%
Brand pharmaceutical products	72.4	%	77.1	%	(4.7	)%
Gross margin on product net revenues	34.8	%	48.9	%	(14.1	)%

Gross profit represents net revenues less cost of sales. Cost of sales includes the cost of manufacturing and packaging for the products we manufacture, the cost of products we purchase from third parties, our profit-sharing or royalty payments made to third parties, changes to our inventory reserves and excess capacity utilization charges, where applicable. Amortization of acquired product rights is not included in our cost of sales.

Gross margins for our Generic segment declined to 26.9% from 39.8% in the year ago period. The decrease in gross margin from our Generic segment for the three months ended June 30, 2006 was primarily due to sales of oxycodone HCl controlled-release tablets and pravastatin sodium tablets during the second quarter of 2006. Sales from these authorized generic products generated $6.8 million of gross profit on $115.6 million of revenues. Excluding these newly launched products, the gross margin for our Generic segment was 34.7%. Margins in our Generic segment were also adversely impacted by plant rationalization costs of $5.9 million in the second quarter and price declines over the past year on existing products.

During the second quarter of 2006, gross margins from our Brand segment decreased primarily due to higher costs and lower production levels in our Salt Lake City, Utah transdermal manufacturing facility. Margins were also impacted by plant rationalization costs incurred in connection with the planned divestiture of our Phoenix, Arizona sterile manufacturing facility.

Research and Development Expenses

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Research and development expenses by segment:				
Generic	$ 18,124	$ 21,818	$ (3,694)	(16.9)%
Brand	13,001	9,668	3,333	34.5 %
Total research and development expenses	$ 31,125	$ 31,486	$ (361)	(1.1)%
as a % of net revenues	*6.1 %*	*7.6 %*		

Research and development expenses consist predominantly of personnel costs, contract research, development and facilities costs associated with the development of our products. The level of research and development expenses are influenced greatly by the commencement and termination of development programs and clinical studies during each quarter.

Research and development expenses within our Generic segment decreased during the three months ended June 30, 2006, as compared to the same period of the prior year, due to lower biostudy costs in the current period.

Research and development expenses within our Brand segment increased during the three months ended June 30, 2006, as compared to the same period of the prior year, primarily due to the commencement of Phase III studies on the gel formulation of oxybutynin for overactive bladder.

Selling, General and Administrative Expenses

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Selling and marketing expenses by segment:				
Generic	$ 13,526	$ 11,688	$ 1,838	15.7 %
Brand	29,765	30,532	(767)	(2.5)%
Total segment selling and marketing expenses	43,291	42,220	1,071	2.5 %
Corporate general and administrative	27,483	25,905	1,578	6.1 %
Total selling, general and administrative expenses	$ 70,774	$		