PharMerica CORP
Form 10-Q
November 04, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2010

or

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

Commission File Number: 001-33380

PHARMERICA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**87-0792558**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
1901 Campus Place	
Louisville, KY	**40299**
(Address of Principal Executive Offices)	**(Zip Code)**

(502) 627-7000

(Registrant s Telephone Number, Including Area Code)

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

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

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

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

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

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

Class of Common Stock	**Outstanding at October 29, 2010**
Common stock, $0.01 par value	29,314,968 shares

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PHARMERICA CORPORATION

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED INCOME STATEMENTS

For the Three Months and Nine Months Ended September 30, 2009 and 2010

(Unaudited)

(In millions, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Revenues	$ 461.0	$ 443.1	$ 1,389.8	$ 1,355.8
Cost of goods sold	393.9	386.3	1,180.9	1,178.1
Gross profit	67.1	56.8	208.9	177.7
Selling, general and administrative expenses	45.0	43.3	144.7	131.1
Amortization expense	2.5	2.2	6.2	6.9
Integration, merger and acquisition related costs and other charges	0.9	2.4	3.5	12.8
Operating income	18.7	8.9	54.5	26.9
Interest expense, net	1.9	0.9	8.4	2.6
Income before income taxes	16.8	8.0	46.1	24.3
Provision for income taxes	2.2	3.2	14.1	9.8
Net income	$ 14.6	$ 4.8	$ 32.0	$ 14.5
Earnings per common share:				
Basic	$ 0.48	$ 0.16	$ 1.06	$ 0.48
Diluted	$ 0.48	$ 0.16	$ 1.05	$ 0.48
Shares used in computing earnings per common share:				
Basic	30,287,709	30,033,618	30,244,014	30,282,566
Diluted	30,508,342	30,122,302	30,373,255	30,423,035

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

As of December 31, 2009 and September 30, 2010

(Unaudited)

(In millions, except share and per share amounts)

	December 31, 2009	September 30, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 51.2	$ 96.7
Accounts receivable, net	215.3	193.8
Inventory	79.8	75.2
Deferred tax assets	39.8	40.8
Prepaids and other assets	23.6	19.2
	409.7	425.7
Equipment and leasehold improvements	119.6	127.2
Accumulated depreciation	(59.0)	(72.2)
	60.6	55.0
Deferred tax assets, net	21.0	10.9
Goodwill	140.1	140.4
Intangible assets, net	90.8	84.8
Other	2.1	4.7
	$ 724.3	$ 721.5
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 59.6	$ 50.3
Salaries, wages and other compensation	30.9	26.4
Other accrued liabilities	6.4	7.1
	96.9	83.8
Long-term debt	240.0	240.0
Other long-term liabilities	16.5	19.5
Commitments and contingencies (See Note 6)		
Stockholders equity:		
Preferred stock, $0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2009 and September 30, 2010	-	-
Common stock, $0.01 par value per share; 175,000,000 shares authorized; 30,619,830 shares and 30,646,597 shares issued as of December 31, 2009 and September 30, 2010, respectively	0.3	0.3
Capital in excess of par value	344.8	348.1
Retained earnings	25.8	40.3

Treasury stock at cost, 1,331,629 shares at September 30, 2010		-		(10.5)
		370.9		378.2
	$	724.3	$	721.5

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months and Nine Months Ended September 30, 2009 and 2010

(Unaudited)

(In millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Cash flows provided by operating activities:				
Net income	$ 14.6	$ 4.8	$ 32.0	$ 14.5
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation	4.5	4.8	13.4	14.1
Amortization	2.5	2.2	6.2	6.9
Integration, merger and acquisition related costs and other charges	-	0.1	0.2	0.6
Stock-based compensation	1.3	0.8	3.2	3.3
Amortization of deferred financing fees	0.1	0.1	0.3	0.4
Deferred income taxes	2.7	3.4	14.3	9.1
Loss on disposition of equipment	-	0.1	0.1	0.2
Other	(0.1)	-	(0.2)	-
Change in operating assets and liabilities:				
Accounts receivable, net	(4.5)	6.7	4.2	21.3
Inventory	(2.4)	3.1	0.1	4.5
Prepaids and other assets	(5.3)	2.2	(2.0)	4.8
Accounts payable	4.8	(4.6)	(3.0)	(9.3)
Salaries, wages and other compensation	1.0	(0.6)	(5.0)	(5.3)
Other accrued liabilities	(2.3)	0.4	(4.2)	3.7
Net cash provided by operating activities	16.9	23.5	59.6	68.8
Cash flows used in investing activities:				
Purchase of equipment and leasehold improvements	(5.8)	(3.7)	(12.3)	(8.8)
Acquisitions	(15.9)	(3.5)	(15.9)	(3.6)
Cash proceeds from sale of assets	-	-	0.1	-
Net cash used in investing activities	(21.7)	(7.2)	(28.1)	(12.4)
Cash flows provided by (used in) financing activities:				
Repayments of capital lease obligations	(0.1)	(0.1)	(0.4)	(0.5)
Issuance of common stock	1.0	-	1.3	0.3
Treasury stock at cost	-	(10.5)	-	(10.5)
Tax windfall (shortfall) from stock-based compensation	-	(0.2)	0.1	(0.2)
Net cash provided by (used in) financing activities	0.9	(10.8)	1.0	(10.9)
Change in cash and cash equivalents	(3.9)	5.5	32.5	45.5
Cash and cash equivalents at beginning of period	77.7	91.2	41.3	51.2

Cash and cash equivalents at end of period	$ 73.8	$ 96.7	$ 73.8	$ 96.7
Supplemental information:				
Cash paid for interest	$ 3.8	$ 0.8	$ 10.3	$ 2.3
Cash paid for taxes	$ 0.2	$ 0.1	$ 1.6	$ 0.4
Supplemental schedule of non-cash activities:				
Capital lease obligations	$ -	$ -	$ 1.8	$ 0.4
Integrity purchase accounting adjustments	$ -	$ -	$ -	$ 0.2

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the Nine Months Ended September 30, 2010

(Unaudited)

(In millions, except share amounts)

	Common Stock		Capital in Excess of	Retained	Treasury	
	Shares	Amount	Par Value	Earnings	Stock	Total
Balance at December 31, 2009	30,619,830	$ 0.3	$ 344.8	$ 25.8	$ -	$ 370.9
Comprehensive income:						
Net income				14.5		14.5
Total comprehensive income				14.5		14.5
Vested performance share units	4,695	-	-	-	-	-
Exercise of stock options and tax components of stock-based awards, net	22,072	-	-	-	-	-
Treasury stock at cost	(1,331,629)	-	-	-	(10.5)	(10.5)
Stock-based compensation - restricted stock	-	-	1.5	-	-	1.5
Stock-based compensation - stock options	-	-	1.8	-	-	1.8
Balance at September 30, 2010	29,314,968	$ 0.3	$ 348.1	$ 40.3	$ (10.5)	$ 378.2

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

PharMerica Corporation (the Corporation) is an institutional pharmacy services company that services healthcare facilities and provides pharmacy management services to hospitals. The Corporation is the second largest institutional pharmacy services company in the United States, operating 90 institutional pharmacies in 41 states. The Corporation s customers are typically institutional healthcare providers, such as nursing centers, assisted living facilities, hospitals and other long-term alternative care settings and generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 89 hospitals in the United States.

Principles of Consolidation

All intercompany transactions have been eliminated.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Corporation and related footnotes for the year ended December 31, 2009, included in the Corporation s Annual Report on Form 10-K. The balance sheet as of December 31, 2009 has been derived from the audited consolidated financial statements as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

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

Use of Estimates

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Potential risks and uncertainties, many of which are beyond the control of the Corporation, include, but are not necessarily limited to, such factors as overall economic, financial and business conditions; delays and reductions in reimbursement by the government and other payers to the Corporation and/or its customers; the overall financial condition of the Corporation s customers; the effect of new government regulations, executive orders and/or legislative initiatives, including those relating to reimbursement and drug pricing policies and changes in the interpretation and application of such policies; efforts by payers to control costs; the outcome of litigation; the outcome of audit, compliance, administrative or investigatory reviews, including governmental/ regulatory inquiries; delays or difficulties in integrating acquired businesses; other contingent liabilities; changes in international economic and political conditions; changes in interest rates; changes in the valuation of the Corporation s financial instruments; changes in tax laws and regulations; access to capital and financing; the demand for the Corporation s products and services; pricing and other competitive factors in the industry; changes in manufacturers rebate programs; shifts in demand for generic drug equivalents; changes in insurance claims experience and related assumptions; variations in costs or expenses; and changes in accounting rules and standards.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and cash equivalents with original maturities of three months or less. The Corporation places its cash in financial institutions that are federally insured. As of December 31, 2009 and September 30, 2010, the Corporation did not hold a material amount of funds in cash equivalent money market accounts. Management believes it effectively safeguards cash assets.

Fair Value of Financial Instruments

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

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

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

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

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

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

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

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Financial liabilities recorded at fair value at December 31, 2009 and September 30, 2010, are set forth in the tables below (dollars in millions):

As of September 30, 2010	Liabilities	Level 1	Level 2	Level 3	Valuation Technique
Deferred Compensation Plan	$ 3.6	$ -	$ 3.6	$ -	A
Contingent Consideration	$ 1.7	$ -	$ -	$ 1.7	C

As of December 31, 2009	Liabilities	Level 1	Level 2	Level 3	Valuation Technique
Deferred Compensation Plan	$ 2.9	$ -	$ 2.9	$ -	A
Contingent Consideration	$ 1.7	$ -	$ -	$ 1.7	C

The deferred compensation plan liability represents an unfunded obligation associated with the deferred compensation plan offered to eligible employees and members of the Board of Directors of the Corporation. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for similar assets or liabilities generated by market transactions. The contingent consideration represents a future earn-out associated with our acquisition of an institutional pharmacy business based in West Virginia (West Virginia Acquisition). The fair value of the liability associated with the contingent consideration is derived using the income approach with unobservable inputs, which include future gross profit forecast and present value assumptions, and there is little or no market data. There were no transfers between the three-tier fair value hierarchy levels during the period.

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

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily consist of amounts due from Prescription Drug Plans (PDPs) under Medicare Part D, institutional healthcare providers, the respective state Medicaid programs, third party insurance companies, and private payers. The Corporation s ability to collect outstanding receivables is critical to its results of operations and cash flows. To provide for accounts receivable that could become uncollectible in the future, the Corporation establishes an allowance for doubtful accounts to reduce the carrying value of such receivables to the extent it is probable that a portion or all of a particular account will not be collected.

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

	December 31, 2009	September 30, 2010
Institutional healthcare providers	$ 138.7	$ 134.3
Medicare Part D	60.2	40.1
Private payor and other	34.5	37.4
Insured	9.7	8.5
Medicaid	10.9	10.3
Medicare	1.5	1.3
Allowance for doubtful accounts	(40.2)	(38.1)
	$ 215.3	$ 193.8
0 to 60 days	64.9 %	62.9 %
61 to 120 days	17.1 %	19.2 %
Over 120 days	18.0 %	17.9 %
	100.0 %	100.0 %

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

	Beginning Balance	Acquisitions/ Transfers	Charges to Costs and Expenses	Write-offs	Ending Balance
Allowance for doubtful accounts:					
Year Ended December 31, 2009	$ 46.5	$ 3.5	$ 16.6	$ (26.4)	$ 40.2
Nine Months Ended September 30, 2010	$ 40.2	$ -	$ 13.1	$ (15.2)	$ 38.1

The allowance for doubtful accounts for 2009 included a transfer of reserves on contractual adjustments into the allowance for doubtful accounts during the period. The reclassification did not impact the provision for bad debt.

Concentration of Credit Risk

For the nine months ended September 30, 2009 and 2010, the Corporation derived approximately 13.0% and 15.0%, respectively, of its revenues from a single customer, including all payer sources associated with the residents of its long-term care facilities.

Deferred Financing Fees

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

Inventory

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Equipment and Leasehold Improvements

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

	Estimated Useful Lives
Leasehold improvements	1-7
Equipment and software	3-10
Leased equipment	1-5

Expenditures for maintenance, repairs and renewals of minor items are expensed as incurred. Major rebuilds and improvements are capitalized. For the three months ended September 30, 2009 and 2010, maintenance and repairs were $1.4 million and $1.6 million, respectively. For the nine months ended September 30, 2009 and 2010, maintenance and repairs were $4.7 million and $4.5 million, respectively.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset to the estimated future undiscounted net cash flows expected to be generated by the asset. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset to its then fair value. The Corporation did not record impairment charges on equipment and leasehold improvements for the nine months ended September 30, 2009 or 2010.

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

Capitalization of Internal Software Costs

The Corporation capitalizes the costs incurred during the application development stage, which include costs to design the software configuration and interfaces, coding, installation, and testing. Costs incurred during the preliminary project stage along with post-implementation stages of internal use computer software are expensed as incurred. Capitalized development costs are amortized over various periods up to three years and are subject to impairment evaluations. Costs incurred to maintain existing software development are expensed as incurred. The capitalization and ongoing assessment of recoverability of development costs requires judgment by management with respect to certain external factors, including, but not limited to, technological and economic feasibility and estimated economic life. For the three months ended September 30, 2009 and 2010, the Corporation capitalized software development costs of $0.8 million and $0.3 million, respectively. For the nine months ended September 30, 2009 and 2010, the Corporation capitalized software development costs of $2.0 million and $1.5 million, respectively. As of December 31, 2009 and September 30, 2010, net capitalized software costs, including amounts for projects which have not been completed, totaled $9.5 million and $9.0 million, respectively.

Goodwill and Other Intangibles

Goodwill represents the excess purchase price of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. Goodwill and intangible assets with indefinite lives are reviewed by the Corporation at least annually for impairment, each of which are

reviewed separately for impairment. The Corporation s business is comprised of two reporting units, institutional pharmacy and hospital management, each of which are reviewed separately for impairment. The Corporation last performed its annual impairment tests for goodwill recorded as of December 31, 2009, and did not incur an impairment charge.

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Self-Insured Employee Health Benefits

The Corporation is self-insured for employee health benefits. The Corporation s self-insurance for employee health benefits includes a stop-loss policy to limit the maximum potential liability of the Corporation for both individual and aggregate claims per year. The Corporation records a monthly expense for self-insurance based on historical claims data and inputs from third-party administrators. For the three months ended September 30, 2009 and 2010, the expense for employee health benefits was $5.7 million and $4.8 million, respectively, and for the nine months ended September 30, 2009 and 2010, the expense for employee health benefits was $14.3 million and $14.2 million, respectively. As of December 31, 2009 and September 30, 2010, the Corporation had $2.5 million and $2.7 million, respectively, recorded as a liability for self-insured employee health benefits.

Supplier Rebates

The Corporation receives rebates on purchases from its vendors and suppliers. The Corporation generally accounts for these rebates and other incentives received from its vendors and suppliers, relating to the purchase or distribution of inventory, as a reduction of cost of goods sold and inventory. The Corporation considers these rebates to represent product discounts, and as a result, the rebates are capitalized as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory. For the three months ended September 30, 2009 and 2010, rebates were $12.9 million and $12.4 million, respectively, and for the nine months ended September 30, 2009 and 2010, rebates were $35.0 million and $38.8 million, respectively. The Corporation had $3.0 million and $3.2 million of rebates capitalized in inventory as of December 31, 2009 and September 30, 2010, respectively.

Delivery Expenses

The Corporation incurred delivery expenses of $14.2 million and $13.5 million for the three months ended September 30, 2009 and 2010, respectively, and $41.5 million and $42.8 million for the nine months ended September 30, 2009 and 2010, respectively, to deliver products sold to its customers. Delivery expenses are reported as a component of cost of goods sold in the accompanying condensed consolidated income statements.

Stock Option Accounting

The Corporation recognizes stock-based compensation expense in its condensed consolidated financial statements using the Black-Scholes-Merton option valuation model for non-vested stock options. See Note 9.

Income Taxes

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

Pharmacy Transaction

The Corporation, formerly known as Safari Holding Corporation, was formed on October 23, 2006, by Kindred Healthcare, Inc. (Kindred or Former Parent) and AmerisourceBergen Corporation (AmerisourceBergen) for the purpose of consummating the transactions contemplated by the Master Transaction Agreement dated October 25, 2006, as amended (the Master Agreement). Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through a series of transactions (collectively, the Pharmacy Transaction), spun-off and combined their respective institutional pharmacy businesses, Kindred Pharmacy Services (KPS) and PharMerica Long-Term Care (PharMerica LTC), into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007 (the Closing Date).

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS

2009 Acquisitions

Integrity Pharmacy Services Acquisition

On December 31, 2009, the Corporation through a wholly-owned subsidiary, acquired all of the membership interests in Integrity Pharmacy Services, LLC (IPS), and Integrity Medical Supplies, LLC (IMS together with IPS, Integrity), for $38.0 million in cash plus $3.3 million to retire outstanding promissory notes in favor of the sellers. The Corporation s primary purpose in acquiring Integrity was to increase the Corporation s market share in certain regions.

The acquisition of Integrity has been accounted for as a business combination using the acquisition method of accounting. The total purchase price of Integrity was allocated to the net tangible and identifiable intangible assets based upon their fair values on December 31, 2009. The excess of the purchase price over the fair values of the net tangible and identifiable intangible assets was recorded as goodwill. For tax purposes, the transaction was considered an asset acquisition, therefore, the amount of goodwill recorded in the transaction of $12.0 million will be tax deductible to the Corporation. The Corporation believes the resulting amount of goodwill reflects its expectations of the synergistic benefits of being able to fully integrate the Integrity business into its existing institutional pharmacy locations.

Except for identifiable intangible assets, and equipment and leasehold improvements, the assets acquired and liabilities assumed were valued at their respective carrying amounts recorded by Integrity as the Corporation believes that their carrying value amounts approximate their fair value at the acquisition date.

The purchase price allocation was recorded as follows (dollars in millions):

Current assets, net of cash acquired	$	9.8
Equipment and leasehold improvements		1.2
Identifiable intangible assets		20.6
Goodwill		12.0
Total assets		43.6
Current liabilities		(4.4)
Purchase price, net of cash acquired	$	39.2

The following are the fair values of the equipment and leasehold improvements of Integrity acquired at the date of acquisition (dollars in millions):

		Fair Value	Weighted Average Useful Lives
Leasehold improvements	$	0.3	7.0

Equipment and software	0.9	4.0
Total equipment and leasehold improvements acquired	$ 1.2	5.1

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

	Fair Value	Weighted Average Useful Lives
Non-competition agreement	$ 0.2	5.0
Customer relationships	20.4	15.0
Total identifiable intangible assets acquired	$ 20.6	14.9

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 ACQUISITIONS (Continued)

West Virginia Acquisition

On August 10, 2009, the Corporation acquired certain assets and assumed certain liabilities of an institutional pharmacy business providing medications, pharmacy and medical supplies and services to residents of long-term care facilities located mostly in West Virginia. The Corporation paid $15.9 million in cash for the business, with an additional amount not to exceed $10.0 million in the form of contingent consideration to be paid at the end of a three year period based upon the cumulative achievement of certain financial performance measures. The transaction was accounted for under the acquisition method of accounting, in which the preliminary purchase price was allocated based upon the fair value of the assets acquired and liabilities assumed with the difference recorded as goodwill. As a result of the acquisition the Corporation recorded $4.4 million as finite-lived intangible assets and $12.6 million of goodwill. The contingent consideration was recorded at fair value at the acquisition date in the amount of $1.7 million. The contingent consideration will be adjusted to fair value through earnings until the final amount is determined.

Other

For the three months ended September 30, 2009 and 2010, the Corporation incurred $0.5 million and $0.9 million, respectively, of acquisition related costs, which have been classified as a component of integration, merger, and acquisition related costs and other charges. For the nine months ended September 30, 2009 and 2010, $0.6 million and $3.8 million, respectively, was incurred for acquisition related costs.

The total amount of goodwill expected to be deductible for tax purposes from past acquisitions of the Corporation was $85.6 million as of September 30, 2010. Deferred tax assets and liabilities are further described in Note 10.

Pro forma

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

The unaudited pro forma effect of the Integrity and West Virginia acquisitions assuming the acquisitions occurred on January 1, 2009, excluding the integration, merger and acquisition related costs and other charges for the three months and nine months ended September 30, 2009, would be as follows (dollars in millions, except per share amounts):

	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2009
Revenues	$ 479.6	$ 1,452.9
Net income	$ 15.9	$ 35.9
Earnings per common share:		
Basic	$ 0.52	$ 1.18
Diluted	$ 0.52	$ 1.18

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 EQUIPMENT AND LEASEHOLD IMPROVEMENTS

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

	December 31, 2009	September 30, 2010
Leasehold improvements	$ 11.6	$ 12.6
Equipment and software	95.3	101.9
Leased equipment	2.6	3.0
Construction in progress	10.1	9.7
	119.6	127.2
Accumulated depreciation	(59.0)	(72.2)
Total Equipment and leasehold improvements	$ 60.6	$ 55.0

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

	Balance at December 31, 2009	Additions	Disposals	Transfers	Balance at September 30, 2010
Equipment and leasehold improvements:					
Leasehold improvements	$ 11.6	$ 0.6	$ (0.1)	$ 0.5	$ 12.6
Equipment and software	95.3	5.6	(1.5)	2.5	101.9
Leased equipment	2.6	0.4	-		3.0
Construction in progress	10.1	2.6	-	(3.0)	9.7
Sub-Total	119.6	9.2	(1.6)	-	127.2
Accumulated depreciation	(59.0)	(14.1)	0.9	-	(72.2)
Total	$ 60.6	$ (4.9)	$ (0.7)	$ -	$ 55.0

Depreciation expense totaled $4.5 million and $4.8 million for the three months ended September 30, 2009 and 2010, respectively. Depreciation expense totaled $13.4 million and $14.1 million for the nine months ended September 30, 2009 and 2010, respectively.

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

Year Ending December 31,

2010	$ 18.4	*
2011	14.3	
2012	10.4	
2013	6.3	
2014	4.1	
Thereafter	15.6	
Total	$ 69.1	

* The 2010 amount shown includes depreciation expense for the nine months ended September 30, 2010 of $14.1 million.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 GOODWILL AND INTANGIBLES

The following table presents the changes in the carrying amount of goodwill for the nine months ended September 30, 2010 (dollars in millions):

Balance at December 31, 2009	$	140.1
Integrity purchase accounting adjustments		0.3
Balance at September 30, 2010	$	140.4

The Corporation does not have accumulated impairments that reduce the gross value of goodwill.

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

Finite Lived Intangible Assets	Balance at December 31, 2009	Additions	Balance at September 30, 2010
Customer relationships	$ 76.6	$ -	$ 76.6
Trade name	28.5	-	28.5
Non-compete agreement	4.7	0.9	5.6
Sub Total	109.8	0.9	110.7
Accumulated amortization	(19.0)	(6.9)	(25.9)
Net intangible assets	$ 90.8	$ (6.0)	$ 84.8

Amortization expense relating to finite-lived intangible assets was $2.5 million and $2.2 million for the three months ended September 30, 2009 and 2010, respectively. Amortization expense relating to finite-lived intangible assets was $6.2 million and $6.9 million for the nine months ended September 30, 2009 and 2010, respectively.

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

Year Ending December 31,		
2010	$	9.1 *
2011		7.2
2012		6.6
2013		6.5
2014		6.5
Thereafter		55.8

	$ 91.7

* The 2010 amount shown includes amortization expense for the nine months ended September 30, 2010 of $6.9 million.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT

The Corporation is a party to a credit agreement among the Corporation, the Lenders named therein, and JPMorgan Chase Bank, N.A. (JPMorgan), as Administrative Agent (the Credit Agreement). The Credit Agreement consists of a $275.0 million term loan facility and a $150.0 million revolving credit facility. As of September 30, 2010, $240.0 million was outstanding under the term loan facility and no amounts were outstanding under the revolving credit facility. Indebtedness under the Credit Agreement matures on July 31, 2012, at which time the commitment of the Lenders to make revolving loans also shall expire. There is no scheduled amortization under the term loan facility but the term loans are subject to certain prepayment obligations relating to asset sales, casualty losses and the incurrence by the Corporation of certain indebtedness.

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

Credit Agreement:	December 31, 2009	September 30, 2010
Term Debt - payable to lenders at LIBOR plus applicable margin (1.26% as of September 30, 2010), matures July 31, 2012	$ 240.0	$ 240.0
Revolving Credit Facility payable to lenders, interest at LIBOR plus applicable margin, matures July 31, 2012	-	-
Total debt	$ 240.0	$ 240.0

The maturity of all of the Corporation s long-term debt will occur on July 31, 2012.

The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of September 30, 2010 was $2.0 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $148.0 million as of September 30, 2010. The revolving credit facility contains a $50.0 million accordion feature, which permits the Corporation to increase the size of the credit facility, up to an aggregate of $200.0 million, subject to securing additional commitments from existing or new lenders.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at our option, a base rate plus a margin between 0.0% and 0.75% per annum, or an adjusted London Interbank Offered Rate (LIBO rate or LIBOR) plus a margin between 0.625% and 1.75% per annum, in each case depending on the leverage ratio of the Corporation. The base rate is the higher of the prime lending rate announced by JPMorgan in New York from time to time and the federal funds rate published by the Federal Reserve Bank of New York plus 0.50%. The Credit Agreement also provides for letter of credit participation fees between 0.625% and 1.75%, letter of credit fronting fees of 0.125%, and a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.125% to 0.250%, in each case depending on the leverage ratio of the Corporation.

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

negative covenants, representations, warranties, and events of default that are customary to facilities of this nature.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 CREDIT AGREEMENT (Continued)

Covenants

The Credit Agreement requires the Corporation to satisfy a fixed charge coverage ratio and a leverage ratio. The minimum fixed charge coverage ratio, which is tested quarterly on a trailing four quarter basis, can be no less than: 2.50:1.00 beginning with January 1, 2010 and thereafter. The maximum total leverage coverage ratio, which also is tested quarterly, cannot exceed 3.00:1.00 beginning with January 1, 2010 and thereafter. The maximum total leverage coverage ratio is not tested when at any time it is less than 2.00:1.00, or both S&P and Moody s have in effect corporate credit ratings for the Corporation that are investment grade. The Corporation remains compliant under the terms of the Credit Agreement. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 3.0% of revenues.

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

	Minimum Fixed Charge Coverage Ratio	Maximum Leverage Ratio	Capital Expenditure
Requirement	> = 2.25 to 1.00	< = 3.50 to 1.00	< = 3.00 %
December 31, 2009	5.09	1.88	1.17 %
Requirement	> = 2.50 to 1.00	< = 3.00 to 1.00	< = 3.00 %
September 30, 2010	5.70	2.48	**

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

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

Deferred Financing Fees

The Corporation capitalized a total of $2.0 million in deferred financing fees associated with the Credit Agreement and recorded them as other assets in the accompanying condensed consolidated balance sheets. As of September 30, 2010, the Corporation had $0.4 million of unamortized deferred financing fees.

NOTE 6 COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

The Corporation is involved in certain legal actions and regulatory investigations arising in the ordinary course of business. None of these legal proceedings are, in the opinion of management, expected to have a material adverse effect on the consolidated financial position, results of operations, or liquidity of the Corporation.

FUL and AMP Changes

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

In addition, the definition of AMP changed to reflect net sales only to drug wholesalers that distribute to retail community pharmacies and to retail community pharmacies that directly purchase from drug manufacturers. Further, the 2010 Health Care Legislation continues the current statutory exclusion of prompt pay discounts offered to wholesalers and adds three other exclusions to the AMP definition. In addition to reporting monthly, the manufacturers will be required to report the total number of units used to calculate each monthly AMP. Centers for Medicare & Medicaid Services (CMS) will use this information when it establishes FULs as a result of the new volume-weighted requirements pursuant to the 2010 Health Care Legislation.

The new AMP became effective on October 1, 2010. Manufacturers are required to report pricing by November 30, 2010. CMS can set new FULs any time thereafter.

The Corporation is unable to fully evaluate the impact of the changes in FUL and AMP to its business.

AWP Changes

Average wholesale price, or AWP, is a pricing benchmark published by First DataBank, Inc. in its Blue Book, which provides drug databases, content integration software, and drug reference products. AWP has been widely used to calculate the majority of the Medicaid, Medicare Part A and Medicare Part D drug reimbursements payable to pharmacy providers. In 2005, several pension funds brought an action against First DataBank and another healthcare provider alleging collusion to set AWPs for branded drugs.

On March 30, 2009, the Court approved the settlement of the litigation. Pursuant to the settlement agreement dated September 26, 2009, First DataBank: (i) adjusted its reporting of Blue Book AWP for those prescription drugs (approximately 1,400 National Drug Codes, or NDCs in number) identified in the plaintiffs previously filed complaint by reducing the mark-up factor utilized in connection with the calculation of the Blue Book AWP data field to 1.20 times the Wholesale Acquisition Cost, or WAC, or direct price for those prescription drugs that are on a mark-up basis; and (ii) established a centralized data repository to facilitate reasonable access to discoverable material from First DataBank concerning its drug price reporting practices.

Independent of the settlement and on the same schedule as the Blue Book AWP adjustment noted above, First DataBank has applied the same 1.20 markup factor to all other NDCs, whose Blue Book AWP is set based upon a markup to WAC or direct price in excess of 1.20 times WAC. First DataBank will also independently discontinue publishing the Blue Book AWP data field for all drugs no later than September 26, 2011.

The Corporation and the preponderance of the Corporation s PDPs, third party insurance companies and its Medicare Part A customers have voluntarily agreed to adjust reimbursement so that pricing would not increase or decrease as a result of the changes to AWP; however, the state Medicaid programs have been unwilling to remain price neutral.

Acquisitions

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

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Prime Vendor Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the Prime Vendor Agreement), with AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen. Pursuant to this agreement, the Corporation has agreed to purchase at least 95% of the Corporation s prescription pharmaceutical drugs from ABDC and to participate in its generic formulary purchase program for a period of five years following the Closing Date. In addition, ABDC will support the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provide inventory management support and packaging services. Unless either party provides certain notice of termination, the agreement will continue on a month-to-month basis upon expiration of the initial five year term. The agreement may be terminated by either party for cause during the initial five year term, and by either party with or without cause thereafter upon 90 days notice. Also under the provisions of the agreement, the Corporation may not undertake any merger, change of ownership, change in control or other transaction without the consent of ABDC unless certain conditions are met.

Information Technology Services Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (KHOI), a wholly owned subsidiary of Kindred (the IT Services Agreement). Pursuant to this agreement, KHOI is the Corporation s exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years, ending on July 31, 2012. The services provided by KHOI include business services necessary to operate, manage, and support certain financial applications the Corporation uses, including enabling and/or supporting technology infrastructure and technology procurement services to support certain business functions. Such services include, among other matters, functions for financial management, systems, and payroll. The Corporation will support internally all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records management, human resources, internal and external customer call center support, and general business systems.

Except for certain services that will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The initial term of the agreement is five years. The agreement will automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior written notice of termination as provided for in the agreement. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation s competitors. Following termination of the IT Services Agreement, KHOI must provide termination and expiration assistance for up to 180 days. The Corporation has incurred $2.9 million and $2.7 million in fees for the three months ended September 30, 2009 and 2010, respectively, under the IT Services Agreement. The Corporation incurred $8.6 million and $8.4 million in fees for the nine months ended September 30, 2009 and 2010, respectively, under the IT Services Agreement.

Employment Agreements

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

The type of compensation due to each of the executive officers in the event of the termination of their employment period varies depending on the nature of the termination. The employment agreements do not entitle the executive officers to any additional payment or benefits solely upon the occurrence of a change in control but do provide additional payments or benefits or both upon a termination of employment in connection

with a change in control. Additionally, the vesting of certain equity based grants made to certain executive officers accelerate upon the occurrence of a change in control.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 COMMITMENTS AND CONTINGENCIES (Continued)

Leases

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Pharmacy locations and administrative offices lease expense	$ 3.5	$ 3.2	$ 10.5	$ 10.4
Office equipment lease expense	0.8	0.5	2.1	1.5
Total lease expense	$ 4.3	$ 3.7	$ 12.6	$ 11.9

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

Year Ending December 31,	Operating Leases	Capital Lease Obligations	Total
2010	$ 14.1 *	$ 0.7	$ 14.8
2011	11.2	0.8	12.0
2012	8.1	0.1	8.2
2013	5.9	-	5.9
2014	3.5	-	3.5
Thereafter	7.1	-	7.1
Total	$ 49.9	$ 1.6	$ 51.5

*The 2010 amount shown includes rental expense for Pharmacy locations and administrative offices lease expense of $10.4 million for the nine months ended September 30, 2010.

NOTE 7 REVENUES

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

other factors which may impact ultimate reimbursement. Amounts are adjusted to actual reimbursed amounts upon cash receipt.

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 REVENUES (Continued)

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

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

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

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009		2010		2009		2010	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Medicare Part D	$ 211.4	45.9 %	$ 204.8	46.2 %	$ 635.9	45.8 %	$ 627.5	46.3 %
Institutional healthcare providers	134.7	29.2	132.8	30.0	414.5	29.8	410.6	30.3
Medicaid	42.1	9.1	39.6	8.9	127.7	9.2	119.7	8.8
Private and other	34.6	7.5	26.7	6.0	94.9	6.8	80.4	6.0
Insured	22.8	5.0	22.0	5.0	68.8	4.9	68.0	5.0
Medicare	1.5	0.3	1.8	0.4	5.2	0.4	5.7	0.4
Hospital management fees	13.9	3.0	15.4	3.5	42.8	3.1	43.9	3.2
Total	$ 461.0	100.0 %	$ 443.1	100.0 %	$ 1,389.8	100.0 %	$ 1,355.8	100.0 %

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

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

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 INTEGRATION, MERGER AND ACQUISITION RELATED COSTS AND OTHER CHARGES

In fiscal year 2009, we began the integration of our pharmacy operating systems. The Corporation expects to continue to incur costs related to the integration of its pharmacy operating systems during fiscal 2010 and 2011. In addition, the Corporation also incurs and will continue to incur costs related to acquisitions.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Integration costs and other charges:				
Pre- Pharmacy Transaction litigation matters	$ -	$ -	$ -	$ 5.0
Professional and advisory fees	-	0.7	-	2.2
General and administrative	0.1	0.1	0.4	0.5
Employee costs	0.2	0.2	1.2	0.4
Severance costs	-	0.4	0.6	0.6
Facility costs	0.1	-	0.7	0.2
Other costs	-	0.1	-	0.1
	0.4	1.5	2.9	9.0
Acquisition costs:				
Professional and advisory fees	0.5	0.5	0.6	1.0
General and administrative	-	0.1	-	1.1
Employee costs	-	-	-	0.2
Facility costs	-	0.1	-	1.3
Other costs	-	0.2	-	0.2
	0.5	0.9	0.6	3.8
Total integration, merger, and acquisition related costs and other charges	$ 0.9	$ 2.4	$ 3.5	$ 12.8
Negative effect on diluted earnings per share	$ (0.02)	$ (0.05)	$ (0.07)	$ (0.25)

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Common Stock

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

Preferred Stock

The certificate of incorporation authorizes the issuance of an aggregate of 1.0 million shares of preferred stock. As of September 30, 2010, there were no shares of preferred stock outstanding.

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

Treasury Stock Purchases

In August 2010, the Board of Directors authorized a share repurchase of up to $25.0 million of the Corporation s common stock. Share repurchases under this authorization may be made in the open market through unsolicited or solicited privately negotiated transactions, or in such other appropriate manner, and will be funded from available cash. The amount and timing of the repurchases will be determined by the Corporation s management and will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. Common stock acquired through the share repurchase program will be held as treasury shares and may be used for general corporate purposes, including reissuances in connection with acquisitions, employee stock option exercises or other employee stock plans. The share repurchase program does not have an expiration date and may be limited, terminated or extended at any time without prior notice. During the three months ended September 30, 2010, the Corporation repurchased 1,327,803 shares of common stock for an aggregate purchase price, including commissions, of $10.5 million at an average purchase price of $7.90 per share.

Additionally, the Corporation may redeem shares from employees upon the vesting of the Corporation s stock awards for minimum statutory tax withholding purposes. The Corporation redeemed 3,826 shares of certain vested awards for an aggregate price of less than $0.1 million, during the three months and nine months ended September 30, 2010. These shares have also been designated by the Corporation as treasury stock.

As of September 30, 2010, the Corporation had a total of 1,331,629 shares held as treasury stock.

Amended and Restated 2007 Omnibus Incentive Plan

The Corporation has adopted the Amended and Restated PharMerica Corporation 2007 Omnibus Incentive Plan (as amended and restated, the Omnibus Plan) under which the Corporation is authorized to grant equity-based and other awards to its employees, officers, directors, and consultants. In connection with the Corporation s 2010 Annual Meeting of Stockholders, the stockholders of the Corporation approved and adopted the amended and restated Omnibus Plan to, among other things, implement a fungible share pool effective as of January 1, 2010, and preserve preferential tax treatment as qualified performance-based compensation under Section 162(m) of the Internal Revenue Code.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

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

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

As of September 30, 2010, total shares available for grants of stock-based awards pursuant to the Omnibus Plan were 4,144,360 shares.

Stock-Based Compensation Expense

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Stock option compensation expense	$ 0.4	$ 0.6	$ 1.4	$ 1.8
Nonvested stock compensation expense	0.9	0.2	1.8	1.5
Total Stock Compensation Expense	$ 1.3	$ 0.8	$ 3.2	$ 3.3
Negative effect on diluted earnings per share	$ (0.03)	$ (0.01)	$ (0.06)	$ (0.06)

As of September 30, 2010, there was $7.8 million of total unrecognized compensation cost related to the Corporation s stock compensation arrangements. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures. The Corporation expects to recognize that cost over weighted average periods ranging from less than one year 2.4 years depending on the type of award granted.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

Year Ending December 31,		
2010	$	4.8 *
2011		3.5
2012		1.6
2013		1.0
2014		0.2
Thereafter		-
Total	$	11.1

*The 2010 amount shown includes stock-based compensation expense for the nine months ended September 30, 2010 of $3.3 million.

The following weighted average assumptions were used to estimate the fair value of options granted during 2009 and the nine months ended September 30, 2010, using the Black-Scholes-Merton option valuation model:

	2009	**2010**
Expected volatility (range)	36.36 - 41.07%	38.53 - 45.54%
Risk free interest rate (range)	0.75 - 2.09%	0.49 - 2.47%
Expected dividends	-	-
Average expected term (years)	2.0 - 5.0	2.0 - 5.0
Average fair value per share of stock options granted based on the Black-Scholes-Merton model	$4.40	$5.79
Weighted average fair value of options granted during the period (in millions)	$2.5	$3.3

Expected Volatility

Volatility is a measure of the tendency of investment returns to vary around a long-term average rate. Historical volatility is an appropriate starting point for setting this assumption. The Corporation also considers how future experience may differ from the past. This may require using other factors to adjust historical volatility, such as implied volatility, peer-group volatility and the range and mean-reversion of volatility estimates over various historical periods. The peer-group utilized consisted of fourteen companies in 2009 and 2010, in the same or similar industries as the Corporation. In addition, if a best estimate cannot be made, management uses the mid-point in the range of reasonable estimates for volatility. The Corporation estimates the volatility of its common stock in conjunction with the Corporation s annual grant and volatility is calculated utilizing the historical volatility of the Corporation and its peer-group. To the extent material grants are made subsequent to the Corporation s annual grant, the volatility calculation is updated through the most recent grant date of the awards.

Risk-Free Interest Rate

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

Expected Dividends

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

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Expected Term

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

Stock Option Activity

The following table summarizes option activity for the periods presented:

	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Term	Aggregate Instrinsic Value (in millions)
Outstanding at December 31, 2008	1,332,649	$ 15.47	5.7 years	
Granted	567,633	15.18		
Exercised	(107,308)	12.69		
Canceled	(59,649)	14.63		
Outstanding at December 31, 2009	1,733,325	$ 15.60	5.2 years	$ 1.0
Granted	562,167	18.28		
Exercised	(22,072)	12.66		
Canceled	(39,256)	16.50		
Outstanding at September 30, 2010	2,234,164	$ 16.28	5.0 years	$ -
Exercisable at September 30, 2010	975,990	$ 15.71	4.2 years	$ -
Expired shares during 2010	4,142			

The total intrinsic value of stock options exercised for the nine months ended September 30, 2009 and 2010 was $0.7 million and $0.1 million, respectively. Cash received from stock option exercises during the nine months ended September 30, 2010 was $0.3 million. The total fair value of options vested for the nine months ended September 30, 2009 and 2010 was $1.6 million and $1.7 million, respectively.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Nonvested Shares

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

	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding shares at December 31, 2008	342,591	$ 15.93
Granted - Restricted Stock	35,633	17.96
Granted - Restricted Stock Units	99,332	15.06
Granted - Performance Share Units	152,580	15.16
Forfeited	(11,533)	14.52
Vested	(84,201)	14.34
Outstanding shares at December 31, 2009	534,402	$ 15.98
Granted - Restricted Stock Units	39,144	$ 16.35
Granted - Performance Share Units	178,219	18.03
Forfeited	(11,132)	16.90
Vested	(84,725)	16.81
Outstanding shares at September 30, 2010	655,908	$ 16.43

The total fair value of shares vested for the nine months ended September 30, 2009 and 2010 was $0.3 million and $1.4 million, respectively.

Based upon the achievement of the performance criteria at the end of the performance cycle for the performance share units issued to date, the Corporation may issue no shares or a maximum of 656,394 shares.

401K Plan

The Corporation sponsors a defined contribution retirement plan for all eligible employees, as defined in the plan document. The plan is qualified under Section 401(k) of the Internal Revenue Code. Contributions to the plan are based upon employee contributions and the Corporation s matching contributions. For the three months ended September 30, 2009 and 2010, the Corporation s matching contributions to the plan were $1.4 million and $1.3 million, respectively, and for the nine months ended September 30, 2009 and 2010, the Corporation s matching contributions to the plan were $4.1 million and $4.0 million, respectively.

Deferred Compensation Plans

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

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

As of December 31, 2009 and September 30, 2010, the Corporation had $2.9 million and $3.6 million, respectively, recognized as a long-term liability related to the deferred compensation plans in the accompanying condensed consolidated balance sheets.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 INCOME TAXES

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Tax provision	$ 2.2	$ 3.2	$ 14.1	$ 9.8
Total provision as a percentage of income before income taxes	13.1 %	40.5 %	30.6 %	40.4 %

The provision for income taxes as a percentage of income before income taxes for the three months and nine months ended September 30, 2010 was higher than the three months and nine months ended September 30, 2009 due to a discrete tax benefit recorded in the third quarter of 2009 related to the adoption of an internal legal entity restructuring plan.

The Corporation derives a current federal and state income tax benefit from the impact of deductions associated with the amortization of tax deductible goodwill acquired through business combinations. As of December 31, 2009 and September 30, 2010, the tax basis of the Corporation s tax deductible goodwill was approximately $113.9 million and $85.6 million, respectively. The future tax benefits of the tax-deductible goodwill are included in the Corporation s deferred tax assets.

The Corporation recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Corporation also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards. As of September 30, 2010, the Corporation has tax benefits from federal net operating loss carryforwards of $18.8 million and tax benefits from state net operating loss carryforwards of $10.0 million, net of valuation allowances. The net operating losses have carryforward periods ranging from 1 to 20 years depending on the taxing jurisdiction.

A valuation allowance is provided for the Corporation s deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized. As of December 31, 2009 and September 30, 2010, the Corporation recognized deferred tax assets totaling $60.8 million and $51.7 million, net of valuation allowances of $1.7 million, respectively.

As of December 31, 2009 and September 30, 2010, the Corporation had $1.7 million recorded as a liability for unrecognized tax benefits for U.S. federal and state tax jurisdictions.

The federal statute of limitations remains open for tax years 2006 through 2009. The Corporation s consolidated U.S. income tax returns for 2007 and 2008 are currently under examination by the IRS. State tax jurisdictions generally have statutes of limitations ranging from three to five years. The Corporation is no longer subject to state and local income tax examinations by tax authorities for years before 2005. The state income tax impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification of IRS settlement to the states. Kindred and AmerisourceBergen are responsible for any taxes that relate to periods prior to the 2007 Pharmacy Transaction.

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 EARNINGS PER SHARE

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Numerator:				
Numerator for basic and diluted earnings per share - net income	$ 14.6	$ 4.8	$ 32.0	$ 14.5
Denominator:				
Denominator for basic earnings per share - weighted average shares	30,287,709	30,033,618	30,244,014	30,282,566
Effect of dilutive securities:				
Employee stock options	117,725	11	55,879	18,482
Employee restricted shares	102,908	88,673	73,362	121,987
Denominator for diluted earnings per share - adjusted weighted average shares	30,508,342	30,122,302	30,373,255	30,423,035
Basic earnings per share	$ 0.48	$ 0.16	$ 1.06	$ 0.48
Diluted earnings per share	$ 0.48	$ 0.16	$ 1.05	$ 0.48
Unexercised employee stock options and unvested restricted shares excluded from the effect of dilutive securities above (a)	197,171	2,309,617	1,475,386	2,038,049

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

Stock options and restricted shares granted by the Corporation are treated as potential common shares outstanding in computing earnings per diluted share. Performance share units are treated as potential common shares outstanding in computing earnings per diluted share only when they are probable to vest.

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

NOTE 12 BUSINESS SEGMENT DATA

The Corporation operates in two reportable business segments: institutional pharmacies and hospital pharmacy management. Institutional pharmacies provide pharmacy services to nursing centers and other healthcare providers and the hospital pharmacy management business provides management services to substantially all of Kindred s hospitals. For business segment reporting purposes, the Corporation defines

segment operating income as earnings before interest, income taxes, depreciation, amortization, integration, merger and acquisition related costs, and other charges, and rent. Segment operating income reported for each of the Corporation s business segments excludes the allocation of corporate overhead.

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

	December 31, 2009	September 30, 2010
Assets:		
Institutional pharmacies	$ 716.1	$ 711.1
Hospital pharmacy management	8.2	10.4
	$ 724.3	$ 721.5
Goodwill:		
Institutional pharmacies	$ 140.1	$ 140.4
Hospital pharmacy management	-	-
	$ 140.1	$ 140.4

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 BUSINESS SEGMENT DATA (Continued)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2010**	**2009**	**2010**
Revenues:				
Institutional pharmacies	$ 447.1	$ 427.7	$ 1,347.0	$ 1,311.9
Hospital pharmacy management	13.9	15.4	42.8	43.9
	$ 461.0	$ 443.1	$ 1,389.8	$ 1,355.8
Net income:				
Segment operating income:				
Institutional pharmacies	$ 29.7	$ 20.7	$ 85.3	$ 68.6
Hospital pharmacy management	1.2	1.3	4.9	4.0
Segment operating income	30.9	22.0	90.2	72.6
Rent	4.3	3.7	12.6	11.9
Depreciation and amortization	7.0	7.0	19.6	21.0
Integration, merger and acquisition related costs and other charges	0.9	2.4	3.5	12.8
Interest expense, net	1.9	0.9	8.4	2.6
Income before income taxes	16.8	8.0	46.1	24.3
Provision for income taxes	2.2	3.2	14.1	9.8
Net income	$ 14.6	$ 4.8	$ 32.0	$ 14.5
Rent:				
Institutional pharmacies	$ 4.3	$ 3.7	$ 12.6	$ 11.9
Hospital pharmacy management	-	-	-	-
	$ 4.3	$ 3.7	$ 12.6	$ 11.9
Depreciation and amortization:				

Institutional pharmacies	$ 7.0	$ 7.0	$ 19.6	$ 21.0
Hospital pharmacy management	-	-	-	-
	$ 7.0	$ 7.0	$ 19.6	$ 21.0
Capital Additions:				
Institutional pharmacies	$ 5.8	$ 3.7	$ 12.3	$ 8.8
Hospital pharmacy management	-	-	-	-
	$ 5.8	$ 3.7	$ 12.3	$ 8.8

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PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 13 SUBSEQUENT EVENTS

On September 26, 2010, the Corporation entered into an Asset Purchase Agreement (the Agreement) with Chem Rx Corporation and certain of its wholly-owned subsidiaries (collectively, Chem Rx), under which the Corporation has agreed to purchase substantially all of the assets and selected vendor contracts of Chem Rx (collectively the Assets), subject to the terms and conditions contained in the Agreement.

On May 10, 2010, Chem Rx filed voluntary petitions for Chapter 11 bankruptcy protection in the Delaware District of the United States Bankruptcy Court (the Bankruptcy Court). It is intended that the acquisition of the Assets would be accomplished through the sale, transfer, and assignment of the Assets by Chem Rx to the Corporation undertaken pursuant to Section 363 of the United States Bankruptcy Code. On October 4, 2010, the Corporation was designated the stalking horse in the bankruptcy proceedings. The acquisition is subject to the approval of the Bankruptcy Court and Chem Rx not receiving a higher offer from a third-party through a Court-approved auction process.

Under the terms of the Agreement, the Corporation has agreed, absent any higher or otherwise better bid, to acquire the Assets from Chem Rx for $70.6 million in cash plus the assumption of specified liabilities related to the Assets. The Corporation has deposited $3.5 million into escrow which will be credited to the purchase price upon completion of the acquisition. If the Agreement is terminated, the deposit will be returned to the Corporation unless the Corporation defaults under the Agreement, in which case the deposit will be retained by Chem Rx. If the Bankruptcy Court approves the Agreement and the Agreement is later terminated for certain reasons, including because Chem Rx enters into a competing transaction, Chem Rx may be required to pay the Corporation a termination fee equal to $1.4 million.

The waiting period under the Hart-Scott Rodino Act applicable to the asset purchase transaction expired on October 14, 2010 at 11:59 p.m. without a request for additional information from the federal antitrust authorities. On November 2, 2010, the Bankruptcy Court preliminarily approved the sale and the sale order was signed by the Bankruptcy Court on November 4, 2010.

The Chem Rx acquisition closed on November 4, 2010.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

certain restrictions resulting from continuing relationships with the Corporation s former parent companies;

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

the demand for the Corporation s products and services;

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

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

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

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

the Corporation s ability to identify and assess exposure to undisclosed or unforeseen liabilities of acquired companies, including liabilities for failure to comply with healthcare laws;

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

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

changes in the reimbursement rates or methods of payment from Medicare and Medicaid and other third party payers, or the implementation of other measures to reduce the reimbursement for the Corporation s products and services or the services of the Corporation s customers or the Corporation s Medicare business covered by specific contracts;

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

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

the effects of changes in the interest rate on the Corporation s outstanding floating rate debt instrument and the increases or decreases in interest expense;

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

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

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

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

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

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

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

the Corporation s risk of loss not covered by insurance;

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

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

the effects on the Corporation s results of operations related to the accounting for the costs of acquisitions;

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

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

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

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

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

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

changes in tax laws and regulations;

the effects of changes to critical accounting estimates; and

other factors, risks and uncertainties referenced in the Corporation s filings with the Commission, including the Risk Factors set forth in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2009.

YOU ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON ANY FORWARD-LOOKING STATEMENTS, ALL OF WHICH SPEAK ONLY AS OF THE DATE OF THIS QUARTERLY REPORT. EXCEPT AS REQUIRED BY LAW, WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR RELEASE ANY REVISIONS TO THESE FORWARD-LOOKING STATEMENTS TO REFLECT ANY EVENTS OR CIRCUMSTANCES AFTER THE DATE OF THIS QUARTERLY REPORT OR TO REFLECT THE OCCURRENCE OF UNANTICIPATED EVENTS. ALL SUBSEQUENT WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS ATTRIBUTABLE TO US OR ANY PERSON ACTING ON THE CORPORATION S BEHALF ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THE CAUTIONARY STATEMENTS CONTAINED OR REFERRED TO IN THIS SECTION AND IN OUR RISK FACTORS SET FORTH IN PART I, ITEM 1A OF THE CORPORATION S ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2009 AND IN OTHER REPORTS FILED WITH THE SEC BY THE CORPORATION.

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General

The condensed consolidated financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this quarterly report on Form 10-Q as of and for the three and nine months ended September 30, 2010, reflect the financial position, results of operations, and cash flows of the Corporation.

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

The Corporation was formed on October 23, 2006, by Kindred Healthcare, Inc. (Kindred or Former Parent) and AmerisourceBergen Corporation (AmerisourceBergen) for the purpose of consummating the transactions contemplated by the Master Transaction Agreement dated October 25, 2006, as amended (the Master Agreement). Pursuant to the Master Agreement, Kindred and AmerisourceBergen, through a series of transactions (collectively, the Pharmacy Transaction), spun-off and combined their respective institutional pharmacy businesses, Kindred Pharmacy Services (KPS) and PharMerica Long-Term Care (PharMerica LTC), into a new, stand-alone, publicly traded company. The Pharmacy Transaction was consummated on July 31, 2007 (the Closing Date).

The Corporation s Business and Industry Trends

Institutional Pharmacy Business

The Corporation is the second largest institutional pharmacy services company in the United States based on revenues. We service healthcare facilities and provide management pharmacy services to hospitals. The Corporation operates 90 institutional pharmacies in 41 states. The Corporation s customers are typically institutional healthcare providers, such as skilled nursing facilities, assisted living facilities, hospitals, and other long-term alternative care settings. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 89 hospitals in the United States.

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

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

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

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Consultant Pharmacist Services

Federal and state regulations mandate that long-term care facilities, in addition to providing a source of pharmaceuticals, retain consultant pharmacist services to monitor and report on prescription drug therapy in order to maintain and improve the quality of resident care. The Omnibus Budget Reconciliation Act of 1987 (OBRA of 1987) implemented in 1990 sought to further upgrade and standardize care by setting forth more stringent standards relating to planning, monitoring, and reporting on the progress of prescription drug therapy, as well as overall drug usage. In addition, the Centers for Medicare & Medicaid Services (CMS) issued revised guidelines to surveyors of long-term care facilities which, effective December 18, 2006, expanded the scope and detail in which surveyors are assessing pharmacy services at facilities, including consultant pharmacy services. In addition, on September 30, 2008, the United States Department of Health and Human Services (HHS) Office of Inspector General published *OIG Supplemental Compliance Program Guidance for Nursing Homes*. With quality of care the first risk area identified, the supplemental guidance is part of a series of recent government efforts focused on improving quality of care at skilled nursing and long-term care facilities. The guidance contains new compliance recommendations and an expanded discussion of risk areas. The guidance stressed that facilities must provide pharmaceutical services to meet the needs of each resident and should be mindful of potential quality of care problems when implementing policies and procedures on proper medication management. It further stated that facilities can reduce risk by educating staff on medication management and improper pharmacy kickbacks for consultant pharmacists and that facilities should review the total compensation paid to consultant pharmacists to ensure it is not structured in a way that reflects the volume or value of particular drugs prescribed or administered to residents.

We provide consultant pharmacist services that help our customers comply with the federal and state regulations applicable to nursing homes. The services offered by our consultant pharmacists include:

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

These services, while costly, may be replicated by local providers.

Ancillary Services

The Corporation provides intravenous drug therapy products and services to its customers. We provide intravenous (IV) (or infusion therapy) products and services for these client facilities as well as hospice and home care patients. Infusion therapy consists of the product (a nutrient, antibiotic, chemotherapy, or other drugs in solution) and the intravenous administration of the product.

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

Hospital Pharmacy Management Services

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

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

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Customers

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

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

At September 30, 2010, we had contracts to provide pharmacy services to 290,691 licensed beds for patients in healthcare facilities throughout the country. We also have significant customer concentrations with facilities operated by Kindred. For the nine months ended September 30, 2010, Kindred institutional pharmacy contracts represented approximately 12.0% of the Corporation s total revenues.

Hospital Pharmacy Management Services. At September 30, 2010, the Corporation provided hospital pharmacy management services to Kindred and other customers at 89 locations. For the nine months ended September 30, 2010, revenues under the Kindred hospital pharmacy management service contracts represented approximately 3.0% of the Corporation s total revenues.

Suppliers/Inventory

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the Prime Vendor Agreement), with AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen. Pursuant to this agreement, the Corporation agreed to purchase at least 95% of the Corporation s prescription pharmaceutical drugs from ABDC and to participate in ABDC s generic formulary purchase program for a period of five years, ending on July 31, 2012. In addition, ABDC supports the distribution of pharmaceuticals that the Corporation contracts directly with manufacturers and provides inventory management support. Also, under the provisions of the agreement, the Corporation may not undertake any merger, change of ownership, change in control or other transaction without the consent of ABDC unless certain conditions are met, including the surviving entity is believed in good faith to be obligated to assume all obligations under the agreement.

We also obtain pharmaceutical and other products from contracts negotiated directly with pharmaceutical manufacturers. We are a member of an industry buying group, which contracts with pharmaceutical manufacturers for discounted prices. While the loss of a supplier could adversely affect our business if alternate sources of supply are unavailable, numerous sources of supply are generally available to us and we have not experienced any difficulty in obtaining pharmaceuticals or other products and supplies to conduct our business.

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

Brand versus Generic

The pharmaceutical industry has been experiencing a higher level of brand-to-generic drug conversions. We expect the generic dispensing rate to rise to approximately 80% over time as the result of a large number of patent expirations. Flomax, Mirapex, Lovenox, Exelon and Effexor XR, five brand drugs from the Corporation s top 50 drug spend, converted to their generic alternative during the nine months ended September 30, 2010.

The following table summarizes the generic drug dispensing rate:

	2009	2010
March 31	73.5 %	74.5 %
June 30	74.2	75.7
September 30	74.5	75.9
December 31	74.7	N/A

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The following table summarizes the material brand-to-generic conversions from 2010 to 2015:

2010	2011	2012	2013	2014	2015
Mirapex (1Q)	Xalatan (1Q)	Seroquel (1Q)	Humalog (2Q)	Nexium (2Q)	Abilify (2Q)
Flomax (1Q)	Levaquin (2Q)	Lexapro (1Q)	Oxycontin (2Q)	Celebrex (2Q)	Zyvox (2Q)
Effexor XR (3Q)	Zyprexa (4Q)	Plavix (2Q)	Advair (3Q)	Renvela (Q3)	Namenda (2Q)
Exelon (3Q)	Lipitor (4Q)	Detrol (3Q)	Cymbalta (4Q)	Copaxone (4Q)	
Lovenox (3Q)		Singulair (3Q)			
Aricept (4Q)		Actos (3Q)			
Prevacid ODT (4Q)		Geodon (3Q)			
		Diovan (3Q)			
		Diovan HCT (3Q)			
		Xopenex (3Q)			

(Number in parentheses equals the quarter of conversion)

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

Supplier and Manufacturer Rebates

We currently receive rebates from certain manufacturers and distributors of pharmaceutical products for achieving targets of market share or purchase volumes. Rebates are designed to prefer, protect, or maintain a manufacturer s products that are dispensed by the pharmacy under its formulary. Rebates for brand name products are generally based upon achieving a defined market share tier within a therapeutic class. Rebates for generic products are more likely to be based on achieving volume requirements. For the three months ended September 30, 2009 and 2010, rebates were $12.9 million and $12.4 million, respectively, and for the nine months ended September 30, 2009 and 2010, rebates were $35.0 million and $38.8 million, respectively. The Corporation had $3.0 million and $3.2 million of rebates capitalized in inventory as of December 31, 2009 and September 30, 2010, respectively.

Information Technology

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

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

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (KHOI), a wholly owned subsidiary of Kindred (the IT Services Agreement). Pursuant to the IT Services Agreement, KHOI is the Corporation s exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years, ending on July 31, 2012. The services provided by KHOI include business services necessary to operate, manage, and support certain financial applications the Corporation uses, including enabling or supporting technology infrastructure and technology procurement services to support certain business functions. Such services include, among other matters, functions for financial management and systems and payroll. The Corporation supports internally all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records

management, human resources, internal and external customer call center support, and general business systems.

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Except for certain services that will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The initial term of the agreement is five years. The agreement will automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior written notice of termination as provided for in the agreement. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation s competitors. Following termination of the IT Services Agreement, KHOI must provide termination and expiration assistance for up to 180 days. The Corporation has incurred costs of $2.9 million and $2.7 million for the three months ended September 30, 2009 and 2010, respectively, and $8.6 million and $8.4 million for the nine months ended September 30, 2009 and 2010, respectively, under the IT Services Agreement.

Sources of Pharmacy Revenues

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

In December 2003, Congress enacted the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA) which included a major expansion of the Medicare program through the introduction of a prescription drug benefit (titled Medicare Part D) which is administered by commercial market insurers contracted with CMS. Under Medicare Part D, Medicare beneficiaries who are also entitled to benefits under a state Medicaid program (so called dual eligibles) now have their outpatient prescription drug costs covered by Medicare Part D, subject to certain limitations. Since January 1, 2006, most of the nursing center residents we serve whose drug costs were previously covered by state Medicaid programs are dual eligibles who qualify for Medicare Part D. Accordingly, Medicaid is no longer a primary payer for the pharmacy services provided to these residents. See Overview of Reimbursement.

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009		2010		2009		2010	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Medicare Part D	$ 211.4	45.9 %	$ 204.8	46.2 %	$ 635.9	45.8 %	$ 627.5	46.3 %
Institutional healthcare providers	134.7	29.2	132.8	30.0	414.5	29.8	410.6	30.3
Medicaid	42.1	9.1	39.6	8.9	127.7	9.2	119.7	8.8
Private and other	34.6	7.5	26.7	6.0	94.9	6.8	80.4	6.0
Insured	22.8	5.0	22.0	5.0	68.8	4.9	68.0	5.0
Medicare	1.5	0.3	1.8	0.4	5.2	0.4	5.7	0.4
Hospital management fees	13.9	3.0	15.4	3.5	42.8	3.1	43.9	3.2
Total	$ 461.0	100.0 %	$ 443.1	100.0 %	$ 1,389.8	100.0 %	$ 1,355.8	100.0 %

Competition

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

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

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Stimulus Package

The American Recovery and Responsibility Act, commonly known as the Stimulus Package, is a $787.0 billion federal bill intended to stimulate the economy through both tax cuts and increased government spending. Within this package there are a variety of healthcare-related provisions including (i) the $87.0 billion temporary increase in Medicaid Federal Medical Assistance Percentage (FMAP), and (ii) the $21.0 billion of funding to encourage adoption of certain health information technology (HIT).

Under Medicaid FMAP, the federal government matches certain state expenditures for Medicaid social service programs. As such, the $87.0 billion increase in FMAP goes directly from the federal government to eligible states. Eligible states will receive a minimum 6.2% FMAP increase retroactive to October 1, 2008 and going forward to December 31, 2010, with additional funds going to states with higher unemployment rates. To ensure eligibility for the FMAP increase, states must maintain or reinstate previously required Medicaid eligibility standards, comply with prompt pay requirements and meet certain other specific criteria. Although the funds are through the FMAP program, states receive the money as general funds and, aside from a prohibition against placing the money in a rainy day fund, may expend the funds at the states discretion. HHS continues to release determinations of enhanced payments on a rolling basis, effective for the quarter and year to date periods.

The Stimulus Package also provides $21.0 billion designated for investment in HIT infrastructure and Medicare and Medicaid incentives to encourage doctors, hospitals, and other providers to adopt HIT. Of this funding, $2.0 billion is set aside for adoption activities while $19.0 billion will go to providers engaged in the meaningful use of electronic health records (EHR). Meaningful users are providers who use certified EHR technology, exchange EHR information to improve quality and coordination of care, and use EHR to submit quality measures. For physicians, the structure largely mirrors the e-prescribing framework set out in the Medicare Improvements for Patients and Providers Act (MIPPA) by incentivizing adoption of HIT through granting up to $44,000 per physician until 2014, and thereafter penalizing physicians who have not yet adopted. Similarly, hospitals are eligible for bonus payments if determined to be meaningful users of EHR. The impact of these provisions, according to the Congressional Budget Office, will be that approximately 90% of doctors and 70% of hospitals adopt EHR technology over the next 10 years. At this time, the Corporation is unable to fully evaluate the impact of the Stimulus Package to its business.

2010 Health Care Legislation

On March 23, 2010, the President signed into law the Patient Protection and Affordable Care Act and on March 30, 2010, the President signed into law the reconciliation law known as Health Care and Education Affordability Reconciliation Act (the Reconciliation Act), combined both Acts will hereinafter be referred to as 2010 Health Care Legislation . Four key provisions of the 2010 Health Care Legislation that are relevant to the Corporation are: (i) the gradual modification to the calculation of the Federal Upper Limit and the definition of AMP, (ii) the closure, over time, of the Part D coverage gap, which is otherwise known as the Donut Hole , (iii) short cycle dispensing requirements, and (iv) Biosimilar Biological Products.

FUL and AMP Changes

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

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

The new AMP became effective on October 1, 2010. Manufaturers are required to report pricing by November 30, 2010. CMS can set new FULs anytime thereafter.

At this time, the Corporation is unable to fully evaluate the impact of the changes in FUL and AMP to its business.

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Part D Coverage Gap

By January 1, 2011, the Secretary of the Department of Health and Human Services (the Secretary) is required to implement the Medicare Coverage Gap Discount Program (the Program). As part of the Program, drug manufacturers will be required to enter into agreements with the Secretary to provide a 50% discount on the negotiated ingredient cost to certain Part D beneficiaries for certain drugs and biologics purchased during the coverage gap (this is exclusive of the pharmacy dispensing fee).

The Reconciliation Act includes a requirement that closes or eliminates the coverage gap, or Donut Hole, by fiscal year 2020. The coverage gap will be eliminated by gradually reducing the coinsurance percentage for both drugs covered and not covered by the Program for each applicable beneficiary.

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

Short Cycle Dispensing

The Secretary shall require Prescription Drug Plans (PDPs), under Medicare Part D and Medicare Advantage prescription drug plans (Medicare Advantage or MAPDs) to utilize specific, uniform dispensing techniques, as determined by the Secretary, in consultation with relevant stakeholders (including representatives of nursing facilities, residents of nursing facilities, pharmacists, the pharmacy industry (including retail and long-term care pharmacy), PDPs, MAPD plans, and any other stakeholders the Secretary determines appropriate), such as weekly, daily, or automated dose dispensing, when dispensing covered Part D drugs to beneficiaries who reside in a long-term care facility to reduce waste associated with 30 day prescriptions for such beneficiaries. This short cycle dispensing provision will take effect on January 1, 2012. At this time, the Secretary has not issued regulations.

Until the regulations are adopted the Corporation is unable to fully evaluate the impact of cycle dispensing changes to its business. Depending on the ultimate outcome, short cycle dispensing could have a material adverse impact on the Corporation s operating costs.

Biosimilar Biological Products

The 2010 Health Care Legislation creates a regulatory approval pathway for biosimilars (alternatively known as generics) for biological products. An innovator biological product will be granted 12 years of exclusivity. At this time, the Corporation is unable to fully evaluate the impact of the changes to biosimilars to its business.

Federal Trade Commission Red Flags Rule

The recently issued Identity Theft Red Flags and Address Discrepancy Rules, referred to as the Red Flags Rule, require creditors that maintain certain kinds of covered accounts to develop and implement a written program to detect and respond to identity theft. Because the Corporation does not require full payment at the time of service of a patient, it will be considered a creditor for purposes of the Red Flags Rule. Therefore, the Corporation will be required to implement a program to detect and respond to identity theft. Failure to implement a program by the deadline can result in substantial monetary penalties. The deadline for compliance with these rules, as well as the scope of their application, has been subject to various regulatory, legislative, and judicial changes. The Federal Trade Commission (Commission) has issued several Enforcement Policies delaying the enforcement of the Red Flags Rule. Most recently, the Commission announced that at the request of Congress it was delaying the enforcement of the Red Flags Rule through December 31, 2010. As such, we cannot fully analyze the potential impact of these Red Flag Rules on our business.

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Overview of Reimbursement

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

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

Medicare

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

Part A

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

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

Part B

The MMA also changed the Medicare payment methodology and conditions for coverage of certain items of durable medical equipment, prosthetics, orthotics, and supplies (DMEPOS) under Medicare Part B. The Corporation provides some of these products to its nursing home customers. The changes include, among other things, a new competitive bidding program. Beginning on January 1, 2011, only suppliers that are winning bidders will be eligible to provide services, at prices established as a result of the competitive bids, to Medicare beneficiaries in the selected areas. Enteral nutrients, equipment and supplies, and oxygen equipment and supplies are among the 10 categories of DMEPOS included in the first round of the competitive bidding process. The Corporation did not participate in the bidding process. The Corporation will continue to evaluate whether it will participate in Round 2 of the bidding, which is not yet scheduled.

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Part D

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

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

We obtain reimbursement for drugs we provide to enrollees of the given Part D Plan in accordance with the terms of agreements negotiated between us and the Part D Plan. The Medicare Part D final rule prohibits Part D plans from paying for drugs and services not specifically called for by the BBA. Beginning in 2010, CMS requires Part D sponsors to use pass-through pricing, based on the price actually received by the pharmacy for drugs, in order to determine beneficiary cost sharing and drug reporting. This change, and similar changes by CMS aimed at ensuring administrative costs are absorbed by the Pharmacy Benefit Manager (PBM) and not the government, may alter the way certain PBMs negotiate prices with pharmacies. Currently, we are unable to fully evaluate the impact of this change in pricing definition on the Corporation.

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

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

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

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

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Medicaid

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

Other

Average wholesale price, or AWP, is a pricing benchmark published by First DataBank, Inc. in its Blue Book, which provides drug databases, content integration software, and drug reference products. AWP has been widely used to calculate the majority of the Medicaid, Medicare Part A and Medicare Part D drug reimbursements payable to pharmacy providers. In 2005, several pension funds brought an action against First DataBank and another healthcare provider alleging collusion to set AWPs for branded drugs.

On March 30, 2009, the Court approved the settlement of the litigation. Pursuant to the settlement on September 26, 2009, First DataBank: (i) adjusted its reporting of Blue Book AWP for those prescription drugs (approximately 1,400 National Drug Codes, or NDCs in number) identified in the plaintiffs previously filed complaint by reducing the mark-up factor utilized in connection with the calculation of the Blue Book AWP data field to 1.20 times the Wholesale Acquisition Cost, or WAC, or direct price for those prescription drugs that are on a mark-up basis; and (ii) established a centralized data repository to facilitate reasonable access to discoverable material from First DataBank concerning its drug price reporting practices.

Independent of the settlement and on the same schedule as the Blue Book AWP adjustment noted above, First DataBank has applied the same 1.20 markup factor to all other NDCs, whose Blue Book AWP is set based upon a markup to WAC or direct price in excess of 1.20 times WAC. First DataBank will also independently discontinue publishing the Blue Book AWP data field for all drugs no later than September 26, 2011.

The Corporation and the preponderance of the Corporation s PDP s, third party insurance companies and its Medicare Part A customers have voluntarily agreed to adjust reimbursement so that pricing would not increase or decrease as a result of the changes to AWP; however, the state Medicaid programs have been unwilling to remain price neutral and accordingly the Corporation is being reimbursed based on the adjusted AWP. This exposure is primarily related to the states in which the Corporation operates, who have refused to adjust their Medicaid reimbursement or otherwise were not reimbursing based on WAC. The National Association of Chain Drug Stores and the National Community Pharmacists Association, the industry trade groups, have filed lawsuits against several state Medicaid programs to force the state Medicaid programs to agree to price neutrality. These cases are still pending. We anticipate that the refusal of the state Medicaid programs to remain price neutral will continue to have a negative impact on our revenues.

The costs associated with complying with federal and state regulations could be significant and the failure to comply with any such legal requirements could have a material adverse effect on our financial condition, results of operations, and liquidity.

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Critical Accounting Estimates

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

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

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

Allowance for doubtful accounts and provision for doubtful accounts

Accounts receivable primarily consist of amounts due from Prescription Drug Plans (PDP s) under Medicaid Part D, long-term care institutions, the respective state Medicaid programs, private payers and third party insurance companies. Our ability to collect outstanding receivables is critical to our results of operations and cash flow. We establish an allowance for doubtful accounts to reduce the carrying value of our receivables to their estimated net realizable value. In addition, certain drugs dispensed are subject to being returned and the responsible paying party is due a credit for such returns.

Our allowances for doubtful accounts, included in our balance sheet at December 31, 2009 and September 30, 2010, were $40.2 million and $38.1 million, respectively.

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

	2009		2010	
	Amount	% of Revenues	Amount	% of Revenues
First Quarter	$ 7.1	1.5%	$ 3.8	0.8%
Second Quarter	3.6	0.8	4.7	1.0
Third Quarter	2.5	0.5	4.6	1.0
Fourth Quarter	3.4	0.8	N/A	N/A

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

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

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

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

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

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

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

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

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

	2009	2010
First Quarter	42.4	40.5
Second Quarter	42.0	40.4
Third Quarter	42.1	40.3
Fourth Quarter	42.9	N/A

In the first quarter of 2010, the Corporation benefited from improved collections from the Part D payors due to the requirements of the MIPPA. MIPPA required Part D payors to pay claims within 30 days, or within 14 days if submitted electronically, beginning with the 2010 plan years. As a result of the MIPPA requirements, the Corporation collected a larger amount of receivables in the first quarter of 2010 than normal. The Corporation does not expect MIPPA to have a similar benefit in future periods.

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The following table shows our summarized aging categories by quarter:

	2009				2010		
	March	June	September	December	March	June	September
0 to 60 days	63.1%	64.3%	63.6%	64.9%	66.2%	65.7%	62.9%
61 to 120 days	17.4	17.0	17.1	17.1	17.8	18.0	19.2
Over 120 days	19.5	18.7	19.3	18.0	16.0	16.3	17.9
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

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

	2009			2010		
	Allowance	Gross Accounts Receivable	% of Gross Accounts Receivable	Allowance	Gross Accounts Receivable	% of Gross Accounts Receivable
First Quarter	$ 49.1	$ 267.8	18.3%	$ 37.6	$ 241.8	15.6%
Second Quarter	50.4	260.6	19.3	37.1	237.6	15.6
Third Quarter	46.3	261.6	17.7	38.1	231.9	16.4
Fourth Quarter	40.2	255.5	15.7	N/A	N/A	N/A

Revenue recognition/Allowance for contractual discounts

Our revenue sources for the quarters ended were as follows:

	Three Months Ended March 31,		Three Months Ended June 30,	
	2009	2010	2009	2010
Medicare Part D	45.9%	46.8%	45.5%	45.8%
Institutional healthcare providers	30.1	30.4	30.1	30.5
Medicaid	9.3	8.7	9.2	8.9
Private and other	6.2	5.7	6.8	6.1
Insured	5.0	4.9	4.9	5.1
Medicare	0.3	0.5	0.4	0.4
Hospital management fees	3.2	3.0	3.1	3.2
Total	100.0%	100.0%	100.0%	100.0%

	Three Months Ended September 30,		Three Months Ended December 31,	
	2009	2010	2009	2010
Medicare Part D	45.9%	46.2%	48.0%	N/A%
Institutional healthcare providers	29.2	30.0	29.0	N/A
Medicaid	9.1	8.9	8.4	N/A
Private and other	7.5	6.0	6.2	N/A
Insured	5.0	5.0	5.0	N/A
Medicare	0.3	0.4	0.4	N/A
Hospital management fees	3.0	3.5	3.0	N/A
Total	100.0%	100.0%	100.0%	- %

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

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

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

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

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

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

Inventory and cost of drugs dispensed

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

As of December 31, 2009 and September 30, 2010, our inventory on our accompanying condensed consolidated balance sheets was $79.8 million and $75.2 million, respectively.

Our inventory turns were as follows for the periods presented:

	2009	2010
First Quarter	16.7	15.7
Second Quarter	16.8	15.5
Third Quarter	16.7	15.3
Fourth Quarter	15.8	N/A

We receive rebates on purchases from various vendors and suppliers. Rebates included in our condensed consolidated income statements as reductions to cost of goods sold were as follows (in millions):

	2009	2010
First Quarter	$ 10.5	$ 13.4
Second Quarter	11.6	13.0
Third Quarter	12.9	12.4
Fourth Quarter	14.5	N/A

We account for rebates and other incentives received from vendors and suppliers, relating to the purchase or distribution of inventory, as a reduction to cost of goods sold and inventory. We consider these rebates to represent product discounts, and as a result, the rebates are capitalized as a reduction of product cost and relieved through cost of goods sold upon the sale of the related inventory.

Goodwill, other intangible assets and accounting for business combinations

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

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Our goodwill included in our accompanying condensed consolidated balance sheets as of December 31, 2009 and September 30, 2010, was $140.1 million and $140.4 million, respectively.

Our net intangible assets included in our accompanying condensed consolidated balance sheets as of December 31, 2009 and September 30, 2010, were $90.8 million and $84.8 million, respectively. The amount of accumulated amortization of intangible assets as of December 31, 2009 and September 30, 2010, was $19.0 million and $25.9 million, respectively.

We are required to test goodwill for impairment annually, absent some triggering event that would accelerate an impairment test, using a fair value approach. We determine fair value using widely accepted valuation techniques, including discounted cash flow and market multiple analyses. These types of analyses require us to make assumptions and estimates regarding future cash flows, industry economic factors, and the profitability of future business strategies.

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

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

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

Accounting for income taxes

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

We assess the likelihood that deferred tax assets will be recovered from future taxable income. A valuation allowance is provided for deferred tax assets if it is more-likely-than-not that some portion or all of the net deferred tax assets will not be realized. Our deferred tax asset balances in our condensed consolidated balance sheets as of December 31, 2009 and September 30, 2010, were $60.8 million and $51.7 million, respectively, including the impact of valuation allowances. Our valuation allowances for deferred tax assets in our condensed consolidated balance sheets as of December 31, 2009 and September 30, 2010, were $1.7 million.

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

Accounting for stock-based compensation

The Corporation has adopted the Amended and Restated PharMerica Corporation 2007 Omnibus Incentive Plan (as amended and restated, Omnibus Plan) under which the Corporation is authorized to grant equity-based and other awards to its employees, officers, directors and consultants. In connection with the Corporation s 2010 Annual Meeting of Stockholders, the stockholders of the Corporation approved and adopted the amended and restated Omnibus Plan to, among other things, implement a fungible share pool effective as of January 1, 2010, and preserve preferential tax treatment as qualified performance-based compensation under Section 162(m) of the Internal Revenue Code.

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

During the nine months ended September 30, 2010, the Compensation Committee granted stock-based compensation awards with respect to 562,167 stock options under the Omnibus Plan with a grant price of $7.82 - $20.19 per share, 39,144 restricted stock units and 178,219 performance share units.

Our stock-based compensation expense for the three months ended September 30, 2009 and 2010, was $1.3 million and $0.8 million, respectively, and was included in selling, general and administrative expenses in the accompanying condensed consolidated income statements. Our stock-based compensation expense for the nine months ended September 30, 2009 and 2010, was $3.2 million and $3.3 million, respectively.

Please refer to Note 9 to our condensed consolidated financial statements included elsewhere in this report for a detailed discussion of our accounting for stock-based compensation.

Key Financial Statement Components

Consolidated Income Statements

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

Cost of goods sold is comprised primarily of the cost of product and is principally attributable to the dispensing of prescription drugs. Our cost of product relating to drugs dispensed by our institutional pharmacies consists primarily of the cost of inventory dispensed and our costs incurred to process and dispense the prescriptions. Cost of goods also includes direct labor, delivery costs, rent, utilities, depreciation, travel costs, professional fees and other costs attributable to the dispensing of medications. In addition, cost of product includes a credit for rebates earned from brand-name pharmaceutical manufacturers whose drugs are included in our formularies. These rebates generally take the form of formulary rebates, which are earned based on the volume of a specific drug dispensed, or market share rebates, which are earned based on the achievement of contractually specified market share levels. The Corporation also receives rebates on generic drugs dispensed and administrative rebates.

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

Integration, merger and acquisition related costs and other charges represents the costs associated Pharmacy Transaction. Integration, merger and acquisition related costs and other charges also includes costs of acquisitions.

Interest expense, net, primarily includes interest expense relating to our senior secured credit facility and the swap agreement that expired on July 31, 2009, partially offset by interest income generated by cash and cash equivalents.

Consolidated Balance Sheets

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

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

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

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

Deferred tax assets primarily represent temporary differences between the financial statement basis and the tax basis of certain accrued expenses, tax deductible goodwill, ability to utilize net operating loss carryforwards, and stock-based compensation. Fixed assets include investments in our institutional pharmacies and information technology, including capitalized software development. Goodwill and intangible assets are comprised primarily of goodwill and intangibles related to our previous acquisitions.

Our primary liabilities include accounts payable, accrued salaries and wages, other current liabilities, debt, and deferred tax liabilities. Accounts payable primarily consist of amounts payable for prescription inventory purchases under our Prime Vendor Agreement and other purchases made in the normal course of business. The balances in accounts payable and accrued salaries and wages are at the highest on Thursday nights and at the lowest on Friday nights, as a result of payments for drug costs and payroll being funded on Friday. Accrued expenses and other current liabilities primarily consist of employee and facility-related cost accruals incurred in the normal course of business, as well as income taxes payable. Our debt is primarily comprised of a loan under our senior secured credit facility. We do not have any off-balance sheet arrangements, other than purchase commitments and lease obligations.

Consolidated Statements of Cash Flows

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

Definitions

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

Assisted Living Facilities (ALF): Represents assisted living facility. Its units or beds will represent the number of apartment type units within the facility.

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

DNA: Represents data not available.

NA: Represents not applicable.

NM: Represents not meaningful.

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

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

Skilled Nursing Facilities (SNF): Represents skilled nursing facilities. Its licensed beds will represent the customer licensed beds and this may not be indicative of its census.

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Results of Operations

The following table presents selected consolidated comparative results of operations and statistical information (dollars in millions, except where indicated):

	Three Months Ended September 30,				Nine Months September 30,			
	2009	Increase (Decrease)		2010	2009	Increase (Decrease)		2010
	Amount			Amount	Amount			Amount
Net revenues								
Institutional Pharmacy	$ 447.1	$ (19.4)	(4.3) %	$ 427.7	$ 1,347.0	$ (35.1)	(2.6) %	$ 1,311.9
Hospital Management	13.9	1.5	10.8	15.4	42.8	1.1	2.6	43.9
Total net revenues	461.0	(17.9)	(3.9)	443.1	1,389.8	(34.0)	(2.4)	1,355.8
Cost of goods sold								
Institutional Pharmacy	381.7	(8.9)	(2.3)	372.8	1,144.8	(5.1)	(0.4)	1,139.7
Hospital Management	12.2	1.3	10.7	13.5	36.1	2.3	6.4	38.4
Total cost of goods sold	393.9	(7.6)	(1.9)	386.3	1,180.9	(2.8)	(0.2)	1,178.1
Gross profit								
Institutional Pharmacy	65.4	(10.5)	(16.1)	54.9	202.2	(30.0)	(14.8)	172.2
Hospital Management	1.7	0.2	11.8	1.9	6.7	(1.2)	(17.9)	5.5
Total gross profit	$ 67.1	$ (10.3)	(15.4) %	$ 56.8	$ 208.9	$ (31.2)	(14.9) %	$ 177.7
Institutional Pharmacy (in whole numbers except where indicated)								
Volume information								
Prescriptions dispensed (in thousands)	9,713	(764)	(7.9) %	8,949	29,447	(1,518)	(5.2) %	27,929
Revenue per prescription dispensed	$ 46.03	$ 1.76	3.8 %	$ 47.79	$ 45.74	$ 1.23	2.7 %	$ 46.97
Gross profit per prescription dispensed	$ 6.73	$ (0.60)	(8.9) %	$ 6.13	$ 6.87	$ (0.70)	(10.2) %	$ 6.17
Gross profit percentage	14.6 %	(1.8)	(12.3) %	12.8 %	15.0 %	(1.9)	(12.7) %	13.1%
Generic drug dispensing rate	74.5 %	1.4	1.9 %	75.9 %	74.1 %	1.3	1.8 %	75.4%
Customer licensed beds under contract								
Beginning of period	314,698	(15,171)	(4.8) %	299,527	321,068	(7,195)	(2.2) %	313,873
Additions	10,549	(5,682)	(53.9)	4,867	23,784	(12,220)	(51.4)	11,564
Losses	(10,923)	(2,780)	25.5	(13,703)	(30,528)	(4,218)	13.8	(34,746)
End of period	314,324	(23,633)	(7.5) %	290,691	314,324	(23,633)	(7.5) %	290,691
Hospital Management (in whole numbers except where indicated)								
Volume information								
Hospital management contracts serviced	85	4	4.7 %	89	85	4	4.7 %	89

Revenues

The decrease in institutional pharmacy revenues of $19.4 million for the three months ended September 30, 2010, compared to the three months ended September 30, 2009, was the result of an unfavorable volume variance of approximately $35.2 million or 764,000 fewer prescriptions dispensed, offset by a favorable rate variance of approximately $15.8 million or a $1.76 increase per prescription dispensed. The rate variance was comprised of approximately $28.8 million due to inflation on drugs dispensed between periods offset by $13.0 million due to the increase in the generic drug dispensing rate during the period from 74.5% to 75.9% and the September 2009 change in the AWP for which state Medicaid reimbursement has not been upwardly adjusted, continued Medicare Part D pricing pressures and other concessions. The volume variance of approximately $35.2 million was due to the decline in customer licensed beds under contract, partially offset by the West Virginia and Integrity Pharmacy Services Acquisitions in August 2009 and December 2009, respectively.

The increase in hospital management revenues for the three months ended September 30, 2010, compared to the three months ended September 30, 2009, of $1.5 million was due primarily to an increase in the number of hospital management contracts serviced, partially offset by concessions with certain contracts serviced in the period.

The decrease in institutional pharmacy revenues of $35.1 million for the nine months ended September 30, 2010, compared to the nine months ended September 30, 2009, was the result of an unfavorable volume variance of approximately $69.4 million or 1,518,000 fewer prescriptions dispensed, offset by a favorable rate variance of approximately $34.3 million or a $1.23 increase per prescription dispensed. The rate variance was comprised of approximately $72.5 million due to inflation on drugs dispensed between periods offset by $38.2 million due to the increase in the generic drug dispensing rate during the period from 74.1% to 75.4% and the September 2009 change in the AWP and other concessions. The volume variance of approximately $69.4 million was due to the decline in customer licensed beds under contract, partially offset by the West Virginia and Integrity Pharmacy Services Acquisitions in August 2009 and December 2009, respectively.

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The increase in hospital management revenues for the nine months ended September 30, 2010, compared to the nine months ended September 30, 2009, of $1.1 million was due primarily to an increase in the number of hospital management contracts serviced, partially offset by concessions with certain contracts serviced in the period.

Cost of Goods Sold

Institutional pharmacy cost of goods sold decreased $8.9 million for the three months ended September 30, 2010, compared to the three months ended September 30, 2009, due primarily to a reduction in drug purchases as a result of 764,000 fewer prescriptions dispensed during the period. Overall total drug costs as a percentage of revenues increased 104 bps. Other costs included in cost of goods sold increased as a percentage of revenues by 76 bps.

Institutional pharmacy cost of goods sold decreased $5.1 million for the nine months ended September 30, 2010, compared to the nine months ended September 30, 2009, due primarily to a reduction in drug purchases as a result of 1,518,000 fewer prescriptions dispensed and an increase in rebates of $3.8 million or 36 bps increase in rebates as a percent of revenues during the period. Rebates increased from the comparable prior period as a result of a more effective management of generic pharmaceutical contracting and formulary control of core pharmaceutical products. Total drug costs as a percentage of revenues increased 159 bps while other costs increased 31 bps from the comparable prior period.

The increase in hospital management cost of goods sold for the three months and nine months ended September 30, 2010, of $1.3 million and $2.3 million, respectively, was due to drug purchases as a result of the four additional hospital management contracts serviced during the period.

Gross Profit and Operating Expenses

Gross profit and other operating expenses for the periods presented were as follows (dollars in millions):

	Three Months Ended September 30,						Nine Months Ended September 30,					
	2009		Increase (Decrease)		2010		2009		Increase (Decrease)		2010	
	Amount	% of Revenue			Amount	% of Revenue	Amount	% of Revenue			Amount	% of Revenue
Gross profit and operating expenses:												
Total gross profit	$ 67.1	14.6 %	$ (10.3)	(15.4) %	$ 56.8	12.8 %	$ 208.9	15.0 %	$ (31.2)	(14.9) %	$ 177.7	13.1 %
Selling, general and administrative expenses	45.0	9.8	(1.7)	(3.8)	43.3	9.7	144.7	10.3	(13.6)	(9.4)	131.1	9.6
Amortization expense	2.5	0.5	(0.3)	(12.0)	2.2	0.5	6.2	0.5	0.7	11.3	6.9	0.5
Integration, merger and acquisition related costs and other charges	0.9	0.2	1.5	166.7	2.4	0.6	3.5	0.3	9.3	265.7	12.8	1.0
Interest expense, net	1.9	0.4	(1.0)	(52.6)	0.9	0.2	8.4	0.6	(5.8)	(69.0)	2.6	0.2
Income before income taxes	16.8	3.7	(8.8)	(52.4)	8.0	1.8	46.1	3.3	(21.8)	(47.3)	24.3	1.8
Provision for income taxes	2.2	0.5	1.0	45.5	3.2	0.7	14.1	1.0	(4.3)	(30.5)	9.8	0.7
Net income	$ 14.6	3.2 %	$ (9.8)	(67.1) %	$ 4.8	1.1 %	$ 32.0	2.3 %	$ (17.5)	(54.7) %	$ 14.5	1.1 %

Institutional pharmacy gross profit for the three months ended September 30, 2010, was $54.9 million or $6.13 per prescription dispensed, compared to $65.4 million or $6.73 per prescription dispensed for the three months ended September 30, 2009. Institutional pharmacy gross profit margin for the three months ended September 30, 2010, was 12.8% compared to 14.6% for the three months ended September 30, 2009. Gross profit was impacted by a continuation of reimbursement pressure under the Medicare and Medicaid programs, other pricing concessions and a decline in licensed beds under contract.

Institutional pharmacy gross profit for the nine months ended September 30, 2010, was $172.2 million or $6.17 per prescription dispensed, compared to $202.2 million or $6.87 per prescription dispensed for the nine months ended September 30, 2009. Institutional pharmacy gross profit margin for the nine months ended September 30, 2010, was 13.1% compared to 15.0% for the nine months ended September 30, 2010. Gross profit was impacted by a continuation of reimbursement pressure under the Medicare and Medicaid programs, other pricing concessions and a decline in licensed beds under contract.

The increase in hospital management gross profit for the three months ended September 30, 2010, of $0.2 million was due to additional hospital management contracts serviced in 2010. The decrease in hospital management gross profit for the nine months ended September 30, 2010 of $1.2 million was due primarily to the June 30, 2009, pricing concessions related to the renegotiated Kindred contract, partially offset by the additional hospital management contracts serviced in 2010.

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Selling, general and administrative expenses

Selling, general and administrative expenses represent the following costs for the periods (dollars in millions):

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2009		Increase (Decrease)		2010	2009		Increase (Decrease)		2010
	Amount	% of Revenue			Amount	% of Revenue Amount	% of Revenue			% of Revenue
Selling, general and administrative expenses										
Total wages, benefits and contract labor	$ 25.6	5.6 %	$ (3.7)	(14.4) %	$ 21.9	4.9 %	$ 79.8	5.7 %	$ (12.2)	(15.3) %	$ 67.6	4.9 %
Contracted services	3.5	0.8	0.2	5.7	3.7	0.8	9.8	0.7	1.4	14.3	11.2	0.8
Provision for doubtful accounts	2.5	0.5	2.0	80.0	4.5	1.0	13.2	0.9	(0.3)	(2.3)	12.9	1.0
Supplies	1.7	0.4	(0.2)	(11.8)	1.5	0.3	5.6	0.4	(0.7)	(12.5)	4.9	0.4
Travel expenses	1.2	0.3	(0.1)	(8.3)	1.1	0.3	3.3	0.2	0.1	3.0	3.4	0.3
Professional fees	2.2	0.5	0.2	9.1	2.4	0.5	7.3	0.5	(1.3)	(17.8)	6.0	0.4
Stock-based compensation	1.3	0.3	(0.5)	(38.5)	0.8	0.2	3.2	0.2	0.1	3.1	3.3	0.2
Depreciation	2.0	0.4	0.4	20.0	2.4	0.5	6.4	0.5	0.7	10.9	7.1	0.5
Rent	1.0	0.2	(0.1)	(10.0)	0.9	0.2	3.1	0.2	(0.1)	(3.2)	3.0	0.2
Maintenance	0.6	0.1	-	-	0.6	0.1	2.0	0.1	(0.3)	(15.0)	1.7	0.1
Other costs	3.4	0.7	0.1	2.9	3.5	0.9	11.0	0.9	(1.0)	(9.1)	10.0	0.8
Total selling, general and administrative expenses	$ 45.0	9.8 %	$ (1.7)	(3.8) %	$ 43.3	9.7 %	$ 144.7	10.3 %	$ (13.6)	(9.4) %	$ 131.1	9.6 %

Total labor costs decreased $3.7 million for the three months ended September 30, 2010, over the comparable period in the prior year as a result of management s continued integration initiative as well as reduced headcount in overhead functions through process improvement and management s focus on controlling costs. Reduction in employee performance based compensation also reduced labor costs. All other costs increased a combined $2.0 million for the three months ended September 30, 2010 compared to the three months ended September 30, 2009.

Total labor costs decreased $12.2 million for the nine months ended September 30, 2010, over the comparable period in the prior year as a result of management s continued integration initiative, lower employee performance based compensation costs, and reduced headcount in overhead functions through process improvement and management s focus on controlling costs. Six pharmacy locations were converted to our proprietary platform or closed during the nine months ended September 30, 2010. All other costs decreased a combined $1.4 million for the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009.

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Depreciation and Amortization

Depreciation expense for the periods presented was as follows (dollars in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009		2010		2009		2010	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Leasehold improvements	$ 0.4	0.1 %	$ 0.5	0.1 %	$ 1.1	0.1 %	$ 1.3	0.1 %
Equipment and software	4.0	0.9	4.2	0.9	11.9	0.9	12.3	0.9
Leased equipment	0.1	NM	0.1	NM	0.4	NM	0.5	NM
Total depreciation expense	$ 4.5	1.0 %	$ 4.8	1.0 %	$ 13.4	1.0 %	$ 14.1	1.0 %
Depreciation expense recorded in cost of goods sold	2.5	0.6	2.4	0.5	7.0	0.5	7.0	0.5
Depreciation expense recorded in selling, general & administrative expenses	2.0	0.4	2.4	0.5	6.4	0.5	7.1	0.5
Total depreciation expense	$ 4.5	1.0 %	$ 4.8	1.0 %	$ 13.4	1.0 %	$ 14.1	1.0 %
Total capital additions	$ 5.8	1.3 %	$ 3.7	0.8 %	$ 12.3	0.9 %	$ 8.8	0.6 %

Amortization expense related to certain identifiable intangibles for the periods presented were as follows (dollars in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009		2010		2009		2010	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
Amortization of intangibles:								
Trade names	$ 0.4	0.1 %	$ 0.4	0.1 %	$ 1.1	0.1 %	$ 1.1	0.1 %
Non-compete agreements	0.3	NM	0.4	0.1	0.5	NM	1.4	0.1
Customer relationships	1.8	0.4	1.4	0.3	4.6	0.3	4.4	0.3
Total amortization expense	$ 2.5	0.5 %	$ 2.2	0.5 %	$ 6.2	0.4 %	$ 6.9	0.5 %

Amortization expense for the three months ended September 30, 2010, compared to the comparable prior period decreased $0.3 million as a result of certain customer relationships becoming fully amortized in the period that related to acquisitions that occurred prior to the Pharmacy Transaction.

Amortization expense for the nine months ended September 30, 2010, compared to the comparable prior period increased $0.7 million due to intangibles acquired through the West Virginia and Integrity Pharmacy Services Acquisitions in August 2009 and December 2009, respectively.

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Integration, Merger and Acquisition Related Costs and Other Charges

Integration, merger and acquisition related costs and other charges incurred by the Corporation for the periods presented were as follows (dollars in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Integration costs and other charges:				
Pre- Pharmacy Transaction litigation matters	$ -	$ -	$ -	$ 5.0
Professional and advisory fees	-	0.7	-	2.2
General and administrative	0.1	0.1	0.4	0.5
Employee costs	0.2	0.2	1.2	0.4
Severance costs	-	0.4	0.6	0.6
Facility costs	0.1	-	0.7	0.2
Other costs	-	0.1	-	0.1
	0.4	1.5	2.9	9.0
Acquisition costs:				
Professional and advisory fees	0.5	0.5	0.6	1.0
General and administrative	-	0.1	-	1.1
Employee costs	-	-	-	0.2
Facility costs	-	0.1	-	1.3
Other costs	-	0.2	-	0.2
	0.5	0.9	0.6	3.8
Total integration, merger and acquisition related costs and other charges	$ 0.9	$ 2.4	$ 3.5	$ 12.8
Negative effect on diluted earnings per share	$ (0.02)	$ (0.05)	$ (0.07)	$ (0.25)

The Corporation incurred integration, merger and acquisition related costs and other charges during the three months and nine months ended September 30, 2009 and 2010 related to costs to convert data, integrate systems and its acquisitions. The Corporation expects to continue to incur costs related to the integration of its pharmacy operating systems during the remainder of fiscal 2010 and fiscal 2011. During the second quarter of 2010 the Corporation recorded an estimated liability of $5.0 million related to certain claims arising from time periods prior to the 2007 Pharmacy Transaction. The Corporation believes the estimated liability is still appropriate as of September 30, 2010.

For the three months and nine months ended September 30, 2010, the Corporation incurred costs of $0.9 million and $3.8 million for acquisition related costs, respectively. Costs were higher in the current period due to the integration of the Integrity Pharmacy Services Acquisitions the Corporation acquired in December 2009 and costs incurred to facilitate potential acquisitions.

Interest Expense

Interest expense for the periods presented was as follows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
Interest Expense:	2009	2010	2009	2010
Term Debt	$ 1.6	$ 0.7	$ 7.9	$ 2.1
Revolving Credit Facility	0.1	0.1	0.3	0.3

Subtotal	1.7	0.8	8.2	2.4
Other:				
Interest income	-	-	(0.2)	(0.2)
Amortization of deferred financing fees	0.2	0.1	0.4	0.4
Total Interest Expense	$ 1.9	$ 0.9	$ 8.4	$ 2.6
Interest Rate (Excluding Applicable Margin):				
Average interest rate on variable term debt	0.42 %	0.31 %	0.79 %	0.28 %
LIBOR - 1 month, at beginning of period	0.30 %	0.35 %	0.44 %	0.23 %
LIBOR - 1 month, at end of period	0.24 %	0.26 %	0.24 %	0.26 %
LIBOR - 3 months, at beginning of period	0.59 %	0.53 %	1.43 %	0.25 %
LIBOR - 3 months, at end of period	0.28 %	0.29 %	0.28 %	0.29 %

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The decrease in interest expense during the three and nine months ended September 30, 2010, compared to the prior year periods was due primarily to the lower LIBOR and the expiration of the interest rate swap on July 31, 2009. The margin over LIBOR was 0.75 - 1.0% during the three months and nine months ended September 30, 2010.

Tax Provision

The tax provision for the periods presented was as follows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Tax provision	$ 2.2	$ 3.2	$ 14.1	$ 9.8
Total provision as a percentage of income before income taxes	13.1 %	40.5 %	30.6 %	40.4 %

The provision for income taxes as a percentage of income before income taxes for the three months and nine months ended September 30, 2010 was higher than the three months and nine months ended September 30, 2009 due to a discrete tax benefit recorded in the third quarter of 2009 related to the adoption of an internal legal entity restructuring plan. Excluding that non-recurring benefit of the $4.5 million valuation allowance release, the provision for income taxes for the three months and nine months ended September 30, 2009 would have been $6.7 million (39.7% of income) and $18.6 million (40.3% of income), respectively. Apart from the discrete tax benefit recorded as a result of the internal restructuring, the effective tax rates in 2010 and 2009 are higher than the federal statutory rate largely as a result of the combined impact of state and local taxes and various non-deductible expenses.

Liquidity and Capital Resources

The primary source of liquidity for the Corporation is cash flows from operations and the availability under the Credit Agreement. Based upon our existing cash levels, expected operating cash flows, capital spending, potential future acquisitions, and the availability of funds under our revolving credit facility, we believe that we have the necessary financial resources to satisfy our expected short-term and long-term liquidity needs.

Cash Flows. The following table presents selected data from our condensed consolidated statements of cash flows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Net cash provided by operating activities	$ 16.9	$ 23.5	$ 59.6	$ 68.8
Net cash used in investing activities	(21.7)	(7.2)	(28.1)	(12.4)
Net cash provided by (used in) financing activities	0.9	(10.8)	1.0	(10.9)
Net change in cash and cash equivalents	(3.9)	5.5	32.5	45.5
Cash and cash equivalents at beginning of period	77.7	91.2	41.3	51.2
Cash and cash equivalents at end of period	$ 73.8	$ 96.7	$ 73.8	$ 96.7

Operating Activities Cash provided by operations aggregated $23.5 million and $68.8 million for the three months and nine months ended September 30, 2010, respectively, compared to $16.9 million and $59.6 million for the three months and nine months ended September 30, 2009, respectively. The increase of $9.2 million for the nine months ended September 30, 2010 is due primarily to the improvement in cash collections compared to the comparable period in the prior year. For the nine months ended September 30, 2010, the Corporation benefited from improved collections from the Part D payers due to the requirements of MIPPA. As a result of the MIPPA requirements, the Corporation collected a larger amount of receivables in the nine month period than normal. The Corporation does not expect MIPPA to have an incremental benefit in future periods.

Investing Activities Cash used in investing activities aggregated $7.2 million and $12.4 million for the three months and nine months ended September 30, 2010, respectively, compared to $21.7 million and $28.1 million for the three months and nine months ended September 30, 2009, respectively. The decrease is due primarily to the West Virginia acquisition and the pharmacy consolidations occurring in the prior year. The acquisition amounts of $3.6 million in the current period was primarily related to the funding of an escrow payment of $3.5 million for the Chem Rx acquisition.

Financing Activities Cash used in financing activities aggregated $10.8 and $10.9 million for the three and nine months ended September 30, 2010, compared to cash provided by financing activities of $0.9 and $1.0 million for the three and nine months ended September 30, 2009. The increase in the amount of cash used is primarily due to the common stock purchased by the Corporation of $10.5 million during the three months ended September 30, 2010 and held as treasury stock. The Corporation expects to continue with the purchase of common stock as authorized by the Board of Directors.

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Chem Rx Acquisition

On September 26, 2010, the Corporation entered into an Asset Purchase Agreement (the Agreement) with Chem Rx Corporation and certain of its wholly-owned subsidiaries (collectively, Chem Rx), under which the Corporation has agreed to purchase substantially all of the assets and selected vendor contracts of Chem Rx (collectively the Assets), subject to the terms and conditions contained in the Agreement.

On May 10, 2010, Chem Rx filed voluntary petitions for Chapter 11 bankruptcy protection in the Delaware District of the United States Bankruptcy Court (the Bankruptcy Court). It is intended that the acquisition of the Assets would be accomplished through the sale, transfer, and assignment of the Assets by Chem Rx to the Corporation undertaken pursuant to Section 363 of the United States Bankruptcy Code. On October 4, 2010, the Corporation was designated the stalking horse in the bankruptcy proceedings. The acquisition is subject to the approval of the Bankruptcy Court and Chem Rx not receiving a higher offer from a third-party through a Court-approved auction process.

Under the terms of the Agreement, the Corporation has agreed, absent any higher or otherwise better bid, to acquire the Assets from Chem Rx for $70.6 million in cash plus the assumption of specified liabilities related to the Assets. The Corporation has deposited $3.5 million into escrow which will be credited to the purchase price upon completion of the acquisition. If the Agreement is terminated, the deposit will be returned to the Corporation unless the Corporation defaults under the Agreement, in which case the deposit will be retained by Chem Rx. If the Bankruptcy Court approves the Agreement and the Agreement is later terminated for certain reasons, including because Chem Rx enters into a competing transaction, Chem Rx may be required to pay the Corporation a termination fee equal to $1.4 million.

The waiting period under the Hart-Scott Rodino Act applicable to the asset purchase transaction expired on October 14, 2010 at 11:59 p.m. without a request for additional information from the federal antitrust authorities. On November 2, 1010, the Bankruptcy Court preliminarily approved the sale and the sale order was signed by the Bankruptcy Court on November 4, 2010.

The Chem Rx acquisition closed on November 4, 2010.

Credit Agreement

The Corporation is a party to a Credit Agreement among the Corporation, the Lenders named therein, and JPMorgan Chase Bank, N.A. (JPMorgan), as Administrative Agent. The Credit Agreement consists of a $275.0 million term loan facility and a $150.0 million revolving credit facility. Indebtedness under the Credit Agreement matures on July 31, 2012. There is no scheduled amortization under the term loan facility but the term loan is subject to certain prepayment obligations relating to certain asset sales, certain casualty losses and the incurrence by the Corporation of certain indebtedness.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at our option, a base rate plus a margin between 0.0% and 0.75% per annum, or an adjusted London Interbank Offered Rate (LIBO rate or LIBOR) plus a margin between 0.625% and 1.75% per annum, in each case depending on the leverage ratio of the Corporation. The base rate is the higher of the prime lending rate announced by JPMorgan in New York from time to time and the federal funds rate published by the Federal Reserve Bank of New York plus 0.50%. The Credit Agreement also provides for letter of credit participation fees between 0.625%, and 1.75%, letter of credit fronting fees of 0.125%, and a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.125% to 0.250%, in each case depending on the leverage ratio of the Corporation. As of September 30, 2010, borrowings under the Credit Agreement bore interest at a rate of 1.26%, including the applicable margin of 1.00%, per annum based upon the one month LIBO rate.

The obligations of the Corporation under and related to the Credit Agreement are secured by substantially all of its assets. Those obligations are guaranteed by many of the Corporation s wholly owned subsidiaries and the obligations of the guarantors are secured by substantially all of their assets. The foregoing includes a pledge of all of the equity interests of substantially all of our direct and indirect domestic subsidiaries and a portion of the equity interests of any future foreign subsidiaries. The Credit Agreement also contains financial and non-financial affirmative and negative covenants, representations, warranties, and events of default that are customary to facilities of this nature.

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The Corporation had a total of $240.0 million outstanding of term debt under the Credit Agreement as of September 30, 2010. The Corporation had no borrowings under the revolving portion of the Credit Agreement as of September 30, 2010. The Credit Agreement provides for the issuance of letters of credit which, when issued, constitute usage and reduce availability on the revolving portion of the Credit Agreement. The amount of letters of credit outstanding as of September 30, 2010, was $2.0 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $148.0 million as of September 30, 2010.

Covenants

The Credit Agreement requires the Corporation to satisfy a fixed charge coverage ratio and a leverage ratio. The minimum fixed charge coverage ratio, which is tested quarterly on a trailing four quarter basis, can be no less than: 2.50:1.00 beginning with January 1, 2010 and thereafter. The maximum leverage ratio, which also is tested quarterly, cannot exceed 3.00:1.00 beginning with January 1, 2010 and thereafter. The maximum leverage ratio is not tested when at any time it is less than 2.00:1.00, or both S&P and Moody s have in effect corporate credit ratings for the Corporation that are investment grade. Pursuant to the terms of the Credit Agreement, the covenant requirements have become more restrictive, however, the Corporation remains compliant and has been compliant since the consummation of the Pharmacy Transaction. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 3.0% of revenues.

The financial covenant ratio and requirements are as follows:

	Minimum Fixed Charge Coverage Ratio	Maximum Leverage Ratio	Capital Expenditure
Requirement	> = 2.25 to 1.00	< = 3.50 to 1.00	< = 3.00 %
December 31, 2009	5.09	1.88	1.17 %
Requirement	> = 2.50 to 1.00	< = 3.00 to 1.00	< = 3.00 %
September 30, 2010	5.70	2.48	**

** *Not applicable as Capital Expenditures Covenant is an annual requirement under the terms of the Credit Agreement.*

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

Prime Vendor Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into a Prime Vendor Agreement (the Prime Vendor Agreement), with AmerisourceBergen Drug Corporation (ABDC), a wholly owned subsidiary of AmerisourceBergen. Pursuant to this agreement, the Corporation agreed to purchase at least 95% of the Corporation s prescription pharmaceutical drugs from ABDC and to participate in its generic formulary purchase program for a period of five years. Also under the provisions of the agreement, the Corporation may not undertake any merger, change of ownership, change in control or other transaction without the consent of ABDC unless certain conditions are met.

If the Corporation fails to reach this minimum purchase volume, ABDC may adjust the price of goods the Corporation purchases from it to reflect the lower than expected purchase volume. In addition, ABDC will support the distribution of pharmaceuticals that the Corporation purchases directly from manufacturers and provide inventory management support and packaging services. Unless either party provides notice of termination, the agreement will continue on a month-to-month basis upon expiration of the initial five year term. The agreement may be terminated by either party for cause during the initial five year term, and by either party with or without cause thereafter upon 90 days notice. As of September 30, 2010, the Corporation was in compliance with the terms of the Prime Vendor Agreement.

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Information Technology Services Agreement

At the consummation of the Pharmacy Transaction, the Corporation entered into an Information Technology Services Agreement with Kindred Healthcare Operating, Inc. (KHOI), a wholly owned subsidiary of Kindred. Pursuant to this IT Services Agreement, KHOI is the Corporation s exclusive provider of certain information services and support related to information technology infrastructure and financial systems for a period of five years. The services provided by KHOI includes business services necessary to operate, manage and support certain financial applications the Corporation uses, including enabling and/or supporting technology infrastructure and technology procurement services to support certain business functions. Such services include, among other matters, functions for financial management and systems and payroll. The Corporation internally supports all other operating systems, including functions for order entry, pharmacy dispensing, clinical consulting, billing and collections, electronic medication management, sales and marketing, medical records management, human resources, internal and external customer call center support and general business systems.

Except for certain services that will be provided at cost, KHOI will provide such services to the Corporation at its cost plus 10%, which will be the actual costs and expenses incurred in providing these services, including certain overhead costs and per hour costs of the KHOI employees providing the services. The IT Services Agreement shall automatically renew for successive one-year periods after the expiration of the initial five year term, absent 120 days prior notice of termination as provided for in the agreement. The initial term expires on July 31, 2012. The IT Services Agreement may be terminated by either party for cause and, in certain circumstances, by the Corporation in the event that KHOI undergoes a change of control to one of the Corporation s competitors. Following termination, KHOI must provide termination and expiration assistance for up to 180 days. The Corporation incurred $2.9 million and $2.7 million to Kindred under the terms of the IT Services Agreement for the three months ended September 30, 2009 and 2010, respectively, and $8.6 million and $8.4 million under the terms of the IT Services Agreement for the nine months ended September 30, 2009 and 2010, respectively.

Treasury Stock

In August 2010, the Board of Directors authorized a share repurchase of up to $25.0 million of the Corporation s common stock. Share repurchases under this authorization may be made in the open market through unsolicited or solicited privately negotiated transactions, or in such other appropriate manner, and will be funded from available cash. The amount and timing of the repurchases will be determined by the Corporation s management and will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. Common stock acquired through the share repurchase program will be held as treasury shares and may be used for general corporate purposes, including reissuances in connection with acquisitions, employee stock option exercises or other employee stock plans. The share repurchase program does not have an expiration date and may be limited, terminated or extended at any time without prior notice. During the three months ended September 30, 2010, we repurchased 1,327,803 million shares of common stock for an aggregate purchase price, including commissions, of $10.5 million at an average purchase price of $7.90 per share.

Additionally, the Corporation may redeem shares from employees upon vesting of the Corporation s stock awards for minimum statutory tax withholding purposes. The Corporation redeemed 3,826 shares of certain vested awards for an aggregate price of less than $0.1 million during the three months ended September 30, 2010. These shares have been designated by the Corporation as treasury stock.

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Supplemental Quarterly Information

The following tables represent the results of the Corporation s quarterly operations for 2009 and for the first, second, and third quarters of 2010 (in millions, except where indicated):

	2009 Quarters				2010 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Net revenues:							
Institutional pharmacy revenues	$ 453.4	$ 446.5	$ 447.1	$ 437.7	$ 448.3	$ 435.9	$ 427.7
Hospital management revenues	14.8	14.1	13.9	13.7	13.9	14.6	15.4
Total revenues	468.2	460.6	461.0	451.4	462.2	450.5	443.1
Cost of goods sold:							
Institutional pharmacy	384.0	379.1	381.7	372.9	386.8	380.1	372.8
Hospital management	12.0	11.9	12.2	11.9	12.1	12.8	13.5
Total cost of goods sold	396.0	391.0	393.9	384.8	398.9	392.9	386.3
Gross profit:							
Institutional pharmacy	69.4	67.4	65.4	64.8	61.5	55.8	54.9
Hospital management	2.8	2.2	1.7	1.8	1.8	1.8	1.9
Total gross profit	72.2	69.6	67.1	66.6	63.3	57.6	56.8
Selling, general and administrative	51.7	48.0	45.0	46.1	44.8	43.0	43.3
Amortization expense	1.8	1.9	2.5	2.8	2.3	2.4	2.2
Integration, merger and acquisition related costs and other charges	2.0	0.6	0.9	1.7	1.2	9.2	2.4
Operating income	16.7	19.1	18.7	16.0	15.0	3.0	8.9
Interest expense, net	3.2	3.3	1.9	1.0	0.9	0.8	0.9
Income before income taxes	13.5	15.8	16.8	15.0	14.1	2.2	8.0
Provision for income taxes	5.3	6.6	2.2	4.8	5.7	0.9	3.2
Net income	$ 8.2	$ 9.2	$ 14.6	$ 10.2	$ 8.4	$ 1.3	$ 4.8
Earnings per common share (1):							
Basic	$ 0.27	$ 0.30	$ 0.48	$ 0.34	$ 0.28	$ 0.04	$ 0.16
Diluted	$ 0.27	$ 0.30	$ 0.48	$ 0.33	$ 0.27	$ 0.04	$ 0.16
Adjusted earnings per diluted share (1)(2):	$ 0.31	$ 0.31	$ 0.35	$ 0.32	$ 0.29	$ 0.22	$ 0.21
Shares used in computing earnings per common share:							
Basic	30.2	30.2	30.3	30.3	30.4	30.4	30.0
Diluted	30.3	30.4	30.5	30.5	30.6	30.6	30.1
Balance sheet data:							
Cash and cash equivalents	$ 52.1	$ 77.7	$ 73.8	$ 51.2	$ 73.5	$ 91.2	$ 96.7
Working capital	$ 307.4	$ 324.2	$ 323.7	$ 312.8	$ 331.3	$ 344.6	$ 341.9
Goodwill	$ 113.7	$ 115.6	$ 128.5	$ 140.1	$ 140.6	$ 140.4	$ 140.4
Intangible assets, net	$ 71.6	$ 69.9	$ 72.3	$ 90.8	$ 88.8	$ 86.6	$ 84.8
Total assets	$ 677.6	$ 684.2	$ 705.9	$ 724.3	$ 720.3	$ 731.2	$ 721.5
Long-term debt	$ 240.0	$ 240.0	$ 240.0	$ 240.0	$ 240.0	$ 240.0	$ 240.0

Total stockholder s equity	$ 330.0	$ 341.9	$ 359.2	$ 370.9	$ 380.2	$ 383.4	$ 378.2
Supplemental information:							
Adjusted EBITDA(2)	$ 25.2	$ 25.8	$ 26.6	$ 25.1	$ 23.1	$ 19.3	$ 18.3
Adjusted EBITDA Margin (2)	5.4 %	5.6 %	5.6 %	5.6 %	5.0 %	4.3 %	4.1 %
Adjusted EBTIDA per prescription dispensed	$ 2.54	$ 2.63	$ 2.74	$ 2.62	$ 2.39	$ 2.07	$ 2.04
Net cash provided by operating activities	$ 13.9	$ 28.8	$ 16.9	$ 25.4	$ 24.7	$ 20.6	$ 23.5
Net cash used in investing activities	$ (3.2)	$ (3.2)	$ (21.7)	$ (48.0)	$ (2.3)	$ (2.9)	$ (7.2)
Net cash provided by (used in) financing activities	$ 0.1	$ -	$ 0.9	$ -	$ (0.1)	$ -	$ (10.8)
Statistical information (in whole numbers except where indicated)							
Institutional Pharmacy							
Volume information							
Prescriptions dispensed (in thousands)	9,919	9,815	9,713	9,590	9,664	9,316	8,949
Revenue per prescription dispensed	$ 45.71	$ 45.49	$ 46.03	$ 45.64	$ 46.39	$ 46.79	$ 47.79
Gross profit per prescription dispensed	$ 7.00	$ 6.87	$ 6.73	$ 6.76	$ 6.36	$ 5.99	$ 6.13
Gross profit percentage	15.3%	15.1%	14.6%	14.8%	13.7%	12.8%	12.8%
Generic drug dispensing rate	73.5%	74.2%	74.5%	74.7%	74.5%	75.7%	75.9%
Customer licensed beds under contract							
Beginning of period	321,068	318,761	314,698	314,324	313,873	307,874	299,527
Additions	6,762	6,473	10,549	12,137	4,111	2,586	4,867
Losses	(9,069)	(10,536)	(10,923)	(12,588)	(10,110)	(10,933)	(13,703)
End of period	318,761	314,698	314,324	313,873	307,874	299,527	290,691
Hospital management contracts serviced	84	85	85	86	86	89	89

(1) The Corporation has never declared a cash dividend. Earnings per common share in actual cents.

(2) See Use of Non-GAAP Measures For Measuring Quarterly Results for a definition and reconciliation.

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Use of Non-GAAP Measures For Measuring Quarterly Results

The Corporation calculates Adjusted EBITDA as provided in the reconciliation below and calculates Adjusted EBITDA Margin by taking Adjusted EBITDA and dividing it by revenues. The Corporation calculates and uses Adjusted EBITDA as an indicator of its ability to generate cash from reported operating results. The measurement is used in concert with net income and cash flows from operating activities, which measure actual cash generated in the period. In addition, the Corporation believes that Adjusted EBITDA and Adjusted EBITDA Margin are a supplemental measurement tool used by analysts and investors to help evaluate overall operating performance and the ability to incur and service debt and make capital expenditures. In addition, Adjusted EBITDA, as defined in the Credit Agreement, is used in conjunction with the Corporation s debt leverage ratio and this calculation sets the applicable margin for the quarterly interest charge. Adjusted EBITDA, as defined in the Credit Agreement, is not the same calculation as this Adjusted EBITDA table. Adjusted EBITDA does not represent funds available for the Corporation s discretionary use and is not intended to represent or to be used as a substitute for net income or cash flows from operating activities data as measured under U.S. generally accepted accounting principles (GAAP). The items excluded from Adjusted EBITDA but included in the calculation of the Corporation s reported net income and cash flows from operating activities are significant components of the accompanying consolidated income statements and cash flows, and must be considered in performing a comprehensive assessment of overall financial performance. The Corporation s calculation of Adjusted EBITDA may not be consistent with calculations of EBITDA used by other companies. The following is a reconciliation of the Corporation s net income, net operating cash flows and earnings per diluted share for the periods presented.

Unaudited Reconciliation of Net Income to Adjusted EBITDA

	2009 Quarters				2010 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Net income	$ 8.2	$ 9.2	$ 14.6	$ 10.2	$ 8.4	$ 1.3	$ 4.8
Add:							
Interest expense, net	3.2	3.3	1.9	1.0	0.9	0.8	0.9
Integration, merger, and acqusition related costs and other charges	2.0	0.6	0.9	1.7	1.2	9.2	2.4
Provision for income taxes	5.3	6.6	2.2	4.8	5.7	0.9	3.2
Depreciation and amortization expense	6.5	6.1	7.0	7.4	6.9	7.1	7.0
Adjusted EBITDA	$ 25.2	$ 25.8	$ 26.6	$ 25.1	$ 23.1	$ 19.3	$ 18.3
Adjusted EBITDA Margin	5.4 %	5.6 %	5.6 %	5.6 %	5.0 %	4.3 %	4.1 %

Unaudited Reconciliation of Adjusted EBITDA to Net Cash Flows from Operating Activities

	2009 Quarters				2010 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Adjusted EBITDA	$ 25.2	$ 25.8	$ 26.6	$ 25.1	$ 23.1	$ 19.3	$ 18.3
Interest expense, net	(3.2)	(3.3)	(1.9)	(1.0)	(0.9)	(0.8)	(0.9)
Provision for income taxes	(5.3)	(6.6)	(2.2)	(4.8)	(5.7)	(0.9)	(3.2)
Integration, merger and acquisition related costs and other charges	(1.8)	(0.6)	(0.9)	(1.5)	(1.1)	(8.8)	(2.3)
Provision for bad debt	7.1	3.6	2.5	3.4	3.8	4.6	4.5
Stock-based compensation	0.6	1.3	1.3	1.4	0.8	1.7	0.8
Amortization of deferred financing fees	0.1	0.1	0.1	0.1	0.2	0.1	0.1
Deferred income taxes	4.8	6.8	2.7	5.4	4.8	0.9	3.4
Loss on disposition of equipment	0.1	-	-	0.2	-	0.1	0.1
Other	(0.1)	-	(0.1)	(0.1)	0.1	(0.1)	-
Changes in assets and liabilities	(13.6)	1.7	(11.2)	(2.8)	(0.4)	4.5	2.7

Net Cash Flows from Operating Activities	$ 13.9	$ 28.8	$ 16.9	$ 25.4	$ 24.7	$ 20.6	$ 23.5

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The Corporation calculates and uses earnings per diluted share, exclusive of the impact of integration, merger and acquisition related costs and other charges and the favorable impact on tax ruling (Adjusted Earnings Per Diluted Share) as an indicator of its core operating results. The measurement is used in concert with net income and earnings per diluted share, which measure actual earnings per share generated in the period. The Corporation believes the exclusion of these charges in expressing earnings per share provides management with a useful measure to assess period to period comparability and is useful to investors in evaluating the Corporation s operating results from period to period. Earnings per diluted share, exclusive of the impact of integration, merger and acquisition related costs and other charges and the favorable impact on tax ruling does not represent the amount that effectively accrues directly to stockholders (i.e., such costs are a reduction in earnings and stockholders equity) and is not intended to represent or to be used as a substitute for earnings per diluted share as measured under GAAP. The impact of integration, merger and acquisition related costs and other charges and the favorable impact of tax rate matters excluded from the earnings per diluted share are significant components of the accompanying condensed consolidated income statements, and must be considered in performing a comprehensive assessment of overall financial performance.

Unaudited Reconciliation of Earnings Per Diluted Share to Adjusted Earnings Per Diluted Share

	2009 Quarters					2010 Quarters		
	First	Second	Third	Fourth	Year	First	Second	Third
Earnings per diluted share	$ 0.27	$ 0.30	$ 0.48	$ 0.33	$ 1.39	$ 0.27	$ 0.04	$ 0.16
Add:								
Diluted earnings per share impact of:								
Integration, merger, and acquisition related costs and other charges	0.04	0.01	0.02	0.03	0.10	0.02	0.18	0.05
Tax rate matters	-	-	(0.15)	(0.04)	(0.19)	-	-	-
Adjusted earnings per diluted common share after impact of above items	$ 0.31	$ 0.31	$ 0.35	$ 0.32	$ 1.30	$ 0.29	$ 0.22	$ 0.21

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Following Represents the Third Quarter 2010 Compared to the Second Quarter 2010

Results of Operations

The following table presents selected consolidated comparative results of operations and statistical information (dollars in millions, except where indicated):

	Quarter Ended					
	June 30, 2010		Increase (Decrease)		September 30, 2010	
	Amount	% of Revenues			Amount	% of Revenues
Net revenues:						
Institutional Pharmacy	$ 435.9	96.8 %	$ (8.2)	(1.9) %	$ 427.7	96.5 %
Hospital Management	14.6	3.2	0.8	5.5	15.4	3.5
Total net revenues	450.5	100.0	(7.4)	(1.6)	443.1	100.0
Cost of goods sold:						
Institutional Pharmacy	380.1	84.4	(7.3)	(1.9)	372.8	84.2
Hospital Management	12.8	2.8	0.7	5.5	13.5	3.1
Total cost of goods sold	392.9	87.2	(6.6)	(1.7)	386.3	87.2
Gross profit:						
Institutional Pharmacy	55.8	12.4	(0.9)	(1.6)	54.9	12.4
Hospital Management	1.8	0.4	0.1	5.6	1.9	0.4
Total gross profit	$ 57.6	12.8 %	$ (0.8)	(1.4) %	$ 56.8	12.8 %
Institutional Pharmacy (in whole numbers except where indicated)						
Volume information						
Prescriptions dispensed (in thousands)	9,316		(367)	(3.9) %	8,949	
Revenue per prescription dispensed	$ 46.79		$ 1.00	2.1 %	$ 47.79	
Gross Profit per prescription dispensed	$ 5.99		$ 0.14	2.3 %	$ 6.13	
Gross Profit percent	12.8%		-	- %	12.8%	
Generic dispensing rate	75.7%		0.2	0.3 %	75.9%	
Customer licensed beds under contract						
Beginning of period	307,874		(8,347)	(2.7) %	299,527	
Additions	2,586		2,281	88.2	4,867	
Losses	(10,933)		(2,770)	25.3	(13,703)	
End of period	299,527		(8,836)	(2.9) %	290,691	
Hospital Management (in whole numbers except where indicated)						
Volume information						
Hospital management contracts serviced	89		-	- %	89	

Revenues

The decrease in institutional pharmacy revenues of $8.2 million for the three months ended September 30, 2010, compared to the three months ended June 30, 2010, was the result of an unfavorable volume variance of approximately $17.1 million or 367,000 fewer prescriptions dispensed, offset by a favorable rate variance of approximately $8.9 million or a $1.00 increase per prescription dispensed. The rate variance

was comprised of approximately $9.9 million due to inflation on drugs dispensed between periods offset by $1.0 million due to the increase in the generic drug dispensing rate during the period from 75.7% to 75.9% and other concessions. The volume variance of approximately $17.1 million was due to the decline in net customer licensed beds under contract.

The increase in hospital management revenues for the three months ended September 30, 2010, of $0.8 million was due primarily to the increase in the number of hospital management contracts being serviced for the entire period, compared to a partial period for the three months ended June 30, 2010.

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Cost of Goods Sold

Institutional pharmacy cost of goods sold decreased $7.3 million for the three months ended September 30, 2010, compared to the three months ended June 30, 2010, primarily due to the reduction of prescriptions dispensed in the period. Drug spend as a percentage of revenues decreased 58 bps, including a decrease in rebates of 9 bps during the period. Other costs included within cost of goods sold as a percent of revenues increased a combined 58 bps, predominately as a result of increased vendor pricing associated with contract labor, back-up pharmacy and courier services.

Hospital management cost of goods sold increased $0.7 million for the three months ended September 30, 2010, compared to the three months ended June 30, 2010, due to an increase in direct cost pass-through, primarily drug costs, billed to the new hospital contracts the Corporation began to services during the three months ended June 30, 2010.

Gross Profit and Operating Expenses

Gross profit and other operating expenses were the following for the periods presented (dollars in millions):

	Quarter Ended					
	June 30, 2010		Increase (Decrease)		September 30, 2010	
	Amount	% of Revenue			Amount	% of Revenue
Gross profit and operating expenses:						
Total gross profit	$ 57.6	12.8 %	$ (0.8)	(1.4) %	$ 56.8	12.8 %
Selling, general and administrative expenses	43.0	9.6	0.3	0.7	43.3	9.7
Amortization expense	2.4	0.5	(0.2)	(8.3)	2.2	0.5
Integration, merger and acquisition related costs and other charges	9.2	2.0	(6.8)	(73.9)	2.4	0.6
Interest expense, net	0.8	0.2	0.1	12.5	0.9	0.2
Income before income taxes	2.2	0.5	5.8	263.6	8.0	1.8
Provision for income taxes	0.9	0.2	2.3	255.6	3.2	0.7
Net income	$ 1.3	0.3 %	$ 3.5	269.2 %	$ 4.8	1.1 %

Institutional pharmacy gross profit for the three months ended September 30, 2010 was $54.9 million, or $6.13 per prescription dispensed, compared to $55.8 million, or $5.99 per prescription dispensed for the three months ended June 30, 2010. The institutional pharmacy gross profit margin for the sequential quarter remained unchanged at 12.8%.

The hospital management gross profit for the three months ended September 30, 2010 increased $0.1 million compared to the three months ended June 30, 2010 due to the additional hospital contracts being serviced for the entire quarter and partially offset by an increase in direct pass-through costs primarily associated with drug costs, billed to the new hospital contracts the Corporation began to service during the three months ended June 30, 2010.

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Selling, general and administrative expenses

Selling, general and administrative expenses represent the following costs for the periods (dollars in millions):

	Quarter Ended					
	June 30, 2010		Increase (Decrease)		September 30, 2010	
	Amount	% of Revenue			Amount	% of Revenue
Selling, general and administrative expenses:						
Total wages, benefits and contract labor	$ 21.1	4.7 %	$ 0.8	0.4 %	$ 21.9	4.9 %
Contracted services	3.6	0.8	0.1	2.8	3.7	0.8
Provision for doubtful accounts	4.6	1.0	(0.1)	(2.2)	4.5	1.0
Supplies	1.7	0.4	(0.2)	(11.8)	1.5	0.3
Travel expenses	1.3	0.3	(0.2)	(15.4)	1.1	0.3
Professional fees	1.5	0.3	0.9	60.0	2.4	0.5
Stock-based compensation	1.7	0.4	(0.9)	(52.9)	0.8	0.2
Depreciation	2.4	0.5	-	-	2.4	0.5
Rent	1.1	0.2	(0.2)	(18.2)	0.9	0.2
Maintenance	0.6	0.1	-	-	0.6	0.1
Other costs	3.4	0.9	0.1	2.9	3.5	0.9
Total selling, general and administrative expenses	$ 43.0	9.6 %	$ 0.3	0.7 %	$ 43.3	9.7 %

Total labor costs increased $0.8 million for the three months ended September 30, 2010, over the three months ended June 30, 2010, due to increased costs for contract labor. Stock-based compensation decreased $0.9 million primarily related to a reduction in employee performance based compensation. Other costs within selling, general and administrative expenses increased $0.4 million during the three months ended September 30, 2010, over the three months ended June 30, 2010.

Depreciation and Amortization

Depreciation expense represents the following costs for the periods (dollars in millions):

	Quarter Ended			
	June 30, 2010		September 30, 2010	
	Amount	% of Revenues	Amount	% of Revenues
Leasehold improvements	$ 0.4	0.1 %	$ 0.5	0.1 %
Equipment and software	4.1	0.9	4.2	0.9
Leased equipment	0.2	NM	0.1	NM
Total depreciation expense	$ 4.7	1.0 %	$ 4.8	1.0 %
Depreciation expense recorded in cost of goods sold	$ 2.3	0.5 %	$ 2.4	0.5 %
Depreciation expense recorded in selling, general & administrative expenses	2.4	0.5	2.4	0.5
Total depreciation expense	$ 4.7	1.0 %	$ 4.8	1.0 %
Total capital additions	$ 2.9	0.6 %	$ 3.7	0.8 %

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Amortization expense represents the following costs for the periods (dollars in millions):

	Quarter Ended			
	June 30, 2010		September 30, 2010	
	Amount	% of Revenues	Amount	% of Revenues
Amortization of intangibles:				
Trade names	$ 0.4	0.1 %	$ 0.4	0.1 %
Non-compete agreements	0.5	0.1	0.4	0.1
Customer relationships	1.5	0.3	1.4	0.3
Total amortization expense	$ 2.4	0.5 %	$ 2.2	0.5 %

Integration, Merger, and Acquisition Related Costs and Other Charges

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

	Quarter Ended	
	June 30, 2010	September 30, 2010
Integration costs:		
Pre-Pharmacy Transaction litigation matters	$ 5.0	$ -
Professional and advisory fees	1.3	0.7
General and administrative	0.2	0.1
Employee costs	0.1	0.2
Severance costs	0.1	0.4
Facility costs	0.2	-
Other costs	-	0.1
	6.9	1.5
Acquisition costs:		
Professional and advisory fees	0.3	0.5
General and administrative	0.6	0.1
Employee costs	0.2	-
Facility costs	1.2	0.1
Other costs	-	0.2
	2.3	0.9
Total integration, merger and acquisition related costs and other charges	$ 9.2	$ 2.4
Negative effect on diluted earnings per share	$ (0.18)	$ (0.05)

The Corporation incurred integration, merger, and acquisition related costs and other charges during the three month periods presented, related to costs to convert data, integrate systems and its acquisitions. The Corporation expects to continue to incur costs related to the integration of its

pharmacy operating systems during the remainder of fiscal 2010 and fiscal 2011. During the second quarter 2010 the Corporation recorded an estimated liability of $5.0 million related to certain claims arising from time periods prior to the 2007 Pharmacy Transaction. The Corporation believes the estimated liability is still appropriate as of September 30, 2010.

For the three months ended September 30, 2010, the Corporation incurred costs of $0.9 million for acquisition related costs. Costs were lower than incurred during the three months ended June 30, 2010 due to the integration of the Integrity Pharmacy Services Acquisition into our existing pharmacy locations that occurred during the beginning of the year. There were no such integrations during the three months ended September 30, 2010.

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Interest Expense

Interest expense represents the following costs for the periods (dollars in millions):

	Quarter Ended	
	June 30, 2010	September 30, 2010
Interest Expense, net:	**Amount**	**Amount**
Term Debt	$ 0.7	$ 0.7
Revolving Credit Facility	0.1	0.1
Subtotal	0.8	0.8
Other:		
Interest income	(0.1)	-
Amortization of deferred financing fees	0.1	0.1
Total interest expense, net	$ 0.8	$ 0.9
Interest rate (excluding applicable margin):		
Average interest rate on variable term debt	0.30 %	0.31 %
LIBOR - 1 month, at beginning of period	0.25 %	0.35 %
LIBOR - 1 month, at end of period	0.35 %	0.26 %
LIBOR - 3 months, at beginning of period	0.29 %	0.53 %
LIBOR - 3 months, at end of period	0.54 %	0.29 %

The margin over LIBOR under the Corporation s Credit Facility was 0.75% and 1.00% during the three months ended June 30, 2010 and September 30, 2010, respectively.

Tax Provision

The tax provision for the periods presented was as follows (dollars in millions):

	Quarter Ended	
	June 30, 2010	September 30, 2010
Provision for income taxes	$ 0.9	$ 3.2
Total provision as a percentage of income before income taxes	40.8 %	40.5 %

The decrease in the provision as a percentage of income before income taxes for the three months ended September 30, 2010, compared to the three months ended June 30, 2010, was due primarily to a reduction in non-deductible expenses.

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Liquidity and Capital Resources

The following compares the Corporation s Statements of Cash Flows for the three months ended June 30, 2010 and September 30, 2010 (dollars in millions):

	Quarter Ended	
	June 30, 2010	September 30, 2010
Cash flows provided by operating activities:		
Net income	$ 1.3	$ 4.8
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	4.7	4.8
Amortization	2.4	2.2
Integration, merger and acquisition related costs and other charges	0.4	0.1
Stock-based compensation	1.7	0.8
Amortization of deferred financing fees	0.1	0.1
Deferred income taxes	0.9	3.4
Loss on disposition of equipment	0.1	0.1
Other	(0.1)	-
Change in operating assets and liabilities:		
Accounts receivable, net	3.5	6.7
Inventory	(1.2)	3.1
Prepaids and other assets	(1.2)	2.2
Accounts payable	6.8	(4.6)
Salaries, wages and other compensation	(1.9)	(0.6)
Other accrued and long-term liabilities	3.1	0.4
Net cash provided by operating activities	20.6	23.5
Cash flows used in investing activities:		
Purchases of equipment and leasehold improvements	(2.9)	(3.7)
Acquisitions	-	(3.5)
Net cash used in investing activities	(2.9)	(7.2)
Cash flows used in financing activities:		
Repayments of capital lease obligations	(0.2)	(0.1)
Issuance of common stock	0.2	-
Treasury stock at cost	-	(10.5)
Tax shortfall from stock-based compensation	-	(0.2)
Net cash used in financing activities	-	(10.8)
Change in cash and cash equivalents	17.7	5.5
Cash and cash equivalents at beginning of period	73.5	91.2
Cash and cash equivalents at end of period	$ 91.2	$ 96.7

Supplemental information:		
Cash paid for interest	$ 0.7	$ 0.8
Cash paid for taxes	$ 0.5	$ 0.1
Supplemental schedule of non-cash activities:		
Integrity working capital adjustment	$ (0.3)	$ -

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

During the reporting period, there have been no material changes in the disclosures set forth in Part II, Item 7A in our Form 10-K for the fiscal year ended December 31, 2009.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Corporation has carried out an evaluation under the supervision and with the participation of management, including the Corporation s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Corporation s disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of the end of the period covered by this report. The Corporation s disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in the Corporation s reports filed under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Commission s rules and forms. The Corporation s disclosure controls and procedures are also intended to provide reasonable assurance that such information is accumulated and communicated to the Corporation s management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives, and management necessarily is required to use its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2010, the Corporation s disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that the Corporation files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

Changes in Internal Control Over Financial Reporting

There have been no changes in the Corporation s internal control over financial reporting during the quarter ended September 30, 2010, that have materially affected, or are reasonably likely to materially affect, the Corporation s internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2009, as updated by the Corporation s Quarterly Report on Form 10-Q for the quarter ended March 31, 2010. We encourage you to read these risk factors in their entirety.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

In August 2010, the Board of Directors authorized a share repurchase of up to $25.0 million of the Corporation s common stock. Share repurchases under this authorization may be made in the open market through unsolicited or solicited privately negotiated transactions, or in such other appropriate manner, and will be funded from available cash. The amount and timing of the repurchases will be determined by the Corporation s management and will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. Common stock acquired through the share repurchase program will be held as treasury shares and may be used for general corporate purposes, including reissuances in connection with acquisitions, employee stock option exercises or other employee stock plans. During the three months ended September 30, 2010, the Corporation repurchased 1,327,803 shares for an aggregate purchase price, including commissions, of $10.5 million at an average purchase price of $7.90 per share.

Additionally, the Corporation may redeem shares from employees upon vesting of the Corporation s stock awards for minimum statutory tax withholding purposes. The Corporation redeemed 3,826 shares of certain vested awards for an aggregate price of less than $0.1 million, during the three months ended September 30, 2010. These shares have been designated by the Corporation as treasury stock.

The following table summarizes our share repurchase activity by month for the three months ended September 30, 2010:

Period	Total Number of Shares Purchased	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of a Publicly Announced Program (2)	Approximate Dollar Value of Shares that may yet be Purchased under the Program (in millions)
July 1, 2010 - July 31, 2010	-	$ -	-	$ 25.0
August 1, 2010 - August 31, 2010	931,629 (1)	7.44	927,803	18.1
September 1, 2010 - September 30, 2010	400,000	8.97	400,000	14.5

(1) The Corporation repurchased 3,826 shares of common stock in connection with the vesting of certain stock awards to cover minimum statutory withholding taxes.

(2) On August 24, 2010, the Corporation announced a share repurchase program where the Corporation is authorized to repurchase up to $25.0 million of the Corporation s common stock. The share repurchase program does not have an expiration date and may be limited, terminated or extended at any time without prior notice.

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Item 6. Exhibits

Exhibit	Description
2.3	Asset Purchase Agreement, dated as of September 26, 2010, by and between Chem Rx Corporation, and certain of its subsidiaries, as Seller, Chem Rx Acquisition Sub, LLC, as Buyer, and PharMerica Corporation, as Buyer s Guarantor
3.1	Certificate of Incorporation of Regulation, as amended (1)
3.2	Amended and Restated By-Laws of the Registrant (2)
4.1	Specimen Common Stock Certificate of the Registrant (3)
10.59	New Employment Agreement dated September 30, 2010 between Gregory S. Weishar and PharMerica Corporation
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Filed with the Corporation s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 31, 2007, as incorporated by reference.

(1) Filed with the Corporation s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 31, 2007, and incorporated herein by reference.

(2) Filed with Amendment No. 2 to the Corporation s Registration Statement on Form S-4/S-1 (Reg. No. 333-142940) filed with the Securities and Exchange Commission on June 27, 2007, and incorporated herein by reference.

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SIGNATURES

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

PHARMERICA CORPORATION

Date: November 4, 2010

/S/ GREGORY S. WEISHAR
Gregory S. Weishar
Chief Executive Officer and Director

Date: November 4, 2010

/S/ MICHAEL J. CULOTTA
Michael J. Culotta
Executive Vice President and Chief Financial Officer

Date: November 4, 2010

/S/ BERARD E. TOMASSETTI
Berard E. Tomassetti
Senior Vice President and Chief Accounting Officer

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