FEDERATED NATIONAL HOLDING CO
Form 10-Q
November 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2016

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 000-25001

Federated National Holding Company

(Exact name of registrant as specified in its charter)

Florida (State or Other Jurisdiction of Incorporation or Organization)	65-0248866 (IRS Employer Identification Number)
14050 N.W. 14th Street, Suite 180, Sunrise, FL (Address of principal executive offices)	33323 (Zip Code)

800-293-2532

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has electronically submitted and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes 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. (Check one):

Large accelerated filer	Accelerated filer	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 No

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

As of November 4, 2016, the registrant had 13,801,757 shares of common stock outstanding.

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FEDERATED NATIONAL HOLDING COMPANY

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

(Unaudited)

	September 30, 2016	December 31, 2015
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value (amortized cost of $370,881 and $338,021, respectively)	$ 378,879	$ 339,178
Debt securities, held-to-maturity, at amortized cost	5,880	6,619
Equity securities, available-for-sale, at fair value (cost of $34,905 and $33,581, respectively)	41,334	38,534
Total investments (including $28,290 and $22,670 related to the VIE, respectively)	426,093	384,331
Cash and cash equivalents (including $14,753 and $14,616 related to the VIE, respectively)	106,200	53,038
Prepaid reinsurance premiums	58,763	120,771
Premiums receivable, net of allowance of $57 and $302, respectively (including $1,589 and $355 related to the VIE, respectively)	63,605	38,594
Reinsurance recoverable, net	25,151	12,714
Deferred acquisition costs	41,247	15,547
Income taxes receivable	16,706	2,691
Property and equipment, net	3,863	2,894
Other assets (including $1,269 and $1,037 related to the VIE, respectively)	7,829	7,605
TOTAL ASSETS	$ 749,457	$ 638,185
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Loss and loss adjustment expense reserves	$ 127,485	$ 97,340

Unearned premiums	309,283	253,960
Debt from consolidated variable interest entity	4,903	4,887
Deferred income taxes, net	12,912	5,627
Other liabilities	31,521	25,612
Total liabilities	486,104	387,426
SHAREHOLDERS' EQUITY:		
Preferred stock, $0.01 par value: 1,000,000 shares authorized	—	—
Common stock, $0.01 par value: 25,000,000 shares authorized;		
13,801,607 and 13,798,773 shares issued and outstanding, respectively	138	138
Additional paid-in capital	136,359	131,998
Accumulated other comprehensive income	8,800	3,985
Retained earnings	99,336	96,461
Total Federated National Holding Company shareholders' equity	244,633	232,582
Noncontrolling interest	18,720	18,177
Total shareholders' equity	263,353	250,759
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 749,457	$ 638,185

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue:				
Net premiums earned	$ 69,405	$ 62,286	$ 184,447	$ 156,298
Net investment income	2,164	1,907	6,398	5,154
Net realized investment gains	1,126	1,126	2,060	3,743
Other income	11,095	7,280	34,909	21,130
Total revenue	83,790	72,599	227,814	186,325
Costs and expenses:				
Losses and loss adjustment expenses	43,613	28,412	120,183	75,510
Commissions and other underwriting expenses	34,512	21,610	75,408	47,934
General and administrative expenses	4,044	4,887	13,211	11,973
Interest expense	81	65	259	161
Total costs and expenses	82,250	54,974	209,061	135,578
Income before income taxes	1,540	17,625	18,753	50,747
Income taxes	102	7,054	6,594	19,519
Net income	1,438	10,571	12,159	31,228
Net income (loss) attributable to noncontrolling interest	44	(22)	239	(383)
Net income attributable to Federated National Holding Company shareholders	$ 1,394	$ 10,593	$ 11,920	$ 31,611
Net income per share attributable to Federated National Holding Company shareholders:				
Basic	$ 0.10	$ 0.77	$ 0.86	$ 2.31
Diluted	$ 0.10	$ 0.76	$ 0.85	$ 2.26
Weighted average number of shares of common stock outstanding:				
Basic	13,780	13,749	13,807	13,710
Diluted	13,943	13,977	13,999	13,978

Dividends declared per share of common stock	$ 0.08	$ 0.04	$ 0.17	$ 0.13

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$ 1,438	$ 10,571	$ 12,159	$ 31,228
Change in net unrealized (losses) gains on investments, available-for-sale	(774)	(2,671)	8,316	(4,681)
Comprehensive income before income taxes	664	7,900	20,475	26,547
Income tax benefit (expense) related to items of other comprehensive income	152	1,083	(3,197)	1,734
Comprehensive income	816	8,983	17,278	28,281
Less: comprehensive income (loss) attributable to noncontrolling interest	44	(17)	543	(494)
Comprehensive income attributable to Federated National Holding Company shareholders	$ 772	$ 9,000	$ 16,735	$ 28,775

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

(In thousands, except share data)

(Unaudited)

	Common Stock			Additional	Accumulated Other		Total Shareholders' Equity Attributable to Federated National Holding		Total
	Preferred Stock	Issued Shares	Amount	Paid-in Capital	Comprehensive Income	Retained Earnings	Company Shareholders	Noncontrolling Interest	Shareholders' Equity
Balance as of December 31, 2015	$ —	13,798,773	$ 138	$ 131,998	$ 3,985	$ 96,461	$ 232,582	$ 18,177	$ 250,759
Net income	—	—	—	—	—	11,920	11,920	239	12,159
Other comprehensive income	—	—	—	—	4,815	—	4,815	304	5,119
Dividends	—	—	—	—	—	(3,563)	(3,563)	—	(3,563)
Shares issued under share-based compensation plans	—	288,815	—	360	—	—	360	—	360
Tax benefits from share-based awards	—	—	—	843	—	—	843	—	843
Repurchases of common stock	—	(285,981)	—	—	—	(5,482)	(5,482)	—	(5,482)
Share-based compensation	—	—	—	3,158	—	—	3,158	—	3,158
Balance as of September 30,	$ —	13,801,607	$ 138	$ 136,359	$ 8,800	$ 99,336	$ 244,633	$ 18,720	$ 263,353

2016

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30,	
	2016	2015
	(in thousands)	
Cash flow from operating activities:		
Net income	$ 12,159	$ 31,228
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Net realized investment gains	(2,060)	(3,743)
Amortization of investment premium or discount, net	3,910	3,795
Depreciation and amortization	620	495
Share-based compensation	4,001	3,175
Changes in operating assets and liabilities:		
Prepaid reinsurance premiums	62,008	(40,967)
Premiums receivable, net	(25,011)	(7,653)
Reinsurance recoverable, net	(12,437)	4,186
Deferred acquisition costs	(25,699)	88
Income taxes receivable, net	(14,858)	(3,953)
Loss and loss adjustment expense reserves	30,146	13,343
Unearned premiums	55,323	57,973
Deferred income taxes, net of other comprehensive income	5,491	5,277
Other, net	5,676	16,970
Net cash provided by operating activities	99,269	80,214
Cash flow from investing activities:		
Sales, maturities and redemptions of investment securities	151,884	134,918
Purchases of investment securities	(188,576)	(195,278)
Purchases of property and equipment	(1,573)	(1,500)
Net cash used in investing activities	(38,265)	(61,860)
Cash flow from financing activities:		
Noncontrolling interest equity investment	—	18,498
Tax benefit related to share-based compensation	843	869
Purchases of FNHC common stock	(5,482)	—
Issuance of common stock for share-based awards	360	130
Dividends paid	(3,563)	(1,847)
Net cash (used in) provided by financing activities	(7,842)	17,650
Net increase in cash and cash equivalents	53,162	36,004

Cash and cash equivalents at beginning of period	53,038	40,157
Cash and cash equivalents at end of period	$ 106,200	$ 76,161

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Continued)

	Nine Months Ended September 30,	
	2016	2015
	(in thousands)	
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	$ 14,360	$ 15,662
Non-cash investing and finance activities:		
Accrued dividends payable	$ 1,134	$ 712

See accompanying notes to unaudited consolidated financial statements.

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1. ORGANIZATION, CONSOLIDATION AND BASIS OF PRESENTATION

Organization

Federated National Holding Company, ("FNHC," the "Company," "we," or "us"), is an insurance holding company that controls substantially all steps in the insurance underwriting, distribution and claims processes through our subsidiaries and our contractual relationships with our independent agents and general agents. We are authorized to underwrite, and/or place through our wholly owned subsidiaries, homeowners' multi-peril ("homeowners'"), personal automobile, commercial general liability, federal flood, and other lines of insurance in Florida and other states. We market, distribute and service our own and third-party insurers' products and our other services through a network of independent agents.

Our wholly owned insurance subsidiary is Federated National Insurance Company ("FNIC"), which is licensed as an admitted carrier in Florida, Texas, Georgia, Alabama, Louisiana and South Carolina. We also serve as managing general agent for Monarch National Insurance Company ("MNIC"), which was founded in 2015 through the joint venture, described below, and is licensed as an admitted carrier in Florida. An admitted carrier is an insurance company that has received a license from the state department of insurance giving the Company the authority to write specific lines of insurance in that state. These companies are also bound by rate and form regulations, and are strictly regulated to protect policyholders from a variety of illegal and unethical practices, including fraud. Admitted carriers are also required to financially contribute to the state guarantee fund, which is used to pay for losses if an insurance carrier becomes insolvent or unable to pay the losses due to their policyholders.

On March 19, 2015, the Company entered into a joint venture to organize MNIC, which received its certificate of authority to write homeowners' property and casualty insurance in Florida from the Florida Office of Insurance Regulation (the "Florida OIR"). The Company's joint venture partners are a majority-owned limited partnership of Crosswinds Holdings Inc., a publicly traded Canadian private equity firm and asset manager ("Crosswinds"); and Transatlantic Reinsurance Company ("TransRe").

The Company and Crosswinds each invested $14.0 million in Monarch Delaware Holdings LLC ("Monarch Delaware"), the indirect parent company of MNIC, for a 42.4% interest in Monarch Delaware (each holding 50% of the voting interests in Monarch Delaware). TransRe invested $5.0 million for a 15.2% non-voting interest in Monarch Delaware and advanced an additional $5.0 million in debt evidenced by a six-year promissory note bearing 6% annual interest payable by Monarch National Holding Company ("MNHC"), a wholly owned subsidiary of Monarch Delaware and the direct parent company of MNIC.

Significant Customer

We entered into an Insurance Agency Master Agreement with Ivantage Select Agency, Inc., ("ISA"), an affiliate of Allstate Insurance Company ("Allstate"), pursuant to which we are authorized by ISA to appoint Allstate agents to offer our homeowners' and commercial general liability insurance products to consumers in Florida. As a percentage of the total homeowners' premiums we underwrote in the three months ended September 30, 2016 and 2015, 24.7% and 25.4%, respectively, were from Allstate's network of Florida agents. For the nine months ended September 30, 2016 and 2015 23.9% and 23.3%, respectively, of the homeowners' premiums we underwrote were from Allstate's network of Florida agents.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of FNHC and all other entities in which we have a controlling financial interest and any variable interest entities ("VIE") in which we are the primary beneficiary. All material inter-company accounts and transactions have been eliminated in consolidation. A VIE is an entity that does not have sufficient equity to finance its own activities without additional financial support or where investors lack certain characteristics of a controlling financial interest. We assess our contractual, ownership or other interests in a VIE to determine if our interest participates in the variability the VIE was designed to absorb and pass onto variable interest holders. We perform an ongoing qualitative assessment of our variable interests in VIEs to determine whether we have a controlling financial interest and would therefore be considered the primary beneficiary of the VIE. If we determine we are the primary beneficiary of a VIE, we consolidate the assets and liabilities of the VIE in our consolidated financial statements.

In connection with the investment in Monarch Delaware, we have determined that we are the primary beneficiary of this VIE, as we possess the power to direct the activities of the VIE that most significantly impact its economic performance. Accordingly, we consolidate the VIE in our consolidated financial statements. Refer to Note 12 for additional information on the VIE.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the rules and regulations of the Securities and Exchange Commission ("SEC"). Accordingly, these financial statements do not include all of the information and notes required by GAAP for

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complete financial statements. Additionally, operating results for interim periods are not necessarily indicative of the results that can be expected for a full year. These unaudited consolidated financial statements reflect, in the opinion of management, all material adjustments (which include only normal recurring adjustments) necessary to fairly state, in all material respects, our financial position and results of operations for the periods presented. Certain GAAP policies, which significantly affect the determination of financial condition, results of operations and cash flows, are summarized below.

This report should be read in conjunction with the Company's 2015 Annual Report on Form 10-K, as amended (the "2015 Form 10-K").

2. SIGNIFICANT ACCOUNTING POLICIES AND PRACTICES

Our significant accounting policies were described in Note 2 to our Consolidated Financial Statements set forth in Part II, Item 8, "Financial Statements and Supplementary Data" of the 2015 Form 10-K. There have been no significant changes in our significant accounting policies for the nine months ended September 30, 2016.

Accounting Estimates and Assumptions

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates.

Similar to other property and casualty insurers, our liability for losses and loss adjustment expense reserves, although supported by actuarial projections and other data, is ultimately based on management's reasoned expectations of future events. Although considerable variability is inherent in these estimates, we believe that this liability is adequate. Estimates are reviewed regularly and adjusted as necessary. Such adjustments are reflected in current operations. Refer to Note 6 accompanying our consolidated financial statements for a discussion of our liability for losses and loss adjustment expense reserves.

Reclassifications

Certain amounts in prior year's consolidated financial statements have been reclassified to conform to the 2016 presentation. These reclassifications had no effect on the reported consolidated statements of operations, balance sheets, and cash flows. In the current period, the Company concluded it was appropriate to reclassify certain revenue accounts that do not have material balances and include them within other income in the consolidated statements of operations. In addition, during the current period, the Company reclassified certain costs and expenses, principally, operating and underwriting expenses, salaries and wages and amortization of deferred policy acquisition costs. These respective account balances are now included in commissions and other underwriting expenses and general and administrative expenses in the consolidated statements of operations. The Company believes these reclassifications provide greater clarity and insight into the consolidated financial statements for the periods presented.

Adjustments

During our third quarter 2015 analysis of actual experience to date under the July 1, 2014 quota share reinsurance contract, we re-evaluated the accounting treatment for quota share reinsurance contracts with retrospective rating provisions. As a result of this re-evaluation, we concluded reinsurance contracts, which have retrospective rating provisions, should be accounted for under Accounting Standards Codification 944, Financial Services — Insurance ("ASC 944"), where amounts due to (from) the assuming companies are accrued based on estimated contract experience to date as though the contracts were terminated. Refer to Note 2 in our Form 10-Q for the period ended September 30, 2015 for additional information.

The adjustments to our accounting for the July 1, 2014 quota share reinsurance treaty, inclusive of other adjustments, are not material in any prior quarter or annual period based on an analysis of quantitative and qualitative factors in accordance with SEC guidance.

As a result, we recorded these adjustments during the year ended December 31, 2015. The prior period adjustments increased net income by $2.2 million for the three and nine months ended September 30, 2015, respectively.

Adopted Accounting Pronouncements

In February 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis ("ASU 2015-02"). ASU 2015-02 amended the consolidation guidance by modifying the evaluation criteria for whether limited partnerships and similar legal entities are variable interest entities or voting interest entities, eliminating the presumption that a general partner should consolidate a limited partnership, and affecting the

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consolidation analysis of reporting entities that are involved with variable interest entities. We adopted the provisions of ASU 2015-02 effective January 1, 2016 and re-evaluated all legal entity investments under the revised consolidation model. The adoption of ASU 2015-02 did not have any impact on our consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, Interest-Imputation of Interest. ASU 2015-03 reduces the complexity of disclosing debt issuance costs and debt discount and premium on the balance sheet by requiring that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. The Company adopted this ASU retrospectively as of January 1, 2016. Other assets and debt from consolidated variable interest entity have been reclassified to be consistent with the adoption of this standard, which resulted in a reduction of $0.1 million each. There were no changes to shareholders' equity as a result of this adoption. There were no other impacts on the Company's consolidated financial statements.

In May 2015, the FASB issued ASU 2015-09, Financial Services – Insurance (Topic 944): Disclosures about Short-Duration-Contracts. The amendments in this ASU apply to all insurance entities that issue short-duration contracts as defined in Topic 944, Financial Services—Insurance. The amendments require insurance entities to disclose for annual reporting periods information on the liability for unpaid claims and claim adjustment expenses. The amendments in this ASU are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. This new guidance affects disclosures only and will have no impact on the Company's consolidated financial statements.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers ("ASU 2014-09"). ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in United States Generally Accepted Accounting Principles when it becomes effective. In July 2015, the FASB voted to delay the effective date of ASU 2014-09 by one year, making it effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption permitted as of the original effective date. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. In addition, during 2016 the FASB issued ASU 2016-08, ASU 2016-10, and ASU 2016-12, all of which clarify certain implementation guidance within ASU 2014-09. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, which addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most notably, this new guidance requires equity investments (except those accounted for under the

equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. This new guidance is effective for annual reporting periods beginning after December 15, 2017. We are currently evaluating the impact the adoption of this standard would have on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02"). Upon the effective date, ASU 2016-02 will supersede the current lease guidance in Topic 840, Leases. Under the new guidance, lessees will be required to recognize for all leases, with the exception of short-term leases, a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis. Concurrently, lessees will be required to recognize a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The guidance is required to be applied using a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative periods presented in the financial statements. We are currently evaluating the effects the adoption of ASU 2016-02 will have on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"), which is intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods therein. Early application is permitted. We are currently evaluating the impact of this guidance on our consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13") which significantly changes the measurement of credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. ASU 2016-13 will require entities to record allowances for available-for-sale debt securities rather than reduce the carrying amount, as currently performed under the other-than-temporary impairment model. Additionally, the standard will require enhanced disclosures for financial assets measured at amortized cost and available-for-sale debt securities to help the financial statement users better understand significant judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an entity's portfolio. ASU 2016-13 is effective for interim and annual

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reporting periods beginning after December 15, 2019, with early adoption permitted. We are currently evaluating the effects the adoption of ASU 2016-13 will have on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 provides guidance on the following eight specific cash flow classification issues: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. Current GAAP does not include specific guidance on these eight cash flow classification issues. The amendments of this ASU are effective for reporting periods beginning after December 15, 2017, with early adoption permitted. The Company is evaluating the effect that ASU 2015-16 will have on its consolidated financial statements and related disclosures.

3. FAIR VALUE

Fair value measurements are generally based upon observable and unobservable inputs. Observable inputs are based on market data from independent sources, while unobservable inputs reflect the Company's view of market assumptions in the absence of observable market information. All assets and liabilities that are carried at fair value are classified and disclosed in one of the following categories:

Level 1 — Quoted prices (unadjusted) in active markets for identical assets or liabilities. An active market is defined as a market where transactions for the financial statement occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 — Quoted market prices for similar assets or liabilities and valuations, using models or other valuation techniques that use observable market data. All significant inputs are observable, or derived from observable information in the marketplace, or are supported by observable levels at which transactions are executed in the market place.

Level 3 — Instruments that use non-binding broker quotes or model driven valuations that do not have observable market data or those that are estimated based on an ownership interest to which a proportionate share of net assets is attributed. Currently, the Company has no level 3 investments.

The Company’s financial instruments measured at fair value and the level of the fair value hierarchy of inputs used were as follows:

	September 30, 2016			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Debt securities:				
United States government obligations and authorities	$ 38,933	$ 26,877	$ —	$ 65,810
Obligations of states and political subdivisions	—	150,873	—	150,873
Corporate	—	149,210	—	149,210
International	—	12,986	—	12,986
	38,933	339,946	—	378,879
Equity securities	40,458	876	—	41,334
Total investments	$ 79,391	$ 340,822	$ —	$ 420,213

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	December 31, 2015			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Debt securities:				
United States government obligations and authorities	$ 34,733	$ 26,820	$ —	$ 61,553
Obligations of states and political subdivisions	—	110,702	—	110,702
Corporate	—	154,620	—	154,620
International	—	12,303	—	12,303
	34,733	304,445	—	339,178
Equity securities	38,012	522	—	38,534
Total investments	$ 72,745	$ 304,967	$ —	$ 377,712

4. INVESTMENTS

Unrealized Gains and Losses

The following table details the difference between amortized cost or cost and estimated fair value, by major investment category, at September 30, 2016 and at December 31, 2015:

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
September 30, 2016				
Debt securities - available-for-sale:				
United States government obligations and authorities	$ 64,810	$ 1,039	$ 39	$ 65,810
Obligations of states and political subdivisions	148,366	2,556	49	150,873
Corporate	144,990	4,305	85	149,210
International	12,715	273	2	12,986

	370,881	8,173	175	378,879
Debt securities - held-to-maturity:				
United States government obligations and authorities	4,173	70	59	4,184
Corporate	1,636	47	—	1,683
International	71	2	—	73
	5,880	119	59	5,940
Equity securities	34,905	7,278	849	41,334
Total investments	$ 411,666	$ 15,570	$ 1,083	$ 426,153

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	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
December 31, 2015				
Debt securities - available-for-sale:				
United States government obligations and authorities	$ 61,384	$ 489	$ 320	$ 61,553
Obligations of states and political subdivisions	109,152	1,590	40	110,702
Corporate	154,957	1,153	1,490	154,620
International	12,528	18	243	12,303
	338,021	3,250	2,093	339,178
Debt securities - held-to-maturity:				
United States government obligations and authorities	4,275	30	204	4,101
Corporate	2,253	14	20	2,247
International	91	—	—	91
	6,619	44	224	6,439
Equity securities	33,581	6,809	1,856	38,534
Total investments	$ 378,221	$ 10,103	$ 4,173	$ 384,151

Net Realized Gains and Losses

The Company calculates the gain or loss realized on the sale of investments by comparing the sales price (fair value) to the cost or amortized cost of the security sold. Net realized gains and losses on investments are determined in accordance with the specific identification method. The following tables detail the Company’s net realized gains (losses) by major investment category for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)		(in thousands)	
Gross realized gains:				
Debt securities	$ 897	$ 226	$ 2,822	$ 973
Equity securities	597	1,847	1,752	4,188
Total gross realized gains	1,494	2,073	4,574	

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash and Cash Equivalents

The Company considers cash and cash equivalents to include cash in banks, commercial paper and deposits with financial institutions that can be liquidated without prior notice or penalty. The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Fair Value of Other Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, marketable securities, accounts and other receivables, investments, trade accounts payable, our $450.0 million aggregate principal amount of 5.000% notes due August 14, 2014 (the 2014 Notes) and $400.0 million aggregate principal amount of 6.125% notes due August 14, 2019 (the 2019 Notes) (together the Senior Notes) and our Senior Credit Facility with Canadian Imperial Bank of Commerce, acting through its New York agency, as administrative agent (the 2006 Credit Facility). The carrying amounts of cash and cash equivalents, marketable securities, accounts and other receivables and trade accounts payable are representative of their respective fair values due to their relatively short maturities. The fair values of investments in companies that are publicly traded are based on quoted market prices. The Company estimates the fair value of its fixed rate long-term obligations based on quoted market rates of interest and maturity schedules for similar issues. At December 31, 2009, the fair value of our Senior Notes was approximately $24.5 million greater than the carrying value.

Inventories

Inventories consist of finished goods held for sale and distribution, raw materials and work in process. Included in inventory at December 31, 2009 and 2008 is approximately $14.1 million and $16.4 million, respectively, of inventory that is pending approval by the U.S. Food and Drug Administration (FDA) or has not been launched due to contractual restrictions. This inventory consists of generic pharmaceutical products that are capitalized only when the bioequivalence of the product is demonstrated or the product is already FDA approved and is awaiting a contractual triggering event to enter the marketplace. Inventories are stated at the lower of cost (first-in, first-out method) or market (net realizable value). The Company writes down inventories to net realizable value based on forecasted demand and market conditions, which may differ from actual results.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Major renewals and improvements are capitalized, while routine maintenance and repairs are expensed as incurred. Costs associated with internally developed software are accounted for in accordance with the guidance for the treatment of costs associated with computer software development that defines those costs to be capitalized and those to be expensed. The Company capitalizes interest on qualified construction projects. At the time property and equipment are retired from service, the cost and accumulated depreciation are removed from the respective accounts and the related gains or losses are reflected in income.

Depreciation expense is computed principally on the straight-line method, over estimated useful lives of the related assets. The following table provides the range of estimated useful lives used for each asset type:

Computer software / hardware	3-7 years
Machinery and equipment	5-18 years
Research and laboratory equipment	5-10 years
Furniture and fixtures	5-10 years
Buildings, improvements, leasehold improvements and other	5-40 years

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company assesses property and equipment for impairment whenever events or changes in circumstances indicate that an asset s carrying amount may not be recoverable.

Investments

The Company s equity investments are accounted for under the equity method when the Company can exert significant influence and ownership does not exceed 50%. Watson accounts for its joint ventures using the equity method. Investments in which the Company owns less than a 20% interest and can not exert significant influence are accounted for using the cost method if the fair value of such investments is not readily determinable.

Marketable Securities

The Company s marketable securities consist of U.S. Treasury and agency securities and equity securities of publicly-held companies. The Company s marketable securities are classified as available-for-sale and are recorded at fair value, based upon quoted market prices. Unrealized temporary adjustments to fair value are included on the balance sheet in a separate component of stockholders equity as unrealized gains and losses and reported as a component of accumulated other comprehensive income. No gains or losses on marketable securities are realized until shares are sold or a decline in fair value is determined to be other-than-temporary. If a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established.

Goodwill and Intangible Assets with Indefinite-Lives

We test goodwill and intangible assets with indefinite-lives for impairment annually at the end of the second quarter by comparing the fair value of each of the Company s reporting units to the respective carrying value of the reporting units. Additionally, we may perform tests between annual tests if an event occurs or circumstances change that could potentially reduce the fair value of a reporting unit below its carrying amount. The Company s reporting units have been identified by Watson as Global Generic, Global Brand and Distribution. The carrying value of each reporting unit is determined by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units.

Goodwill is considered impaired if the carrying amount of the net assets exceeds the fair value of the reporting unit. Impairment, if any, would be recorded in operating income and this could result in a material reduction in net income and earnings per share. During the second quarter of 2009, the Company performed its annual impairment assessment of goodwill and trade name intangible assets with indefinite-lives and determined there was no impairment. No impairment indicators occurred subsequent to our second quarter review.

Included in intangible assets with indefinite-lives are trade name intangible assets acquired prior to January 1, 2009 and acquired in-process research and development (IPR&D) intangibles acquired after January 1, 2009. Upon adoption of FASB issued authoritative guidance on January 1, 2009, using the purchase method of accounting, IPR&D intangible assets are recognized at their fair value on the balance sheet regardless of the likelihood of success of the related product or technology. Prior to January 1, 2009, amounts allocated to IPR&D intangible assets were expensed at the date of acquisition.

IPR&D intangible assets represent the value assigned to acquired research and development projects that, as of the date acquired, represent the right to develop, use, sell and/or offer for sale a product or other intellectual property that we have acquired with respect to products and/or processes that have not been completed or approved. The IPR&D intangible assets will be subject to impairment testing until completion or abandonment of each project. Impairment testing will require the development of significant estimates and assumptions involving the determination of estimated net cash flows for each year for each project or product

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(including net revenues, cost of sales, research and development costs, selling and marketing costs), the appropriate discount rate to select in order to measure the risk inherent in each future cash flow stream, the assessment of each asset s life cycle, competitive trends impacting the asset and each cash flow stream as well as other factors. The major risks and uncertainties associated with the timely and successful completion of the IPR&D projects include legal risk and regulatory risk. No assurances can be given that the underlying assumptions used to prepare the discounted cash flow analysis will not change or the timely completion of each project to commercial success will occur. For these and other reasons, actual results may vary significantly from estimated results.

Upon successful completion of each project and launch of the product, Watson will make a separate determination of useful life of the IPR&D intangible and amortization will be recorded as an expense over the estimated useful life.

Contingent Consideration

Subsequent to January 1, 2009, contingent consideration is recorded at the acquisition date estimated fair value of the contingent payment for all acquisitions. The fair value of the contingent consideration is remeasured at each reporting period with any adjustments in fair value included in our consolidated statement of operations.

Revenue Recognition

Revenue is generally realized or realizable and earned when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller s price to the buyer is fixed or determinable, and collectibility is reasonably assured. The Company records revenue from product sales when title and risk of ownership have been transferred to the customer, which is typically upon delivery to the customer. Revenues recognized from research, development and licensing agreements (including milestone payments) are recorded on the contingency-adjusted performance model which requires deferral of revenue until such time as contract milestone requirements, as specified in the individual agreements, have been met. Under this model, revenue related to each payment is recognized over the entire contract performance period, starting with the contract s commencement, but not prior to earning and/or receiving the milestone payment (i.e., removal of any contingency). The amount of revenue recognized is based on the ratio of costs incurred to date to total estimated cost to be incurred. Royalty and commission revenue is recognized in accordance with the terms of their respective contractual agreements when collectibilty is reasonably assured and revenue can be reasonably measured.

Provisions for Sales Returns and Allowances

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

customer inventory data, customer contract programs and product pricing trends to analyze and validate the SRA reserves.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Chargebacks The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to the Company by our wholesale customer for a particular product and the negotiated contract price that the wholesaler s customer pays for that product. The Company s chargeback provision and related reserve vary with changes in product mix, changes in customer pricing and changes to estimated wholesaler inventories. The provision for chargebacks also takes into account an estimate of the expected wholesaler sell-through levels to indirect customers at contract prices. The Company validates the chargeback accrual quarterly through a review of the inventory reports obtained from our largest wholesale customers. This customer inventory information is used to verify the estimated liability for future chargeback claims based on historical chargeback and contract rates. These large wholesalers represent 85% 90% of the Company s chargeback payments. The Company continually monitors current pricing trends and wholesaler inventory levels to ensure the liability for future chargebacks is fairly stated.

Rebates Rebates include volume related incentives to direct and indirect customers and Medicaid rebates based on claims from Medicaid benefit providers.

Volume rebates are generally offered to customers as an incentive to continue to carry our products and to encourage greater product sales. These rebate programs include contracted rebates based on customer s purchases made during an applicable monthly, quarterly or annual period. The provision for rebates is estimated based on our customers contracted rebate programs and our historical experience of rebates paid. Any significant changes to our customer rebate programs are considered in establishing our provision for rebates. The Company continually monitors its customer rebate programs to ensure that the liability for accrued rebates is fairly stated.

The provision for Medicaid rebates is based upon historical experience of claims submitted by the various states. The Company monitors Medicaid legislative changes to determine what impact such legislation may have on our provision for Medicaid rebates. Our accrual of Medicaid rebates is based on historical payment rates and is reviewed on a quarterly basis against actual claim data to ensure the liability is fairly stated.

Returns and Other Allowances Our provision for returns and other allowances include returns, pricing adjustments, promotional allowances and billback adjustments.

Consistent with industry practice, the company maintains a return policy that allows our customers to return product for credit. In accordance with our return goods policy, credit for customer returns of product is applied against outstanding account activity or by check. Product exchanges are not permitted. Customer returns of product are not resalable unless the return is due to a shipping error. Our estimate of the provision for returns is based upon historical experience and current trends of actual customer returns. Additionally, we consider other factors when estimating our current period return provision, including levels of inventory in our distribution channel as well as significant market changes which may impact future expected returns, and make adjustments to our current period provision for returns when it appears product returns may differ from our original estimates.

Pricing adjustments, which include shelf stock adjustments, are credits issued to reflect price decreases in selling prices charged to our direct customers. Shelf stock adjustments are based upon the amount of product our customers have in their inventory at the time of an agreed-upon price reduction. The provision for shelf stock adjustments is based upon specific terms with our direct customers and includes estimates of existing customer inventory levels based upon their historical purchasing patterns. The Company regularly monitors all price changes to help evaluate

our reserve balances. The adequacy of these reserves is readily determinable as pricing adjustments and shelf stock adjustments are negotiated and settled on a customer-by-customer basis.

Promotional allowances are credits, which are issued in connection with a product launch or as an incentive for customers to begin carrying our product. The Company establishes a reserve for promotional allowances based upon these contractual terms.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Billback adjustments are credits that are issued to certain customers who purchase directly from the Company as well as indirectly through a wholesaler. These credits are issued in the event there is a difference between the customer s direct and indirect contract price. The provision for billbacks is estimated based upon historical purchasing patterns of qualified customers who purchase product directly from the Company and supplement their purchases indirectly through the Company s wholesale customers.

Cash Discounts Cash discounts are provided to customers that pay within a specific period. The provision for cash discounts are estimated based upon invoice billings, utilizing historical customer payment experience. Our customer s payment experience is fairly consistent and most customer payments qualify for the cash discount. Accordingly, our reserve for cash discounts is readily determinable.

Net revenues and accounts receivable balances in the Company s consolidated financial statements are presented net of SRA estimates. In addition, certain SRA balances are included in accounts payable and accrued liabilities. Accounts receivable are presented net of SRA balances of $332.9 million and $285.7 million at December 31, 2009 and 2008, respectively. Accounts payable and accrued liabilities include $83.6 million and $42.5 million at December 31, 2009 and 2008, respectively, for certain rebates and other amounts due to indirect customers. The following table summarizes the activity in the Company s major categories of SRA (in millions):

	Chargebacks	Rebates	Returns and Other Allowances	Cash Discounts	Total
Balance at December 31, 2006	$ 164.4	$ 180.5	$ 42.5	$ 14.1	$ 401.5
Provision related to sales in 2007	1,234.9	376.5	167.4	68.0	1,846.8
Credits and payments	(1,234.9)	(402.7)	(153.8)	(69.2)	(1,860.6)
Balance at December 31, 2007	164.4	154.3	56.1	12.9	387.7
Provision related to sales in 2008	1,224.0	309.1	179.8	67.2	1,780.1
Credits and payments	(1,267.8)	(337.6)	(166.4)	(67.8)	(1,839.6)
Balance at December 31, 2008	120.6	125.8	69.5	12.3	328.2
Add: Arrow Acquisition	5.3	35.9	10.3	1.5	53.0
Provision related to sales in 2009	1,169.0	415.1	183.8	72.8	1,840.7
Credits and payments	(1,177.5)	(389.5)	(167.1)	(71.3)	(1,805.4)
Balance at December 31, 2009	$ 117.4	$ 187.3	$ 96.5	$ 15.3	$ 416.5

The Company does not expect future payments of SRA to materially exceed our current estimates. However, if future SRA payments were to materially exceed our estimates, such adjustments may have a material adverse impact on our financial position, results of operations and cash flows.

Shipping and Handling Costs

The Company records shipping and handling costs in selling and marketing expenses. These expenses were $51.9 million, $50.8 million and $45.9 million in 2009, 2008 and 2007, respectively.

Concentration of Major Customers and Suppliers

For the year ended December 31, 2009, the Company s three largest customers accounted for 13%, 11%, and 9%, individually, of the Company s net revenues. For the year ended December 31, 2008, the Company s three largest customers accounted for 11%, 11%, and 9%, individually, of the Company s net revenues. For the year ended December 31, 2007, the Company s three largest customers accounted for 12%, 11%, and 9%, individually, of the Company s net revenues. No other individual customers accounted for more than 10% of net revenues.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company is subject to a concentration of credit risk with respect to its accounts receivable balance, all of which is due from wholesalers, distributors, chain drug stores and service providers in the health care and pharmaceutical industries throughout the U.S. Approximately 53% and 61% of the gross accounts receivable balance consists of amounts due from the four largest customers at December 31, 2009 and 2008, respectively. The Company performs ongoing credit evaluations of its customers and maintains an allowance for potential uncollectible accounts. Actual losses from uncollectible accounts have been minimal.

Certain of the Company s finished products and raw materials are obtained from single source suppliers. Although the Company seeks to identify more than one source for its various finished products and raw materials, loss of a single source supplier could have an adverse effect on the Company s results of operations, financial condition and cash flows. Third-party manufactured products accounted for approximately 53%, 58% and 57% of our product net revenues in 2009, 2008 and 2007, respectively.

Research and Development Activities

R&D activities are expensed as incurred and consist of self-funded R&D costs and the costs associated with work performed under collaborative R&D agreements. R&D expenses include direct and allocated expenses. R&D expenses incurred under collaborative agreements were approximately $6.8 million, $5.9 million, and $2.7 million for the years ended December 31, 2009, 2008 and 2007, respectively.

Income Taxes

Income taxes are accounted for using an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement and tax bases of assets and liabilities at the applicable tax rates. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company evaluates the realizability of its deferred tax assets by assessing its valuation allowance and by adjusting the amount of such allowance, if necessary. The factors used to assess the likelihood of realization include the Company s forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Failure to achieve forecasted taxable income in applicable tax jurisdictions could affect the ultimate realization of deferred tax assets and could result in an increase in the Company s effective tax rate on future earnings.

Income tax positions must meet a more-likely-than-not recognition threshold to be recognized. Income tax positions that previously failed to meet the more-likely-than-not threshold are recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not threshold are derecognized in the first subsequent financial reporting period in which that threshold is no longer met. We recognize potential accrued interest and penalties related to unrecognized tax benefits within the consolidated statements of income as income tax expense.

Comprehensive Income

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company s stockholders. Other comprehensive income refers to revenues, expenses, gains and losses that, under generally accepted accounting principles, are included in comprehensive income, but excluded from

net income as these amounts are recorded directly as an adjustment to stockholders equity. Watson s other comprehensive income (loss) is composed of unrealized gains (losses) on its holdings of publicly traded equity securities, net of realized gains (losses) included in net income, foreign currency translation adjustments and unrealized gains (losses) on cash flow hedges.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Earnings Per Share (EPS)

Basic EPS is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted EPS is based on the treasury stock method and includes the effect from potential issuance of common stock, such as shares issuable upon conversion of our convertible contingent senior debentures (CODES), and shares issuable pursuant to the exercise of stock options, assuming the exercise of all in-the-money stock options. Common share equivalents have been excluded where their inclusion would be anti-dilutive. The Company is required to add the weighted average potential common shares outstanding associated with the conversion of the CODES to the number of shares outstanding for the calculation of diluted EPS for all periods in which the securities were outstanding. On September 14, 2009 the CODES were redeemed in accordance with the terms of the CODES. A reconciliation of the numerators and denominators of basic and diluted EPS consisted of the following (in millions, except per share amounts):

	Years Ended December 31,		
	2009	2008	2007
EPS basic			
Net income	$ 222.0	$ 238.4	$ 141.0
Basic weighted average common shares outstanding	105.0	102.8	102.2
EPS basic	$ 2.11	$ 2.32	$ 1.38
EPS assuming dilution			
Net income	$ 222.0	$ 238.4	$ 141.0
Add: Interest expense on CODES, net of tax	5.5	7.9	7.8
Net income, adjusted	$ 227.5	$ 246.3	$ 148.8
Basic weighted average common shares outstanding	105.0	102.8	102.2
Effect of dilutive securities:			
Conversion of CODES	10.1	14.4	14.4
Dilutive stock awards	1.3	0.5	0.4
Diluted weighted average common shares outstanding	116.4	117.7	117.0
EPS diluted	$ 1.96	$ 2.09	$ 1.27

Stock awards to purchase 3.5 million, 8.1 million and 7.6 million common shares in 2009, 2008 and 2007, respectively, were outstanding but not included in the computation of diluted EPS as the awards were anti-dilutive.

Share-based Compensation

The Company recognizes compensation expense for all share-based compensation awards made to employees and directors based on estimated fair values. The Company estimates the fair value of its stock option plans using the Black-Scholes option pricing model (the Option Model). The Option Model requires the use of subjective and complex assumptions, including the option s expected term and the estimated future price volatility of the underlying stock, which determine the fair value of the share-based awards. The Company s estimate of expected term was determined based on the weighted average period of time that options granted are expected to be outstanding considering current vesting schedules and the historical exercise patterns of existing option plans. The expected volatility assumption used in the Option Model is based on implied volatility based on traded options on the Company s stock. The risk-free interest rate used in the

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Option Model is based on the yield of U.S. Treasuries with a maturity closest to the expected term of the Company s stock options.

Share-based compensation expense recognized during a period is based on the value of the portion of share-based awards that are expected to vest with employees. Accordingly, the recognition of share-based compensation expense has been reduced for estimated future forfeitures. These estimates will be revised in future periods if actual forfeitures differ from the estimates. Changes in forfeiture estimates impact compensation expense in the period in which the change in estimate occurs.

The following weighted average assumptions were used for stock options granted during the year ended December 31, 2007:

Dividend yield	None
Expected volatility	28%
Risk-free interest rate	4.33%
Expected term	6.4 years
Weighted average fair value per share at grant date	$11.49

No stock options were granted during the years ended December 31, 2009 and 2008.

Recent Accounting Pronouncements

On July 1, 2009, the Financial Accounting Standards Board (FASB) Accounting Standards Codification (the Codification) became the authoritative source of accounting principles to be applied to financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP). In accordance with the Codification, any references to accounting literature will be to the relevant topic of the Codification or will be presented in plain English. The Codification is not intended to change or alter existing GAAP. The adoption of the Codification did not have a material impact on the Company s consolidated financial statements.

In September 2006, the FASB issued authoritative guidance for fair value measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The Company adopted the provisions of the guidance effective January 1, 2008 for all financial assets and liabilities and any other assets and liabilities that are recognized or disclosed at fair value on a recurring basis (see NOTE 15 Fair Value Measurement). For nonfinancial assets and liabilities measured at fair value on a non-recurring basis, SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2008. The adoption of the provisions of the guidance for nonfinancial assets and liabilities measured at fair value on a non-recurring basis on January 1, 2009 did not have a material impact on the Company s consolidated financial statements.

In December 2007, the FASB revised the authoritative guidance for business combinations, which establishes principles and requirements for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed and any noncontrolling interest in a business combination at their fair value at acquisition date. The guidance alters the treatment of acquisition-related costs, business combinations achieved in stages (referred to as a step

acquisition), the treatment of gains from a bargain purchase, the recognition of contingencies in business combinations, the treatment of in-process research and development in a business combination as well as the treatment of recognizable deferred tax benefits. The guidance is effective for business combinations closed in fiscal years beginning after December 15, 2008. In the year ended December 31, 2009, the Company recorded acquisition expense of $16.6 million in accordance with the provisions of the guidance.

In December 2007, the FASB issued authoritative guidance for noncontrolling interests. The guidance establishes accounting and reporting standards for the noncontrolling interest (formerly referred to as minority

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

interest) in a subsidiary and for the deconsolidation of a subsidiary. The guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008. The adoption of the authoritative guidance for noncontrolling interests on January 1, 2009 did not have a material impact on the Company s consolidated financial statements. The guidance has been applied for our Arrow Acquisition and has not had a material impact on the Company s consolidated financial statements.

In April 2008, the FASB issued a staff position that amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB s issued guidance for goodwill and other intangible assets, and also requires expanded disclosure related to the determination of intangible asset useful lives. The statement is effective for fiscal years beginning after December 15, 2008. The adoption of the statement did not have a material impact on the Company s consolidated financial statements.

In May 2009, the FASB issued authoritative guidance for subsequent events which establishes general standards of accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued. The guidance is effective for financial statements issued for interim or fiscal years ending after June 15, 2009. The adoption of the provisions of the guidance did not have a material impact on the Company s consolidated financial statements.

In June 2009, the FASB issued an amendment to the accounting and disclosure requirements for the consolidation of variable interest entities (VIEs). The amendment eliminates the quantitative approach previously required for determining the primary beneficiary of a VIE and requires an enterprise to perform a qualitative analysis when determining whether or not to consolidate a VIE. The amendment requires an enterprise to continuously reassess whether it must consolidate a VIE and also requires enhanced disclosures about an enterprise s involvement with a VIE and any significant change in risk exposure due to that involvement, as well as how its involvement with a VIE impacts the enterprise s financial statements. This amendment is effective for fiscal years beginning after November 15, 2009. We are currently evaluating the impact of the adoption of this amendment on the Company s consolidated financial statements.

In October 2009, the FASB issued an amendment to its accounting guidance on revenue arrangements with multiple deliverables, which addresses the unit of accounting for arrangements involving multiple deliverables and how consideration should be allocated to separate units of accounting, when applicable. The amendment requires that arrangement considerations be allocated at the inception of the arrangement to all deliverables using the relative selling price method and provides for expanded disclosures related to such arrangements. The amendment is effective for revenue arrangement entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is allowed. We are currently evaluating the impact of the adoption of this amendment on the Company s consolidated financial statements.

NOTE 3 Share-Based Compensation

As indicated above, the Company recognizes compensation expense for all share-based compensation awards made to employees and directors based on estimated fair values. A summary of the Company s share-based compensation plans is presented below.

Equity Award Plans

The Company has adopted several equity award plans, all of which have been approved by the Company s shareholders, that authorize the granting of options, restricted stock and other forms of equity awards of the Company s common shares subject to certain conditions. At December 31, 2009, the Company had reserved 6.8 million of its common shares for issuance of share-based compensation awards under the Company s equity award plans.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Option award plans require options to be granted at the fair value of the shares underlying the options at the date of the grant and generally become exercisable over periods ranging from three to five years and expire in ten years. In conjunction with certain of the Company s acquisitions, Watson assumed stock option and warrant plans from the acquired companies. The options and warrants in these plans were adjusted by the individual exchange ratios specified in each transaction. No additional options or warrants have been granted under any of the assumed plans.

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

Share-Based Compensation

Share-based compensation expense recognized in the Company s results of operations for the years ended December 31, 2009, 2008 and 2007 was $19.1 million, $18.5 million and $14.2 million, respectively. Share-based compensation capitalized to inventory was $2.7 million, $3.3 million and $3.4 million for the years ended December 31, 2009, 2008 and 2007, respectively.

NOTE 4 Arrow Acquisition

Description of the Transaction

On December 2, 2009, Watson acquired all the outstanding equity of privately held Arrow Group for cash, stock and certain contingent consideration (the Arrow Acquisition). In accordance with the terms of the share purchase agreement dated June 16, 2009, as amended on November 26, 2009 (together the Acquisition Agreement), the Company acquired all the outstanding equity of the Arrow Group for the following consideration:

The payment of cash and the assumption of certain liabilities totaling $1.05 billion;

Approximately 16.9 million restricted shares of Common Stock of Watson (the Restricted Common Stock);

200,000 shares of newly designated mandatorily redeemable, non-voting Series A Preferred Stock of Watson (the Mandatorily Redeemable Preferred Stock) placed in escrow for the benefit of the former shareholders of the Arrow Group (the Arrow Selling Shareholders); and

Certain contingent consideration based on the after-tax gross profits on sales of the authorized generic version of Lipitor® (atorvastatin) in the U.S. calculated and payable as described in the Acquisition Agreement. For additional information on the contingent payment, refer to NOTE 10 Other Long-Term Liabilities.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents a summary of the purchase price consideration for the Arrow Acquisition (in millions):

	Amount
Cash consideration	$ 1,050.0
Fair value of Restricted Common Stock	636.2
Fair value of Mandatorily Redeemable Preferred Stock	150.0
Fair value estimate of atorvastatin contingent payment consideration (refer to NOTE 10 Other Long-Term Liabilities.)	110.0
	$ 1,946.2

Fair Value of Consideration Transferred

In accordance with existing U.S. GAAP, the fair value of Restricted Common Stock issued as part of the consideration transferred was measured on the closing date of the acquisition at the then-current market price of $37.55 per share for a total Common Consideration of approximately $636.2 million.

Mandatorily Redeemable Preferred Stock was issued in the form of zero-coupon, non-convertible preferred stock which will be redeemable in the amount of $200.0 million, less the amount of any indemnity payments, three years after the Acquisition Date. The fair value of the Mandatorily Redeemable Preferred Stock at Acquisition Date is estimated by the Company to be $150.0 million, based on the terms they were issued under and the cost of the Company s other fixed rate borrowings and is presented within long-term debt. For additional information on the Mandatorily Redeemable Preferred Stock, refer to NOTE 9 Long-Term Debt.

The Company determined the acquisition date fair value of the contingent consideration obligation based on a probability-weighted income approach derived from atorvastatin revenue estimates and post-tax gross profit levels and a probability assessment with respect to the likelihood of achieving the various earn-out criteria. The fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement as defined in fair value measurement accounting. The resultant probability-weighted cash flows were discounted using an effective annual interest rate of 10.4%. At each reporting date, the Company will revalue the contingent consideration obligation to estimated fair value and record changes in fair value as income or expense in our consolidated statement of operations. Changes in the fair value of the contingent consideration obligations may result from changes in discount periods and rates, changes in the timing and amount of revenue estimates and changes in probability assumptions with respect to the likelihood of achieving the various earn-out criteria. As of December 31, 2009 the range of outcomes and the assumptions used to develop the estimates have not changed significantly from those used at Acquisition Date. Accretion expense related to the increase in the net present value of the contingent liability will be included in interest expense for the period.

Divestiture of Certain Assets

In order to obtain regulatory approval under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the HSR Act), in connection with the Arrow Acquisition, Watson and the Arrow Group were required to divest certain assets. In conjunction with the closing, Watson sold its Abbreviated New Drug Application (ANDA) for Cabergoline, the generic equivalent to Dostinex, to Impax Laboratories, Inc. The Arrow Group sold its pending ANDA for Dronabinol, a generic equivalent to Marinol, to Impax Laboratories, Inc.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Resolution Chemicals Ltd. (Resolution), the subsidiary of the Arrow Group that manufactures the Dronabinol active pharmaceutical ingredient, was divested in accordance with the terms of the consent order under the HSR Act immediately prior to the closing.

Allocation of Consideration Transferred

The transaction has been accounted for using the purchase method of accounting under existing U.S. GAAP. The purchase method under existing U.S. GAAP requires, among other things, that assets acquired and liabilities assumed in a business purchase combination be recognized at their fair values as of the acquisition date and that IPR&D be recorded at fair value on the balance sheet regardless of the likelihood of success of the related product or technology. In addition, any common stock consideration transferred is measured at acquisition date at the then current market price.

The purchase price for the Arrow Acquisition was provisionally allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at Acquisition Date, with the excess being allocated to goodwill, as follows (in millions):

	Amount
Cash and cash equivalents	$ 64.9
Accounts receivable	109.7
Inventories	187.9
Other current assets	173.9
Property, plant & equipment	83.7
IPR&D intangible assets	724.0
Intangible assets	514.0
Goodwill	780.0
Other assets	10.6
Current liabilities	(310.8)
Long-term deferred tax and other tax liabilities	(387.8)
Other long-term liabilities	(3.9)
Net assets acquired	$ 1,946.2

Management s purchase price allocation is provisional until the Company receives more information to complete its allocation of certain intellectual properties by tax jurisdiction (which may impact intangible asset valuations) and its evaluation of uncertain tax positions and related deferred income tax assets and liabilities.

Inventories

The fair value of inventories acquired included a step-up in the value of inventories of approximately $26.0 million. Approximately $14.2 million was amortized to cost of sales during 2009 and the remaining $11.8 million will be

amortized to cost of sales in the first quarter of 2010.

Other Current Assets

Included in other current assets was $90.0 million related to the fair value of amounts due from Sepracor, Inc. (Sepracor) prior to the end of 2010 (the Sepracor Receivable) for the transfer of certain product rights and technology from the Arrow Group. In April, 2008, the Arrow Group entered into license and development agreements with Sepracor for the development, commercialization, marketing, sale and distribution of certain inhalation pharmaceutical products and packaging technology held by the Arrow Group. Under the license and development agreements, Sepracor is required to pay certain non-refundable milestone amounts

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

prior to December 31, 2010 as consideration for the transfer of know-how and the grants of rights and licenses to the Arrow technology. The fair value of the Sepracor Receivable was estimated to be $90.0 million at Acquisition Date.

IPR&D and Intangible Assets

IPR&D intangible assets represent the value assigned to acquired research and development projects that, as of the Acquisition Date, had not established technological feasibility and had no alternative future use. The IPR&D intangible assets will be capitalized and accounted for as indefinite-lived intangible assets and will be subject to impairment testing until completion or abandonment of the projects. Upon successful completion of each project and launch of the product, Watson will make a separate determination of useful life of the IPR&D intangible and amortization will be recorded as an expense over the estimated useful life.

Intangible assets represent the Arrow Group s currently marketed products (CMP) and have an estimated weighted average useful life of seven years.

The fair value of the IPR&D and identifiable intangible assets is determined primarily using the income approach, which is a valuation technique that provides an estimate of the fair value of an asset based on market participant expectations of the cash flows an asset would generate over its remaining useful life. Some of the more significant assumptions inherent in the development of the identifiable intangible assets valuations, from the perspective of a market participant, include the estimated net cash flows for each year for each project or product (including net revenues, cost of sales, research and development costs, selling and marketing costs and working capital/asset contributory asset charges), the appropriate discount rate to select in order to measure the risk inherent in each future cash flow stream, the assessment of each asset s life cycle, competitive trends impacting the asset and each cash flow stream as well as other factors. The discount rate used to arrive at the present value of IPR&D projects as of the Acquisition Date was approximately 10.4% to reflect the internal rate of return and incremental commercial uncertainty in the projections as the products have not yet received FDA approval. The major risks and uncertainties associated with the timely and successful completion of the IPR&D projects include legal risk and regulatory risk. No assurances can be given that the underlying assumptions used to prepare the discounted cash flow analysis will not change or the timely completion of each project to commercial success will occur. For these and other reasons, actual results may vary significantly from estimated results.

Goodwill Allocation

Among the primary reasons the Company entered into the Arrow Acquisition and factors that contributed to a purchase price allocation resulting in the recognition of goodwill were a history of operating margins and profitability, a strong research and development department including generic biologic capability and several first-to file opportunities, expanded commercial footprint on a global basis and key pipeline additions, including atorvastatin and budesonide which will enable Watson to expand its product offerings and offer its customers a greater breadth of product offerings. The goodwill recognized from the Arrow Acquisition is not deductible for tax purposes. All goodwill from the Arrow Acquisition was assigned to the Global Generic segment.

Long-Term Deferred Tax Liabilities and Other Tax Liabilities

Long-term deferred tax liabilities and other tax liabilities reflects a deferred income tax liability representing the estimated impact of purchase accounting adjustments for the inventory fair value step-up, property, plant and equipment fair value adjustment, contingencies adjustment and identifiable IPR&D and intangible assets fair value adjustment. This estimate of deferred tax liabilities was determined based on the excess book basis over the tax basis resulting from the above fair value adjustments using an estimated weighted average statutory tax rate of approximately 30%. This estimate is preliminary and is subject to

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

change based upon management s final determination of the fair values of tangible and identifiable intangible assets acquired and liabilities assumed by taxing jurisdiction.

Acquisition-Related Expenses

Included in general and administrative expenses in the consolidated statement of operations for the year ended December 31, 2009 were pretax charges totaling $16.6 million for advisory, legal and regulatory costs in connection with the Arrow Acquisition

Unaudited Pro Forma Results of Operations

The following table presents the unaudited pro forma operating results for the Company, assuming the Arrow Acquisition had occurred as of the beginning of each period presented. The unaudited pro forma results reflect certain adjustments related to the acquisition, such as increased depreciation and amortization expense on the fair valuation of assets acquired , the impact of acquisition financing in place at December 31, 2009 and the related tax effects. The pro forma results do not include any anticipated synergies which may be achievable subsequent to the Acquisition Date. Accordingly, such pro forma amounts are not necessarily indicative of the results that actually would have occurred had the acquisition been completed on the dates indicated, nor are they indicative of the future operating results of the combined company.

	Year Ended December 31,	
	2009	2008
	(In millions, except per share amounts)	
Net revenues	$ 3,261.9	$ 3,170.6
Net income	119.3	281.5
Earnings per share:		
Basic	0.99	2.35
Diluted	0.98	2.34

NOTE 5 Other Income

Other income consisted of the following (in millions):

	Years Ended December 31,		
	2009	2008	2007
Earnings on equity method investments	$ 10.8	$ 10.6	$ 7.5
(Loss) gain on sale of securities	(1.1)	9.6	2.3
Other income (expense)	0.2	0.2	(0.1)

$ 9.9	$ 20.4	$ 9.7

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 6 Balance Sheet Components

Selected balance sheet components consisted of the following (in millions):

	December 31, 2009	2008
Inventories:		
Raw materials	$ 196.8	$ 109.1
Work-in-process	64.1	44.2
Finished goods	494.7	354.5
	755.6	507.8
Less: Inventory reserves	63.3	34.7
Inventories, net	$ 692.3	$ 473.1
Property and equipment:		
Buildings and improvements	$ 382.4	$ 335.2
Furniture and fixtures	45.1	33.0
Leasehold improvements	78.5	67.9
Land and land improvements	31.9	24.0
Machinery and equipment	526.3	469.2
Research and laboratory equipment	94.9	72.0
Construction in progress	39.6	68.6
Total property and equipment, at cost	1,198.7	1,069.9
Less accumulated depreciation	(503.2)	(411.4)
Total property and equipment, net	$ 695.5	$ 658.5

Included in property and equipment are assets held for sale having a net book value of $2.0 at December 31, 2009 and 2008, respectively

Accounts payable and accrued expenses:		
Trade accounts payable	$ 266.1	$ 148.0
Accrued payroll and related benefits	82.1	82.0
Accrued third-party rebates	60.2	25.1
Royalties and sales agent payables	36.8	43.9
Accrued severence, retention and shutdown costs	12.9	16.3
Interest payable	16.9	6.4
Accrued indirect returns	23.5	17.4
Other accrued expenses	116.7	42.2

Total accounts payable and accrued expenses	$ 615.2	$ 381.3

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7 Investments in Marketable Securities and Other Investments

	December 31, 2009	2008
	(In millions)	
Marketable securities:		
U.S. Treasury and agency securities maturing within one year	$ 6.0	$ 8.0
U.S. Treasury and agency securities maturing within two years	6.3	4.3
Equity securities	1.3	0.9
Total marketable securities	$ 13.6	$ 13.2
Investments and other assets:		
Investment in equity method investments	$ 75.4	$ 59.7
Cost method investments	6.4	0.3
Other long-term investments	3.0	0.1
Other assets	29.7	20.5
Total investments and other assets	$ 114.5	$ 80.6

Watson s marketable securities and other long-term investments are classified as available-for-sale and are recorded at fair value based on quoted market prices using the specific identification method. These investments are classified as either current or non-current, as appropriate, in the Company s Consolidated Balance Sheets.

The following table provides a summary of the fair value and unrealized gains (losses) related to Watson s available-for-sale securities (in millions):

At December 31, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury and agency securities	$ 12.3	$	$	$ 12.3
Equity securities current	0.7	0.6		1.3
Current	13.0	0.6		13.6
Equity securities non-current	0.1	2.9		3.0

Total	$ 13.1	$ 3.5	$	$ 16.6

At December 31, 2008	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury and agency securities	$ 12.1	$ 0.2	$	$ 12.3
Equity securities current	2.8		(1.9)	0.9
Current	14.9	0.2	(1.9)	13.2
Equity securities non-current	0.1			0.1
Total	$ 15.0	$ 0.2	$ (1.9)	$ 13.3

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Current Investments

The Company invests in U.S. Treasury and agency securities. These investments are included in marketable securities on the Company s Consolidated Balance Sheets at December 31, 2009 and 2008. Also, included in the Company s Consolidated Balance Sheets in marketable securities at December 31, 2009 and 2008 are the

Company s investment in the common stock of inVentiv Health, Inc. (inVentive). During the year ended December 31, 2009 the Company recorded an other-than-temporary impairment charge of $2.2 million related to our investment in common shares of inVentiv. Current investments are classified as available-for-sale and are recorded at fair value based on quoted market prices.

Non-current Investments

The Company s investments in the common stock of NovaDel Pharma, Inc., Amarin Corporation plc (Amarin) and Acura Pharmaceuticals, Inc. (Acura) are classified as other long-term investments and are included in investments and other assets on the Company s Consolidated Balance Sheets at December 31, 2009 and 2008. On December 23, 2009 the Company exercised its warrant to purchase common stock (Warrant) of Acura pursuant to the net issue cashless exercise provisions of the Warrant. Under the cashless exercise provision, the Company received approximately 533,000 shares of Acura common stock. The Company recorded an unrealized gain of $2.8 million related to our investment in Acura.

Investment in Equity Method Investments

The Company s investments in equity method investments at December 31, 2009 primarily consists of its investment in joint venture Scinopharm Taiwan Ltd. (Scinopharm).

In 2004, the Company made a $15.3 million investment in Scinopharm, a private company that specializes in process R&D and the production of active pharmaceutical ingredient (API). During the fourth quarter of 2005 the Company made an additional $19.4 million investment in the common shares of Scinopharm which increased its ownership percentage to approximately 24%. Accordingly, the Company accounts for its investment in Scinopharm under the equity method. In January 2006, the Company made an additional investment in Scinopharm of approximately $12.0 million which increased its ownership share to approximately 31%. (Refer to NOTE 17 Subsequent Events for additional information on Scinopharm).

Prior to December 31, 2008 the Company held an equity method investment in Somerset Pharmaceuticals, Inc. (Somerset), a joint venture in which Watson and Mylan Inc. (Mylan) both held a fifty percent interest. On July 28, 2008 the Company sold its fifty percent interest in Somerset to Mylan.

The Company recorded net earnings from equity method investments of $10.8 million in 2009, $10.6 million in 2008 and $7.5 million in 2007, respectively.

The Company is not required to provide ongoing investments or additional funding to its joint ventures.

Cost Method Investments

The Company s cost method investments consist primarily of investments in common shares of a number of private and public companies where our ownership interest is under 20% or where we do not have the ability to exercise significant influence.

Other Assets

Other assets include security and equipment deposits and deferred financing fees, net of amortization.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8 Goodwill, Product Rights and Other Intangibles

Goodwill for the Company s reporting units consisted of the following:

	December 31, 2009	2008
	(In millions)	
Brand segment	$ 348.2	$ 348.2
Generic segment	1,213.6	433.6
Distribution segment	86.3	86.3
Total goodwill	$ 1,648.1	$ 868.1

The increase in goodwill in 2009 is due to the Arrow Acquisition. Under the purchase method of accounting, the Company allocated $780.0 million to goodwill, which represents the excess of the purchase price over the fair value of the identifiable net tangible and intangible assets acquired (for additional information on the Arrow Acquisition see NOTE 4-Arrow Acquisition). The entire amount of goodwill related to the Arrow Acquisition was allocated to the Company s Global Generic segment.

Other intangible assets consist primarily of product rights. The original cost and accumulated amortization of these intangible assets, where applicable, consisted of the following:

	December 31, 2009	2008
	(In millions)	
Intangibles with definite lives		
Product rights and other related intangibles	$ 1,851.2	$ 1,320.7
Core technology	52.5	52.5
Customer relationships	49.1	49.1
	1,952.8	1,422.3
Less accumulated amortization	(1,031.1)	(938.5)
	921.7	483.8
Intangibles with indefinite lives		
IPR&D	724.0	
Trade Name	76.2	76.2

Total product rights and related intangibles, net	$ 1,721.9	$ 560.0

Intangible assets acquired with the Arrow Acquisition amounted to $1,238.0 million, including $514.0 million relating to CMP and $724.0 relating to IPR&D intangibles. CMP intangibles have been included in product rights and other related intangibles and will be amortized over a weighted average useful life of approximately seven years.

In December 2008, the Company acquired a portfolio of generic pharmaceutical products that were divested as a result of the merger between Teva Pharmaceutical Industries, Ltd. (Teva) and Barr Pharmaceuticals, Inc. The portfolio of products consists of 17 products, including 15 FDA-approved products and 2 development-stage products. Key products in the portfolio include cyclosporine capsules and liquid, desmopressin acetate tablets, glipizide/metformin HCI tablets, mirtazapine orally disintegrating tablets and metoclopramide HCI tablets. The Company acquired the portfolio of existing approved products for an upfront payment of $36.0 million and will make additional payments to Teva if certain milestones are met on the development-stage products. Teva has agreed to supply the products to Watson until manufacturing is transferred to Watson or a third party.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Watson reevaluates the carrying value of identifiable intangible and long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The Company continually evaluates the appropriateness of useful lives assigned to long-lived assets, including product rights.

Assuming no additions, disposals or adjustments are made to the carrying values and/or useful lives of the assets, annual amortization expense on product rights and related intangibles is estimated to be approximately $154.9 million in 2010, $151.5 million in 2011, $145.7 million in 2012, $133.3 million in 2013 and $124.3 million in 2014. These amounts do not include the amortization expense or potential impairment of IPR&D intangibles as we are unable to reasonably predict the timing of future approval and launch dates or the potential abandonment or future impairment of each acquired IPR&D project. The Company s current product rights and related intangibles have a weighted average remaining useful life of approximately seven years.

NOTE 9 Long-Term Debt

Long-term debt consisted of the following:

	December 31,	
	2009	2008
	(In millions)	
Senior Notes,		
2014 Notes	$ 450.0	$
2019 Notes	400.0	
	850.0	
Less: Unamortized discount	(2.5)	
Senior Notes, net	847.5	
2006 Credit Facility	400.0	300.0
CODES		574.7
Mandatorily Redeemable Preferred Stock	151.2	
Loan with Lombard Odier Darier Hentsch & Cie. (Lombard Loan)	55.0	
Other notes payable	4.1	3.2
	1,457.8	877.9
Less: Current portion	307.6	53.2
Total long-term debt	$ 1,150.2	$ 824.7

Senior Notes

The offering of $450.0 million of 2014 Notes and $400.0 million of 2019 Notes was registered under an automatic shelf registration statement filed with the Securities and Exchange Commission (SEC). The Senior Notes were issued pursuant to a senior note indenture dated as of August 24, 2009 between the Company and Wells Fargo Bank, National Association, as trustee, as supplemented by a first supplemental indenture dated August 24, 2009 (together the Senior Note Indentures).

Interest payments are due on the Senior Notes semi-annually in arrears on February 15 and August 15, respectively, beginning February 15, 2010 at an effective annual interest rate of 5.43% on the 2014 Notes and 6.35% on the 2019 Notes.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company may redeem the Senior Notes on at least 15 days but no more than 60 days prior written notice for cash for a redemption price equal to the greater of 100% of the principal amount of the Senior Notes to be redeemed and the sum of the present values of the remaining scheduled payments, as defined by the Senior Note Indentures, of the Senior Notes to be redeemed, discounted to the date of redemption at the applicable treasury rate, as defined by the Senior Note Indentures, plus 40 basis points. As of December 31, 2009, the fair value of our Senior Notes was approximately $24.5 million greater than the carrying value.

Upon a change of control triggering event, as defined by the Senior Note Indentures, the Company is required to make an offer to repurchase the Senior Notes for cash at a repurchase price equal to 101% of the principal amount of the Senior Notes to be repurchased plus accrued and unpaid interest to the date of purchase.

The Company used a portion of the net proceeds from the offering of Senior Notes to repay $100.0 million of the term facility under the 2006 Credit Facility and to redeem $575.0 million outstanding under the CODES. The remaining net proceeds have been used to fund a portion of the cash consideration for the Arrow Acquisition.

2006 Credit Facility

In November 2006, the Company entered into the 2006 Credit Facility with Canadian Imperial Bank of Commerce, acting through its New York agency, as Administrative Agent, Wachovia Capital Markets, LLC, as Syndication Agent, and a syndicate of banks. The 2006 Credit Facility provides an aggregate of $1.15 billion of senior financing to Watson, consisting of a $500.0 million revolving credit facility (Revolving Facility) and a $650.0 million senior term loan facility (Term Facility).

The 2006 Credit Facility has a five-year term and bears interest equal to LIBOR plus 0.75% (subject to certain adjustments). The indebtedness under the 2006 Credit Facility is guaranteed by Watson s material domestic subsidiaries. The remainder under the Revolving Facility is available for working capital and other general corporate requirements subject to the satisfaction of certain conditions. Indebtedness under the 2006 Credit Facility may be prepayable, and commitments reduced at the election of Watson without premium (subject to certain conditions).

On July 1, 2009, the Company entered into an amendment to the 2006 Credit Facility which, among other things, provided certain modifications and clarifications with respect to refinancing of the Company s outstanding indebtedness, allowed an increase in the Company s ability to incur general unsecured indebtedness from $100.0 million to $500.0 million and provides an exclusion from certain restrictions under the 2006 Credit Facility on up to $151.4 million of certain anticipated acquired indebtedness under the Arrow Acquisition. The terms of the amendment also required the repayment of $100.0 million on the term facility under the 2006 Credit Agreement. As a result of this $100.0 million repayment, the Company s results for the year ended December 31, 2009 reflect a $0.8 million charge for losses on the early extinguishment of debt in respect of the 2006 Credit Facility. In addition to the above repayment on the term facility of the 2006 Credit Facility, the Company also made a $75.0 million repayment on the Revolving Facility of the 2006 Credit Facility in the year ended December 31, 2009. The Company borrowed $275.0 million under the Revolving Facility to fund a portion of the cash consideration for the Arrow Acquisition. As of December 31, 2009, $250.0 million was outstanding on the Revolving Facility and $150.0 million was outstanding on the Term Facility. There are no scheduled debt payments required in 2010 and the full amount outstanding on the Term facility is due November 2011.

Under the terms of the 2006 Credit Facility, each of the Company s subsidiaries, other than minor subsidiaries, entered into a full and unconditional guarantee on a joint and several basis. The Company is

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

subject to, and, as of December 31, 2009, was in compliance with, financial and operation covenants under the terms of the 2006 Credit Facility. The agreement currently contains the following financial covenants:

maintenance of a minimum net worth of at least $1.62 billion;

maintenance of a maximum leverage ratio not greater than 2.5 to 1.0; and

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

At December 31, 2009, the Company s net worth was $3.02 billion, and its leverage ratio was 1.79 to 1.0. The Company s interest coverage ratio for the year ended December 31, 2009 was 21.8 to 1.0.

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

CODES

In March 2003, the Company issued $575.0 million of CODES, which under the terms of the CODES were convertible into shares of Watson s common stock upon the occurrence of certain events with interest payments due semi-annually in March and September at an effective annual interest rate of 2.1%. On August 24, 2009, the Company gave notice to Wells Fargo Bank, National Association, as trustee of the CODES (the Trustee), and the Trustee delivered an irrevocable notice of redemption to the holders of the CODES that the Company elected to redeem the CODES for cash at a price equal to 100% of the principal amount of the CODES, plus interest accrued and unpaid to, but excluding, the redemption date. On September 14, 2009 the CODES were redeemed in accordance with the terms of the CODES. As a result of the redemption of the CODES, the Company s results for the year ended December 31, 2009 reflect a $1.2 million charge for losses on the early extinguishment of debt in respect of the CODES.

Mandatorily Redeemable Preferred Stock

In connection with the Arrow acquisition, on December 2, 2009, pursuant to the Purchase Agreement, Watson issued 200,000 shares of newly designed non-voting Series A Preferred Stock of Watson having a stated value of $1,000 per share (the Stated Value), or an aggregate stated value of $200 million, which have been placed in an indemnity escrow account for a period of three years.

The provisions for the Mandatorily Redeemable Preferred Stock are as follows:

Dividends

The holders of Mandatorily Redeemable Preferred Stock shall be entitled to receive dividends, when and of declared by the board of directors.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Liquidation Preference

In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Company, the holders of the Mandatorily Redeemable Preferred Stock will be paid out of the assets of Watson available for distribution to Watson s shareholders before any payment shall be paid to the holders of Watson s common stock, an amount equal to the Stated Value of the Mandatorily Redeemable Preferred Stock.

Mandatory Redemption

Each share of Mandatorily Redeemable Preferred Stock is mandatorily redeemable by Watson in cash on December 2, 2012, the third anniversary of its issuance at the Stated Value.

Change in Control Redemption

Upon occurrence of a Change in Control event (as defined in the Certificate of Designations of the Mandatorily Redeemable Preferred Stock that was previously filed with the SEC on December 2, 2009), Watson shall have the right to redeem all of the outstanding Mandatorily Redeemable Preferred Stock in cash for a price per share equal to the Stated Value.

Voting Rights

The holders of the Mandatorily Redeemable Preferred Stock are not entitled to vote on any matters presented to the shareholders of Watson for their actions or consideration at any meetings of the shareholders of Watson (or by written consent of shareholders in lieu of the meetings), except that the written consent or affirmative vote of at least two thirds of the then outstanding shares of Mandatorily Redeemable Preferred Stock consenting or voting separately as a class is required on any matters that would amend, alter or repeal any terms, preferences, special rights or powers of the Mandatorily Redeemable Preferred Stock. The holders of the Mandatorily Redeemable Preferred Stock may also vote on any matters required by law.

In accordance with the existing U.S GAAP, the Mandatorily Redeemable Preferred Stock have been reported as long-term debt and accretion expense has been classified as interest expense. The fair value of the Mandatorily Redeemable Preferred Stock was estimated to be $150.0 million at December 2, 2009 based on the mandatory redemption value of $200.0 million on December 2, 2012 using a discount rate of 9.63% per annum. At December 31, 2009, the unamortized accretion expense for the Preferred Stock was $48.8 million.

Lombard Loan

On November 25, 2009, prior to closing the Arrow Acquisition, the Arrow Group received loan proceeds from Lombard Odier Darier Hentsch & Cie in the amount of $90.0 million. The Lombard Loan was structured as three separate fixed-term advances: (i) a $35.0 million advance that bears interest at a rate of 1.29% per annum, maturing on December 31, 2009, (ii) a $20.0 million advance that bears interest at a rate of 1.37% per annum, maturing on March 12, 2010, and (iii) a $35.0 million advance bearing interest at a rate of 1.99% per annum, maturing on December 31, 2010. The Lombard Loan is mandatorily repayable from anticipated net proceeds from the Sepracor Receivable. The Lombard Loan is guaranteed by one or more of the Arrow Selling Shareholders (the Guarantor). In

the event Sepracor fails to make anticipated royalty/milestone payments to Watson on the Sepracor Receivable for any reason, the Guarantor must repay the outstanding portion of the Lombard Loan or reimburse Arrow Group for such defaulted amount.

In accordance with the terms of the Lombard Loan, $35.0 million was paid on December 31, 2009. At December 31, 2009 $55.0 million of the Lombard Loan was outstanding and is included in current liabilities.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Value of Outstanding Debt

Based on quoted market rates of interest and maturity schedules for similar debt issues, we estimate that the fair values of our 2006 Credit Facility and our other notes payable approximated their carrying values on December 31, 2009. As of December 31, 2009, the fair value of our Senior Notes was $24.5 million greater than the carrying value. While changes in market interest rates may affect the fair value of our fixed-rate debt, we believe the effect, if any, of reasonably possible near-term changes in the fair value of such debt on our financial condition, results of operations or cash flows will not be material.

Annual Debt Maturities

At December 31, 2009, annual maturities of long-term debt were as follows: $57.7 million in 2010, $400.1 million in 2011, $200.1 million in 2012, $1.2 million in 2013, $450.0 million in 2014 and $400.0 million thereafter. Amounts represent total anticipated cash payments on our Senior Notes, Mandatorily Redeemable Preferred Stock, Lombard Loan, 2006 Credit Facility and other current and long-term debt assuming existing debt maturity schedules. Any early settlement of our Senior Notes through redemption or repurchase privileges, as defined under the terms of the Senior Notes, or prepayment of our 2006 Credit Facility would change the timing of principal amounts due under the Company s long-term debt obligations.

NOTE 10 Other Long-Term Liabilities

In accordance with the Acquisition Agreement, the Arrow Selling Shareholders will have the right to receive certain contingent payments based on the after-tax gross profits on sales of atorvastatin within the U.S. (the Territory) from product launch date up to and including May 31, 2013 (the Contingent Payment Period). Accordingly, other long-term liabilities at Acquisition Date and at December 31, 2009 includes the fair value of the contingent liability of $110.0 million and $111.0 million, respectively.

The determination of contingent payment amounts is dependent upon the existence of generic competition within the Territory and post-tax gross profits earned, as defined in the Acquisition Agreement. Should there be no competing generic product launched in the Territory during the Contingent Payment Period, payment of contingent consideration will be calculated as 50% of the post-tax gross profits, as defined in the Acquisition Agreement. Should there be a competing product to atorvastatin launched in the Territory during the Contingent Payment Period, payment of contingent consideration will be calculated as either 85% of the post-tax gross profits or 15% of the post-tax gross profits, as defined in the Acquisition Agreement, with total contingent payments being limited to $250.0 million during the Contingent Payment Period.

The Company determined the acquisition date fair value of the contingent consideration obligation based on a probability-weighted income approach derived from atorvastatin revenue estimates and post-tax gross profit levels and a probability assessment with respect to the likelihood of achieving the various earn-out criteria. The fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement as defined in fair value measurement accounting. The resultant probability-weighted cash flows were discounted using an effective annual interest rate of 10.4%. At each reporting date, the Company will revalue the contingent consideration obligation to estimated fair value and record changes in fair value as income or expense in our consolidated statement of operations. Changes in the fair value of the contingent consideration obligations may result

from changes in discount periods and rates, changes in the timing and amount of revenue estimates and changes in probability assumptions with respect to the likelihood of achieving the various earn-out criteria. As of December 31, 2009 the range of outcomes and the assumptions used to develop the estimates have not changed significantly from those used at Acquisition Date. Accretion expense related to the increase in the net present value of the contingent liability will be included in interest expense for the period.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11 Income Taxes

The Company s income before provision for income taxes was generated from the United States and international operations as follows:

	Years Ended December 31,		
	2009	2008	2007
	(In millions)		
Income before income taxes:			
U.S.	$ 366.5	$ 353.2	$ 216.8
Foreign	(3.9)	5.1	7.5
Income before income taxes	$ 362.6	$ 358.3	$ 224.3

The Company s provision for income taxes consisted of the following:

	Years Ended December 31,		
	2009	2008	2007
	(In millions)		
Current provision:			
Federal	$ 133.0	$ 101.3	$ 79.3
State	20.2	14.3	10.0
Foreign	6.4	0.8	0.2
Total current provision	159.6	116.4	89.5
Deferred provision (benefit):			
Federal	(7.8)	3.1	(7.5)
State	(5.5)	0.4	(0.7)
Foreign	(5.7)		1.9
Total deferred provision (benefit)	(19.0)	3.5	(6.3)
Total provision for income taxes	$ 140.6	$ 119.9	$ 83.2

The exercise of certain stock options resulted in a tax benefit and has been reflected as a reduction of income taxes payable and an increase to additional paid-in capital. Such benefits recorded were $2.3 million, $0.2 million, and

$1.0 million for the years ended December 31, 2009, 2008, and 2007, respectively.

Reconciliations between the statutory federal income tax rate and the Company s effective income tax rate were as follows:

	Years Ended December 31,		
	2009	**2008**	**2007**
Federal income tax at statutory rates	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	3.2%	2.8%	3.0%
Favorable tax authorities outcome	0.0%	(2.2)%	0.0%
Charitable contributions	(0.1)%	(0.5)%	(1.2)%
Valuation allowance	(0.5)%	(0.7)%	2.0%
Sale of Somerset	0.0%	(1.2)%	0.0%
Transaction Costs	1.6%	0.0%	0.0%
Other	(0.4)%	0.3%	(1.7)%
Effective income tax rate	38.8%	33.5%	37.1%

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred tax assets and liabilities are measured based on the difference between the financial statement and tax basis of assets and liabilities at the applicable tax rates. The significant components of the Company s net deferred tax assets (liabilities) consisted of the following:

	December 31,	
	2009	2008
	(In millions)	
Benefits from net operating loss carryforwards	$ 45.0	$ 2.0
Benefits from tax credit carryforwards	23.0	
Differences in financial statement and tax accounting for:		
Inventories, receivables and accruals	101.6	98.6
Property, equipment and intangible assets	(472.8)	(101.7)
Deferred revenue	12.1	14.7
Deferred interest expense	(76.3)	(67.8)
Share-based compensation	10.5	9.0
Other	16.1	26.4
Total deferred tax liability, gross	(340.8)	(18.8)
Less valuation allowance	(76.2)	(8.1)
Total deferred tax liability, net	$ (417.0)	$ (26.9)

The Company had the following carryforwards at December 31, 2009:

$299.2 million state tax net operating loss (NOL) which begin to expire in 2010;

$2.0 million U.S. federal capital loss carryovers which begin to expire in 2013;

$138.3 million foreign tax NOLs which begin to expire in 2010 ; and

tax credits of $23.0 million in a foreign jurisdiction which are not subject to expiration.

Additionally, due to restrictions imposed as a result of ownership changes to acquired subsidiaries, the amount of NOL carryforwards available to offset future taxable income is subject to limitation. The annual NOL utilization may be further limited if additional changes in ownership occur. A valuation allowance has been established due to the uncertainty of realizing certain net operating losses, tax credits and deferred tax assets relating to some impaired investments.

Deferred income taxes have not been provided on the undistributed earnings of certain of the Company s foreign subsidiaries of approximately $36.1 million and $18.0 million as of December 31, 2009 and 2008, respectively. These amounts have been indefinitely reinvested. It is not practicable to calculate the deferred taxes associated with these

earnings; however, foreign tax credits would likely be available to reduce federal income taxes in the event of distribution.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting for Uncertainty in Income Taxes

At December 31, 2009, 2008 and 2007, the liability for income tax associated with uncertain tax positions was $72.2 million, $61.3 million and $71.2 million, respectively. This amount is reduced for timing differences and amounts primarily arising from business combinations which, if recognized, would be recorded to goodwill. As of December 31, 2009, the net amount of $57.5 million, if recognized, would favorably affect the Company s effective tax rate. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	December 31,		
	2009	2008	2007
	(In millions)		
Balance at the beginning of the year	$ 61.3	$ 71.2	$ 69.2
Increases for current year tax positions	6.9	5.0	6.6
Increases for prior year tax positions	12.7	7.8	34.3
Decreases for prior year tax positions	(3.9)	(11.9)	(33.0)
Settlements	(4.4)	(10.8)	(5.9)
Lapse of applicable statue of limitations	(0.4)		
Balance at the end of the year	$ 72.2	$ 61.3	$ 71.2

The Company s continuing practice is to recognize interest and penalties related to uncertain tax positions in tax expense. During the years ended December 31, 2009, 2008 and 2007, the company recognized approximately $1.4 million, ($0.8) million and $3.3 million in interest and penalties. At December 31, 2009, 2008 and 2007 the Company had accrued $5.1 million (net of tax benefit of $3.1 million), $3.9 million (net of tax benefit of $2.3 million) and $6.2 million (net of tax benefit of $3.6 million) of interest and penalties related to uncertain tax positions, respectively.

The Company conducts business globally and, as a result, it files federal, state and foreign tax returns. The Company strives to resolve open matters with each tax authority at the examination level and could reach agreement with a tax authority at any time. While the Company has accrued for amounts it believes are the probable outcomes, the final outcome with a tax authority may result in a tax liability that is more or less than that reflected in the consolidated financial statements. Furthermore, the Company may later decide to challenge any assessments, if made, and may exercise its right to appeal. The uncertain tax positions are reviewed quarterly and adjusted as events occur that affect potential liabilities for additional taxes, such as lapsing of applicable statutes of limitations, proposed assessments by tax authorities, negotiations with or between tax authorities and issuance of new legislation, regulations, rulings or case law. Management believes that adequate amounts of tax and related penalty and interest have been provided for any adjustments that may result from these uncertain tax positions.

With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2000. In 2008, the Internal Revenue Service (IRS) began examining the Company s 2004, 2005, and 2006 tax years. The IRS has indicated that it is their intention to complete their examination of those years in 2010. While it is often difficult to predict the final outcome or the timing of resolution of any particular

uncertain tax position, the Company has accrued for amounts it believes are the most likely outcomes. As a result of the proposed completion of the IRS exam, the potential completion and/or settlement of other examinations in state and foreign jurisdictions, and the future completion of the Company s assessment of the uncertain tax positions of the Arrow Group, the quantification of all those potential changes cannot be estimated at this time. With respect to the possible completion of the IRS exam for the 2004-2006 tax years, the range of such change could vary, but the amount of such change could result in a reduction of uncertain tax benefits of as much as $17.1 million, which is exclusive of the impact of any

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

refunds, settlements and deferred tax impacts and represents positions primarily related to transaction costs, charitable contributions, the disposition of assets and the taxation of foreign income in the U.S.

NOTE 12 Stockholders Equity

Preferred stock

In 1992, the Company authorized 2.5 million shares of no par preferred stock. The Board has the authority to fix the rights, preferences, privileges and restrictions, including but not limited to, dividend rates, conversion and voting rights, terms and prices of redemptions and liquidation preferences without vote or action by the stockholders. On December 2, 2009 the Company issued 200,000 shares of Mandatorily Redeemable Preferred Stock. The Mandatorily Redeemable Preferred Stock is redeemable in cash on December 2, 2012 and is accordingly, included within long-term debt in the consolidated balance sheet at December 31, 2009 (for additional information on the Mandatorily Redeemable Preferred Stock refer to NOTE 9 Long-Term Debt).

Stock option plans

The Company has adopted several stock option plans, all of which have been approved by the Company s shareholders that authorize the granting of options to purchase the Company s common shares subject to certain conditions. At December 31, 2009, the Company had reserved 6.8 million of its common shares for issuance upon exercise of options granted or to be granted under these plans and for restricted stock grants (see discussion below). The option award plans require options to be granted at the fair value of the shares underlying the options at the date of the grant and generally become exercisable over periods ranging from three to five years and expire in ten years. In conjunction with certain of the Company s acquisitions, Watson assumed stock option and warrant plans from the acquired companies. The options and warrants in these plans were adjusted by the individual exchange ratios specified in each transaction. No additional options or warrants will be granted under any of the assumed plans.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of the Company s stock option plans consisted of the following (options and aggregate intrinsic value in millions):

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding, December 31, 2006	10.9	$ 36.39		
Granted	0.6	30.60		
Exercised	(0.6)	26.25		
Cancelled	(1.1)	36.81		
Outstanding, December 31, 2007	9.8	36.62		
Granted				
Exercised	(0.3)	27.42		
Cancelled	(2.2)	39.51		
Outstanding, December 31, 2008	7.3	36.11		
Granted				
Exercised	(1.2)	28.55		
Cancelled	(0.8)	41.74		
Outstanding, December 31, 2009	5.3	$ 36.91	3.6	$ 31.8
Vested and expected to vest at December 31, 2009	5.2	$ 37.05	3.6	$ 30.8
Options exercisable at December 31, 2009	4.6	$ 37.94	3.1	$ 25.3

As of December 31, 2009, the Company had $1.5 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 1.3 years. Total intrinsic value of options exercised for the year ended December 31, 2009 and 2008 was $7.4 million and $0.7 million, respectively.

Restricted Stock Plan

Beginning in 2005, the Compensation Committee of the Board authorized and issued restricted stock to the Company s Participants under the Company s equity compensation plans. The restricted stock award program offers Participants the opportunity to earn shares of our common stock over time, rather than options that give Participants the right to purchase stock at a set price. Restricted stock awards are grants that entitle the holder to shares of common stock

subject to certain terms. Watson s restricted stock awards generally have restrictions eliminated over a one- to four-year period. Restrictions generally lapse for non-employee directors after one year. Restrictions generally lapse for employees over a two- to four-year period. The fair value of restricted stock grants is based on the fair market value of our common stock on the respective grant dates. Restricted stock compensation is being amortized and charged to operations over the same period as the restrictions are eliminated for the Participants.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of the changes in restricted stock grants during the year ended December 31, 2009 is presented below (shares and aggregate intrinsic value in millions):

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Restricted shares outstanding at December 31, 2008	1.6	$ 29.38	1.8	$ 46.0
Granted	0.9	28.91		27.2
Vested	(0.4)	31.50		(12.2)
Cancelled	(0.2)	28.71		(5.3)
Restricted shares outstanding at December 31, 2009	1.9	$ 28.79	1.7	$ 55.7

As of December 31, 2009, the Company had $20.1 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 1.7 years.

Stock Repurchases

During the years ended December 31, 2009 and 2008, the Company repurchased approximately 118,000 and 30,000 shares of its common stock surrendered to the Company to satisfy tax withholding obligations in connection with the vesting of restricted stock issued to employees for total consideration of $3.6 million and $0.9 million, respectively.

NOTE 13 Reportable Segments

Watson has three reportable segments: Global Generic, Global Brand and Distribution. The Global Generic segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Global Brand segment includes patent-protected products and certain trademarked off-patent products that Watson sells and markets as brand pharmaceutical products. The Distribution segment mainly distributes generic pharmaceutical products manufactured by third parties, as well as by Watson, primarily to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians offices under the Anda trade name. Sales are principally generated through an in-house telemarketing staff and through internally developed ordering systems. The Distribution segment operating results exclude sales by Anda of products developed, acquired, or licensed by Watson s Global Generic and Global Brand segments. Arrow operating results are included in the Global Generic segment subsequent to the date of acquisition except for operating results from Eden which will be included in our Global Brand segment.

The accounting policies of the operating segments are the same as those described in NOTE 2 Summary of Significant Accounting Policies. The other classification consists primarily of commission revenue, royalties and revenues from research, development and licensing fees and also includes co-promotion revenue and revenue (including the amortization of deferred revenue) relating to our obligation to manufacture and supply products to third parties. The Company evaluates segment performance based on segment contribution. Segment contribution represents segment net revenues less cost of sales (excludes amortization), direct R&D expenses and selling and marketing expenses. The Company does not report total assets, capital expenditures, corporate general and administrative expenses, amortization, gains on disposal or impairment losses by segment as such information has not been used by management, or has not been accounted for at the segment level.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Segment net revenues, segment operating expenses and segment contribution information for the Company s Global Generic, Global Brand and Distribution segments consisted of the following:

	Years Ended December 31,		
	2009	**2008**	**2007**
Global Generic Segment			
Product sales	$ 1,641.8	$ 1,404.0	$ 1,408.9
Other	26.4	70.3	93.0
Net revenues	1,668.2	1,474.3	1,501.9
Operating expenses:			
Cost of sales(1)	947.1	883.8	917.9
Research and development	140.4	119.2	102.4
Selling and marketing	53.8	55.2	55.4
Global Generic Contribution	**$ 526.9**	**$ 416.1**	**$ 426.2**
Contibution margin	31.6%	28.2%	28.4%
Global Brand Segment			
Product sales	$ 393.7	$ 397.0	$ 375.2
Other	67.3	58.0	53.5
Net revenues	461.0	455.0	428.7
Operating expenses:			
Cost of sales(1)	89.3	107.1	99.9
Research and development	56.9	50.9	42.4
Selling and marketing	144.5	118.2	108.0
Global Brand Contribution	**$ 170.3**	**$ 178.8**	**$ 178.4**
Contibution margin	36.9%	39.3%	41.6%
Distribution Segment			
Product sales	$ 663.8	$ 606.2	$ 566.1
Other			
Net revenues	663.8	606.2	566.1
Operating expenses:			
Cost of sales(1)	560.4	511.9	487.0
Research and development			
Selling and marketing	64.8	59.5	52.0
Distribution Contribution	**$ 38.6**	**$ 34.8**	**$ 27.1**

Contibution margin	5.8%	5.7%	4.8%
Total Segment Contribution	**$ 735.8**	**$ 629.7**	**$ 631.7**
Corporate general and administrative	257.1	190.5	205.7
Amortization	92.6	80.7	176.4
Loss (gain) on asset sales and impairments	2.2	0.3	(6.1)
Operating income	$ 383.9	$ 358.2	$ 255.7

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

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s net product sales are represented by the sale of products in the following therapeutic categories for the years ended December 31,:

	2009	2008	2007
		(In millions)	
Central nervous system	$ 836.7	$ 795.7	$ 772.1
Hormones and synthetic substitutes	609.8	525.7	551.2
Cardiovascular	269.4	245.5	312.9
Nephrology	141.5	174.4	170.7
Gastrointestinal	133.7	130.0	73.6
Other	708.2	535.9	469.6
	$ 2,699.3	$ 2,407.2	$ 2,350.1

NOTE 14 Business Restructuring Charges

During the first quarter of 2008, the Company announced efforts to reduce its cost structure including the planned closure of its manufacturing facilities in Carmel, New York and its distribution center in Brewster, New York. Activity related to our business restructuring and facility rationalization activities for the year ended December 31, 2009 consisted of the following:

	Accrual Balance at December 31, 2008	Charged to Expense	Cash Payments	Non-cash Adjustments	Accrual Balance at December 31, 2009
			(In millions)		
Cost of sales					
Severance and retention	$ 13.7	$ 10.6	$ (11.2)	$	$ 13.1
Product transfer costs	0.7	10.8	(10.5)		1.0
Facility decommission costs	0.2	0.7	(0.7)		0.2
Accelerated depreciation		7.2		(7.2)	
	14.6	29.3	(22.4)	(7.2)	14.3
Operating expenses					
Research and development	0.7	2.3	(1.8)	(0.4)	0.8

Selling, general and administrative	0.8	1.0	(1.0)		0.8
	1.5	3.3	(2.8)	(0.4)	1.6
Total restructuring charges	$ 16.1	$ 32.6	$ (25.2)	$ (7.6)	$ 15.9

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Activity related to our business restructuring and facility rationalization activities for the year ended December 31, 2008 consisted of the following:

	Charged to Expense	Cash Payments	Non-cash Adjustments	Accrual Balance at December 31, 2008
		(In millions)		
Cost of sales	$ 28.1	$ (6.1)	$ (7.4)	$ 14.6
Operating expenses				
Research and development	1.5	(0.8)		0.7
Selling, general and administrative	0.9	(0.1)		0.8
Total restructuring charges	$ 30.5	$ (7.0)	$ (7.4)	$ 16.1

Product transfer costs consist of documentation, testing and shipping costs to transfer product to other facilities. Operating expenses include severance and retention. Retention is expensed only to the extent earned by employees. Activity related to our business restructuring and facility rationalization activities is primarily attributable to our Global Generic segment.

While the final closing date will depend on a number of factors, we anticipate these facilities will close by the end of 2010.

NOTE 15 Fair Value Measurement

In September 2006, the FASB issued authoritative guidance for fair value measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The Company adopted the provisions of the guidance effective January 1, 2008 for all financial assets and liabilities and any other assets and liabilities that are recognized or disclosed at fair value on a recurring basis. The Company adopted the provisions of the guidance for nonfinancial assets and liabilities measured at fair value on a non-recurring basis effective January 1, 2009. Although the adoption of the guidance did not materially impact the Company s financial condition, results of operations or cash flows, we are required to provide additional disclosures within our consolidated financial statements.

The guidance defines fair value as the price that would be received to sell an asset or paid to transfer the liability (an exit price) in an orderly transaction between market participants and also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The fair value hierarchy within the guidance distinguishes three levels of inputs that may be utilized when measuring fair value, including level 1 inputs (using quoted prices in active markets for identical assets or liabilities), level 2 inputs (using inputs other than level 1 prices such as quoted prices for similar assets and

liabilities in active markets or inputs that are observable for the asset or liability) and level 3 inputs (using unobservable inputs supported by little or no market activity based on our own assumptions used to measure assets and liabilities). A financial asset or liability s classification within the above hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Financial assets and liabilities measured at fair value or disclosed at fair value on a recurring basis as at December 31, 2009 consisted of the following (in millions):

	Fair Value Measurements as at December 31, 2009 Using:			
	Total	**Level 1**	**Level 2**	**Level 3**
Assets:				
Marketable securities	$ 13.6	$ 13.6	$	$
Investments	3.0	3.0		
Liabilities:				
Contingent consideration	111.0			111.0

	Fair Value Measurements as at December 31, 2008 Using:			
	Total	**Level 1**	**Level 2**	**Level 3**
Marketable securities	$ 13.2	$ 13.2	$	$
Investments	0.1	0.1		

Marketable securities and investments consist of available-for-sale investments in U.S. Treasury and agency securities and publicly traded equity securities for which market prices are readily available. Unrealized gains or losses on marketable securities and investments are recorded in accumulated other comprehensive (loss) income.

The fair value measurement of the contingent consideration obligation to the Arrow Selling Shareholders is determined using Level 3 inputs. The fair value of the contingent consideration obligation is based on a probability-weighted income approach. The measurement is based upon unobservable inputs supported by little or no market activity based on our own assumptions. Changes in the value of the contingent consideration obligation is recorded as a component of operating income in our consolidated statement of operations.

NOTE 16 Commitments and Contingencies

Facility and Equipment Leases

The Company has operating leases for certain facilities and equipment. The terms of the operating leases for the Company s facilities require the Company to pay property taxes, normal maintenance expenses and maintain minimum insurance coverage. Total rental expense for operating leases in 2009, 2008 and 2007 was $20.0 million, $19.0 million and $18.1 million, respectively.

At December 31, 2009, future minimum lease payments under all non-cancelable operating leases are approximately $20.6 million in 2010, $18.2 million in 2011, $12.4 million in 2012, $8.7 million in 2013, $8.4 million in 2014 and $33.4 million thereafter.

Employee Retirement Plans

The Company maintains certain defined contribution retirement plans covering substantially all U.S.-based employees. The Company contributes to the plans based upon the employee contributions. Watson s contributions to these retirement plans were $11.0 million, $10.6 million and $8.6 million in the years ended December 31, 2009, 2008 and 2007, respectively. The Company does not sponsor any defined benefit retirement plans or postretirement benefit plans.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Legal Matters

Watson and its affiliates are involved in various disputes, governmental and/or regulatory inspections, inquires, investigations and proceedings, and litigation matters that arise from time to time in the ordinary course of business. The process of resolving matters through litigation or other means is inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows. The Company s regular practice is to expense legal fees as services are rendered in connection with legal matters, and to accrue for liabilities when losses are probable and reasonably estimable.

Cipro® Litigation. Beginning in July 2000, a number of suits were filed against Watson, The Rugby Group, Inc. (Rugby) and other company affiliates in various state and federal courts alleging claims under various federal and state competition and consumer protection laws. Several plaintiffs have filed amended complaints and motions seeking class certification. Approximately 42 cases had been filed against Watson, Rugby and other Watson entities. Twenty-two of these actions have been consolidated in the U.S. District Court for the Eastern District of New York (*In re: Ciprofloxacin Hydrochloride Antitrust Litigation, MDL Docket No. 001383*). On May 20, 2003, the court hearing the consolidated action granted Watson s motion to dismiss and made rulings limiting the theories under which plaintiffs can seek recovery against Rugby and the other defendants. On March 31, 2005, the court hearing the consolidated action granted summary judgment in favor of the defendants on all of plaintiffs claims, denied the plaintiffs motions for class certification, and directed the clerk of the court to close the case. On May 7, 2005, three groups of plaintiffs from the consolidated action (the direct purchaser plaintiffs, the indirect purchaser plaintiffs and plaintiffs Rite Aid and CVS) filed notices of appeal in the United States Court of Appeals for the Second Circuit, appealing, among other things, the May 20, 2003 order dismissing Watson and the March 31, 2005 order granting summary judgment in favor of the defendants. The three appeals were consolidated by the appellate court. On August 25, 2005, the defendants moved to transfer the appeals to the United States Court of Appeals for the Federal Circuit on the ground that patent issues are involved in the appeal. On November 7, 2007, the motions panel of the U.S. Court of Appeals for the Second Circuit granted the motion in part, and ordered the appeal by the indirect purchaser plaintiffs transferred to the United States Court of Appeals for the Federal Circuit. On October 15, 2008, the United States Court of Appeals for the Federal Circuit affirmed the dismissal of the indirect purchasers claims, and on December 22, 2008, denied the indirect purchaser plaintiffs petition for rehearing and rehearing en banc. On March 23, 2009, the indirect purchaser plaintiffs filed a petition for writ of certiorari with the United States Supreme Court. On June 22, 2009, the Supreme Court denied the petition. In the appeal in the United States Court of Appeals for the Second Circuit by the direct purchaser plaintiffs and plaintiffs CVS and Riteaid, the Second Circuit heard oral argument by the parties on April 28, 2009, and advised the parties that the court had invited the United States Department of Justice to provide comments on the case. On July 6, 2009, the Department of Justice submitted a brief on the matter, expressing no opinion on the Cipro action but suggesting certain standards to evaluate reverse payment patent settlements. On August 12, 2009, the parties responded to the Department of Justice s brief. Other actions are pending in various state courts, including New York, California, Kansas, Tennessee, and Florida. The actions generally allege that the defendants engaged in unlawful, anticompetitive conduct in connection with alleged agreements, entered into prior to Watson s acquisition of Rugby from Sanofi Aventis (Aventis), related to the development, manufacture and sale of the drug substance ciprofloxacin hydrochloride, the generic version of Bayer s brand drug, Cipro®. The actions generally seek declaratory judgment, damages, injunctive relief, restitution and other relief on behalf of certain purported classes of individuals and other entities. The court hearing the case in New York has dismissed the action. Appellants have sought leave to appeal the dismissal of the New York action to the New York Court of Appeals. On April 18, 2006, the New York Supreme Court, Appellate Division, denied the appellants

motion. In the action pending in Kansas, the court has administratively terminated the matter pending the outcome of the appeals in the consolidated case. In the action pending in the California Superior Court for the County of San Diego (*In re: Cipro Cases I & II, JCCP Proceeding*

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Nos. 4154 & 4220), on July 21, 2004, the California Court of Appeal granted in part and denied in part the defendants petition for a writ of mandate seeking to reverse the trial court s order granting the plaintiffs motion for class certification. Pursuant to the appellate court s ruling, the majority of the plaintiffs will be permitted to pursue their claims as a class. On August 31, 2009, the California Superior Court granted defendants motion for summary judgment, and final judgment was entered on September 24, 2009. On November 19, 2009, the plaintiffs filed a notice of appeal. In addition to the pending actions, Watson understands that various state and federal agencies are investigating the allegations made in these actions. Aventis has agreed to defend and indemnify Watson and its affiliates in connection with the claims and investigations arising from the conduct and agreements allegedly undertaken by Rugby and its affiliates prior to Watson s acquisition of Rugby, and is currently controlling the defense of these actions.

Governmental Reimbursement Investigations and Drug Pricing Litigation. In November 1999, Schein Pharmaceutical, Inc., now known as Watson Pharma, Inc. (Watson Pharma) was informed by the U.S. Department of Justice that Watson Pharma, along with numerous other pharmaceutical companies, is a defendant in a *qui tam* action brought in 1995 under the U.S. False Claims Act currently pending in the U.S. District Court for the Southern District of Florida. Watson Pharma has not been served in the *qui tam* action. A *qui tam* action is a civil lawsuit brought by an individual or a company (the qui tam relator) for an alleged violation of a federal statute, in which the U.S. Department of Justice has the right to intervene and take over the prosecution of the lawsuit at its option. Pursuant to applicable federal law, the *qui tam* action is under seal as to Watson Pharma. The Company believes that the *qui tam* action relates to whether allegedly improper price reporting by pharmaceutical manufacturers led to increased payments by Medicare and/or Medicaid. The *qui tam* action may seek to recover damages from Watson Pharma based on its price reporting practices. Watson Pharma subsequently also received and responded to notices or subpoenas from the Attorneys General of various states, including Florida, Nevada, New York, California and Texas, relating to pharmaceutical pricing issues and whether allegedly improper actions by pharmaceutical manufacturers led to excessive payments by Medicare and/or Medicaid. On June 26, 2003, the Company received a request for records and information from the U.S. House Committee on Energy and Commerce in connection with that committee s investigation into pharmaceutical reimbursements and rebates under Medicaid. The Company produced documents in response to the request. Other state and federal inquiries regarding pricing and reimbursement issues are anticipated.

Beginning in July 2002, the Company and certain of its subsidiaries, as well as numerous other pharmaceutical companies, were named as defendants in various state and federal court actions alleging improper or fraudulent reporting practices related to the reporting of average wholesale prices and wholesale acquisition costs of certain products, and that the defendants committed other improper acts in order to increase prices and market shares. Some of these actions have been consolidated in the U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 1456*). The consolidated amended Class Action complaint in that case alleges that the defendants acts improperly inflated the reimbursement amounts paid by various public and private plans and programs. The amended complaint alleges claims on behalf of a purported class of plaintiffs that paid any portion of the price of certain drugs, which price was calculated based on its average wholesale price, or contracted with a pharmacy benefit manager to provide others with such drugs. The Company filed an Answer to the Amended Consolidated Class Action Complaint on April 9, 2004. Defendants in the consolidated litigation have been divided into two groups. Certain defendants, referred to as the Track One defendants, have proceeded on an expedited basis. Classes were certified against these defendants, a trial has been completed with respect to some of the claims against this group of defendants, the presiding judge has issued a ruling granting judgment to the plaintiffs, that judgment is being appealed, and many of the claims have been settled. Other

defendants, referred to as the Track Two Defendants , including the Company, have entered into a settlement agreement resolving all claims against the Track Two Defendants in the Consolidated Class Action. The total amount of the settlement for all of the Track Two Defendants is $125 million. The amount to be paid by each Track Two

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Defendant is confidential. On July 2, 2008, the United States District Court for the District of Massachusetts preliminarily approved the Track Two settlement. On April 27, 2009, the Court held a hearing to further consider the fairness of the proposed Track Two settlement. The Court adjourned the hearing without ruling on the fairness of the proposed settlement until additional notices are provided to certain of the class members in the action. The settlement is not expected to materially adversely affect the Company s business, results of operations, financial condition and cash flows.

The Company and certain of its subsidiaries also are named as defendants in various lawsuits filed by numerous states and qui tam relators, including Texas, Kansas, Nevada, Montana, Massachusetts, Wisconsin, Kentucky, Alabama, Illinois, Mississippi, Florida, Arizona, Missouri, Alaska, Idaho, South Carolina, Hawaii, Utah, and Iowa captioned as follows: *State of Nevada v. American Home Products, et al., Civil Action No. 02-CV-12086-PBS, United States District Court for the District of Massachusetts; State of Montana v. Abbott Laboratories, et al., Civil Action No. 02-CV-12084-PBS, United States District Court for the District of Massachusetts; Commonwealth of Massachusetts v. Mylan Laboratories, et al., Civil Action No. 03-CV-11865-PBS, United States District Court for the District of Massachusetts; State of Wisconsin v. Abbott Laboratories, et al., Case No. 04-cv-1709, Wisconsin Circuit Court for Dane County; Commonwealth of Kentucky v. Alpharma, Inc., et al., Case Number 04-CI-1487, Kentucky Circuit Court for Franklin County; State of Alabama v. Abbott Laboratories, Inc. et al., Civil Action No. CV05-219, Alabama Circuit Court for Montgomery County; State of Illinois v. Abbott Laboratories, Inc. et al., Civil Action No. 05-CH-02474, Illinois Circuit Court for Cook County; State of Mississippi v. Abbott Laboratories, Inc. et al., Civil Action No. G2005-2021 S/2, Mississippi Chancery Court of Hinds County; State of Florida ex rel. Ven-A-Care, Civil Action No 98-3032G, Florida Circuit Court in Leon County; State of Arizona ex rel. Terry Goddard, No. CV 2005-18711, Arizona Superior Court for Maricopa County; State of Missouri ex rel. Jeremiah W. (Jay) Nixon v. Mylan Laboratories, et al, Case No. 054-2486, Missouri Circuit Court of St. Louis; State of Alaska v. Alpharma Branded Products Division Inc., et al., In the Superior Court for the State of Alaska Third Judicial District at Anchorage, C.A. No. 3AN-06-12026 CI; State of Idaho v. Alpharma USPD Inc. et al., In the District Court of the Fourth Judicial District of the State of Idaho, in and for the County of Ada, C.A. No. CV0C-0701847; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7152; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7155; State of Hawaii v. Abbott Laboratories, Inc. et al., In the Circuit Court of the First Circuit, State of Hawaii, C.A. No. 06-1-0720-04 EEH; State of Utah v. Actavis U.S., Inc., et al., In the Third Judicial District Court of Salt Lake County, Civil No. 07-0913719; State of Iowa v. Abbott Laboratories, Inc., et al., In the U.S. District Court for the Southern District of Iowa, Central Division, Case No. 07-CV-00461; State of Texas ex rel. Ven-A-Care of the Florida Keys, Inc. v. Alpharma Inc., et al, Case No. 08-001565, in the District Court of Travis County, Texas; and United States of America ex rel. Ven-A-Care of the Florida Keys, Inc., Civil Action No. 08-10852, in the U.S. District Court for the District of Massachussetts and State of Kansas ex rel. Steve Six v. Watson Pharmaceuticals, Inc. and Watson Pharma, Inc., Case Number: 08CV2228, District Court of Wyandotte County, Kansas, Civil Court Department.*

These cases generally allege that the defendants caused the plaintiffs to overpay pharmacies and other providers for prescription drugs under state Medicaid Programs by inflating the reported average wholesale price or wholesale acquisition cost, and by reporting false prices to the United States government under the Best Prices rebate program. Several of these cases also allege that state residents were required to make inflated copayments for drug purchases under the federal Medicare program, and companies were required to make inflated payments on prescription drug

purchases for their employees. Many of these cases, some of which have been removed to federal court, are in the early stages of pleading or are proceeding through pretrial discovery. On January 20, 2006, the Company was dismissed without prejudice from the actions brought by the States of Montana and Nevada because the Company was not timely served. In the case

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brought on behalf of the Commonwealth of Massachusetts the Court recently denied cross-motions for summary judgment. The case brought against the Company on behalf of Arizona was settled in May 2009 and was dismissed with prejudice on June 29, 2009. The case brought against the Company on behalf of Alabama was tried in June and July of 2009. At the conclusion of the trial, the jury was unable to reach a verdict, and the court declared a mistrial and ordered the case to be retried. The case brought against the Company on behalf of Kentucky had been scheduled for trial in September 2010, but that trial date was vacated and the case has not been rescheduled for trial. The case brought against the Company on behalf of Mississippi has been scheduled for trial in December 2010. The case brought against the Company on behalf of Texas has been scheduled for trial in January 2011. The cases brought against the Company on behalf of Hawaii and Massachusetts have been settled.

The City of New York filed an action in the United States District Court for the Southern District of New York on August 4, 2004, against the Company and numerous other pharmaceutical defendants alleging similar claims. The case was transferred to the United States District Court for the District of Massachusetts, and was consolidated with several similar cases filed by individual New York counties. A corrected Consolidated Complaint was filed on June 22, 2005 (*City of New York v. Abbott Laboratories, Inc., et al., Civil Action No. 01-CV-12257-PBS, United States District Court for the District of Massachusetts*). The Consolidated Complaint included as plaintiffs the City of New York and 30 New York counties. Since the filing of the Consolidated Complaint, cases brought by a total of 14 additional New York counties have been transferred to the District of Massachusetts. On January 27, 2010, the U.S. District Court granted Plaintiffs motion for partial summary judgment as to each of the generic defendants, including Watson, with respect to some of Watson s drugs reimbursed at the Federal Upper Limit, and found violations of New York s state false claims act statute. If final judgment is entered based upon this ruling, Plaintiffs will be entitled to compensatory damages, treble damages and penalties in amounts that are not currently known or reasonably estimatable. In February 2010, Watson and certain other defendants filed a motion to amend the Court s Order to certify an immediate interlocutory appeal, and seeking among other things, clarification of New York s false claims act statute. In February 2007, three of the New York counties cases were sent back to New York state court (Erie, Oswego and Schenectady counties). On April 5, 2007, an additional action raising similar allegations was filed by Orange County, New York (*County of Orange v. Abbott Laboratories, Inc., et al.*, *United States District Court for the Southern District of New York, Case No. 07-CV-2777*). The Company is therefore named as a defendant by the City of New York and 41 New York counties, consolidated in the District of Massachusetts case, as well as by four additional New York counties, with three of these cases pending in New York state courts. Many of the state and county cases are included in consolidated or single-case mediation proceedings, and the Company is participating in these proceedings.

In December 2009, the Company learned that numerous pharmaceutical companies, including certain subsidiaries of the Company, have been named as defendants in a qui tam action pending in the United States District Court for the District of Massachusetts (*United States of America ex rel. Constance A. Conrad v. Actavis Mid-Atlantic, LLC, f/k/a Biovail Pharmaceuticals, LLC, et. al.,USDC Case No. 02-CV-11738-NG).* The seventh amended complaint, which was served on certain of the Company s subsidiaries in December 2009, alleges that the defendants falsely reported to the United States that certain pharmaceutical products were eligible for Medicaid reimbursement and thereby allegedly caused false claims for payment to be made through the Medicaid program.

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

FDA Matters. In May 2002, Watson reached an agreement with the FDA on the terms of a consent decree with respect to its Corona, California manufacturing facility. The court approved the consent decree on May 13, 2002 (*United States of America v. Watson Laboratories, Inc., and Allen Y. Chao*, United States

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District Court for the Central District of California, EDCV-02-412-VAP). The consent decree with the FDA does not require any fine, a facility shutdown, product recalls or any reduction in production or service at the Company s Corona facility. The consent decree applies only to the Corona facility and not other manufacturing sites. On July 9, 2008, the court entered an order dismissing Allen Y. Chao, the Company s former President and Chief Executive Officer, from the action and from the consent decree. The decree requires Watson to ensure that its Corona, California facility complies with the FDA s current Good Manufacturing Practices (cGMP) regulations.

Pursuant to the agreement, Watson hired an independent expert to conduct inspections of the Corona facility at least once each year. In December 2002, February 2003, January 2004, January 2005, January 2006, January 2007, January-February 2008, January 2009, and January 2010, respectively, the first, second, third, fourth, fifth, sixth, seventh and eighth annual inspections were completed and the independent expert submitted its report of the inspection to the FDA. In each instance, the independent expert reported its opinion that, based on the findings of the audit of the facility, the FDA s applicable cGMP requirements, applicable FDA regulatory guidance, and the collective knowledge, education, qualifications and experience of the expert s auditors and reviewers, the systems at Watson s Corona facility audited and evaluated by the expert are in compliance with the FDA s cGMP regulations. However, the FDA is not required to accept or agree with the independent expert s opinion. The FDA conducted an inspection of that facility from March 31, 2004 until May 6, 2004. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection, including observations related to certain laboratory test methods and other procedures in place at the facility. In June 2004 the Company submitted its response to the FDA Form 483 inspectional observations and met with FDA officials to discuss its response, including the corrective actions the Company had taken, and intended to take, to address the inspectional observations. The FDA conducted another inspection of the facility from April 5, 2005 through April 13, 2005. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. The FDA conducted another inspection of the facility from July 10, 2006 through July 21, 2006. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. From February 20, 2007 through March 9, 2007, the FDA conducted another inspection of the facility. At the conclusion of the inspection, the FDA issued a Form 483 listing the observations made during the inspection. In March 2007 the Company submitted its response to the FDA Form 483 inspectional observations, including the corrective actions the Company has taken to address the inspectional observations. The FDA conducted another inspection of the facility from October 18, 2007 through October 26, 2007. At the conclusion of the inspection, the FDA issued a Form 483 listing two observations made during the pre-approval portion of the inspection related to two pending Abbreviated New Drug Applications (ANDAs). No formal observations were made concerning the Company s compliance with cGMP. The FDA conducted another inspection of the facility from June 16, 2008 through July 1, 2008. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. The FDA conducted another inspection of the facility from September 21, 2009 through September 24, 2009. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. However, if in the future, the FDA determines that, with respect to its Corona facility, Watson has failed to comply with the consent decree or FDA regulations, including cGMPs, or has failed to adequately address the observations in the Form 483, the consent decree allows the FDA to order Watson to take a variety of actions to remedy the deficiencies. These actions could include ceasing manufacturing and related operations at the Corona facility, and recalling affected products. Such actions, if taken by the FDA, could have a material adverse effect on the Company, its results of operations, financial position and cash flows.

Federal Trade Commission Investigations. The Company has received Civil Investigative Demands or requests for information from the Federal Trade Commission seeking information and documents related to the terms on which the

Company has settled lawsuits initiated by patentees under the Hatch-Waxman Act, and other commercial arrangements between the Company and third parties. These investigations relate to the

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Company s August 2006 settlement with Cephalon, Inc. related to the Company s generic version of Provigil® (modafinil), and its April 2007 agreement with Sandoz, Inc. related to the Company s forfeiture of its entitlement to 180 days of marketing exclusivity for its 50 milligram dosage strength of its generic version of Toprol XL® (metoprolol xl). The Company believes these agreements comply with applicable laws and rules. However, if the Federal Trade Commission concludes that any of these agreements violate applicable antitrust laws or rules, it could initiate legal action against the Company. These actions, if successful, could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Androgel® Antitrust Litigation. On January 29, 2009, the U.S. Federal Trade Commission and the State of California filed a lawsuit in the United States District Court for the Central District of California (*Federal Trade Commission, et. al. v. Watson Pharmaceuticals, Inc., et. al., USDC Case No. CV 09-00598)* alleging that the Company s September 2006 patent lawsuit settlement with Solvay Pharmaceuticals, Inc., related to AndroGel® 1% (testosterone gel) CIII is unlawful. The complaint generally alleges that the Company improperly delayed its launch of a generic version of Androgel® in exchange for Solvay s agreement to permit the Company to co-promote Androgel® for consideration in excess of the fair value of the services provided by the Company. The complaint alleges violation of federal and state antitrust and consumer protection laws and seeks equitable relief and civil penalties. On February 2 and 3, 2009, three separate lawsuits alleging similar claims were filed in the United States District Court for the Central District of California by various private plaintiffs purporting to represent certain classes of similarly situated claimants. *(Meijer, Inc., et. al., v. Unimed Pharmaceuticals, Inc., et. al., USDC Case No. EDCV 09-0215); (Rochester Drug Co-Operative, Inc. v. Unimed Pharmaceuticals Inc., et. al., Case No. EDCV 09-0226); (Louisiana Wholesale Drug Co. Inc. v. Unimed Pharmaceuticals Inc., et. al, Case No. EDCV 09-0228)*. On April 8, 2009, the Court granted the defendants motion to transfer and transferred the cases to the Northern District of Georgia. On April 21, 2009 the State of California voluntarily dismissed its lawsuit against the Company without prejudice. The Federal Trade Commission and the private plaintiffs in the Northern District of Georgia filed amended complaints on May 28, 2009. The private plaintiffs amended their complaints to include allegations concerning conduct before the U.S. Patent and Trademark Office, conduct in connection with the listing of Solvay s patent in the Food and Drug Administration s Orange Book, and sham litigation. On July 20, 2009, and August 31, 2009, the defendants (including the Company) filed motions to dismiss the Federal Trade Commission action and the private plaintiff actions, respectively. On March 31, April 17, and April 21, 2009, additional actions alleging similar claims were filed in the United States District Court for the District of New Jersey (*Stephen L. LaFrance Pharm., Inc. d/b/a SAJ Dist. v. Unimed Pharms., Inc., et al., Civ. No. 09-1507*); (*Fraternal Order of Police, Fort Lauderdale Lodge 31, Insurance Trust Fund v. Unimed Pharms. Inc., et al., Civ. No. 09-1856*); (*Scurto v. Unimed Pharms., Inc., et al., Civ. No. 09-1900*). These actions purport to assert similar claims on behalf of various class representatives. On April 20, 2009, the Company was dismissed without prejudice from the *Stephen L. LaFrance* action pending in the District of New Jersey. On June 2, 2009, a District of New Jersey magistrate judge granted the defendants motion to transfer, and denied the plaintiffs motion for reconsideration of that decision on June 24, 2009. On July 13, 2009, the plaintiffs appealed the magistrate judge s decision transferring the cases to the district court judge, and on September 30, 2009 the district court judge affirmed the magistrate s decision transferring the actions to the Northern District of Georgia. On May 19, 2009, an additional action alleging similar claims was filed in the District of Minnesota (*United Food and Commercial Workers Unions and Employers Midwest Health Benefits Fund v. Unimed Pharms., Inc., et al., Civ. No. 09-1168*). This action purports to assert similar claims on behalf of a putative class of indirect purchasers of AndroGel®. On June 10, 2009, the defendants (including the Company) filed a motion to transfer the *United Food and Commercial Workers* action to the Northern District of Georgia. On June 11, 2009, the *United Food and Commercial Workers* plaintiff filed a motion to have all of the private plaintiff cases consolidated under the Multidistrict Litigation

rules of the federal courts. On June 17 and 29, 2009, two additional actions alleging similar claims were filed in the Middle District of Pennsylvania (*Rite Aid Corp. et al. v. Unimed Pharms., Inc. et al., Civ. No. 09-1153,* and *Walgreen Co., et al. v. Unimed Pharms., Inc., et al., Civ. No. 09-1240*), by plaintiffs purporting to be direct purchasers of AndroGel®. On June 22, 2009, the *Rite*

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Aid plaintiffs filed a motion to have all of the private plaintiff cases consolidated under the Multidistrict Litigation rules of the federal courts. On July 22, 2009, the defendants (including the Company) filed motions to transfer the *Rite Aid* and *Walgreen* actions from the Middle District of Pennsylvania to the Northern District of Georgia. On October 5, 2009, the Judicial Panel on Multidistrict Litigation transferred all actions pending outside of the Northern District of Georgia to that district for consolidated pre-trial proceedings (*In re: AndroGel® Antitrust Litigation (No. II), MDL Docket No. 2084*). On October 15, 2009, the judge presiding over the consolidated litigations ordered all direct purchaser plaintiffs (*Meijer Inc., Rochester Drug Co-Operative, Inc., Louisiana Wholesale Drug Co. Inc., Rite Aid Corp., Walgreen Co., and Stephen L. LaFrance Pharm., Inc.*) to file a consolidated opposition to the Company s pending motion to dismiss. The consolidated opposition was filed on October 28, 2009. On October 30, 2009, the defendants moved to dismiss the complaints filed by the indirect purchaser plaintiffs. All of the aforementioned lawsuits related to Androgel® are now pending in the United States District Court for the Northern District of Georgia. On February 22, 2010, the judge presiding over the consolidated litigations granted the Company s motions to dismiss the complaints, except the portion of private plaintiffs complaints that include allegations concerning sham litigation.

On October 30, 2009, an additional action raising similar allegations under Tennessee state law was filed in the Circuit Court for Cocke County, Tennessee (*Jabo s Pharmacy Inc. v. Solvay Pharmaceuticals, Inc., et al*., Case No. 31,837). On December 4, 2009, the defendants (including the Company) removed the case to the United States District Court for the Eastern District of Tennessee, Greeneville Division. Also on December 4, 2009, the Company filed a motion with the Judicial Panel on Multidistrict Litigation requesting that the Tennessee action be centralized with all the other cases relating to Androgel® in the United States District Court for the Northern District of Georgia. On December 16, 2009, the Judicial Panel on Multidistrict Litigation issued a Conditional Transfer Order. On December 30, 2009, Plaintiff filed a motion to vacate the Conditional Transfer Order, which motion is currently pending. On January 13, 2010, Plaintiff filed a motion to remand the action to Tennessee state court; the motion has been briefed and is currently pending.

The Company believes that these actions are without merit and intends to defend itself vigorously. However, these actions, if successful, could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Hormone Replacement Therapy Litigation. Beginning in early 2004, a number of product liability suits were filed against the Company and certain Company affiliates, for personal injuries allegedly arising out of the use of hormone replacement therapy products, including but not limited to estropipate and estradiol. These complaints also name numerous other pharmaceutical companies as defendants, and allege various injuries, including ovarian cancer, breast cancer and blood clots. Approximately 102 cases are pending against Watson and/or its affiliates in state and federal courts representing claims by approximately 110 plaintiffs. Many of the cases involve multiple plaintiffs. The majority of the cases have been transferred to and consolidated in the United States District Court for the Eastern District of Arkansas (*In re: Prempro Products Liability Litigation, MDL Docket No. 1507*). Discovery in these cases is ongoing. The Company maintains product liability insurance against such claims. However, these actions, if successful, or if insurance does not provide sufficient coverage against the claims, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Levonorgestrel/Ethinyl Estradiol Tablets (Seasonale®). On December 13, 2007, Duramed Pharmaceuticals, Inc. sued the Company and certain of its subsidiaries in the United States District Court for the District of New Jersey, alleging that sales of the Company s Quasense™ (levonorgestrel/ethinyl estradiol) tablets, the generic version of Duramed s

Seasonale® tablets, infringes Duramed s U.S. Patent No. RE 39,861 (*Duramed Pharmaceuticals, Inc. v. Watson Pharmaceuticals, Inc., et. al., Case No. 07cv05941*). The complaint seeks damages and injunctive relief. On March 3, 2008, the Company answered the complaint. Discovery is ongoing. The Company believes it has substantial meritorious defenses to the case. However, the Company has sold and

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is continuing to sell its generic version of Seasonale®. Therefore, an adverse determination could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Medical West Ballas Pharmacy, LTD, et al. v. Anda, Inc., (Circuit Court of the County of St. Louis, State of Missouri, Case No. 08SL-CC00257). In January 2008, Medical West Ballas Pharmacy, LTD, filed a purported class action complaint against the Company alleging conversion and alleged violations of the Telephone Consumer Protection Act (TCPA) and Missouri Consumer Fraud and Deceptive Business Practices Act. In April 2008, plaintiff filed an amended complaint substituting Anda, Inc., a subsidiary of the Company, as the defendant. The amended complaint alleges that by sending unsolicited facsimile advertisements, Anda misappropriated the class members paper, toner, ink and employee time when they received the alleged unsolicited faxes, and that the alleged unsolicited facsimile advertisements were sent to the plaintiff in violation of the TCPA and Missouri Consumer Fraud and Deceptive Business Practices Act. The complaint seeks to assert class action claims on behalf of the plaintiff and other similarly situated third parties. In April 2008, Anda filed an answer to the amended complaint, denying the allegations. In November 2009, the court granted plaintiff s motion to expand class of plaintiffs from individuals for which Anda lacked evidence of express permission or an established business relationship to All persons who on or after four years prior to the filing of this action, were sent telephone facsimile messages advertising pharmaceutical drugs and products by or on behalf of Defendant. Discovery in the action is ongoing. No trial date has been set. Anda intends to defend the action vigorously. However, this action, if successful, could have an adverse effect on the Company s business, results of operations, financial condition and cash flows.

Watson and its affiliates are involved in various other disputes, governmental and/or regulatory inspections, inquires, investigations and proceedings that could result in litigation, and other litigation matters that arise from time to time. The process of resolving matters through litigation or other means is inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows.

NOTE 17 Subsequent Events

On February 26, 2010, we entered into an agreement with Uni-President Enterprises Corporation to sell our outstanding shares of ScinoPharm. Under the terms of the stock purchase agreement, we will sell our entire holdings of shares for net proceeds of approximately $94.0 million. The transaction is subject to the parties obtaining approvals from various government agencies in Taiwan, as well as other customary closing conditions. Assuming all closing conditions are met, we expect the transaction to close during the first half of 2010. The carrying value of our investment in Scinopharm at December 31, 2009 was $69.4 million.

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Schedule II
Watson Pharmaceuticals, Inc.

Valuation and Qualifying Accounts
Years Ended December 31, 2009, 2008 and 2007

	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions/ Write-offs	Other*	Balance at End of Period
			(In millions)		
Allowance for doubtful accounts:					
Year ended December 31, 2009	$ 3.3	$ 3.4	$ (3.1)	$ 1.8	$ 5.4
Year ended December 31, 2008	3.8	1.2	(1.7)		3.3
Year ended December 31, 2007	5.9	0.1	(2.2)		3.8
Inventory reserves:					
Year ended December 31, 2009	34.7	51.0	(22.4)		63.3
Year ended December 31, 2008	47.7	45.7	(58.7)		34.7
Year ended December 31, 2007	58.3	46.8	(57.4)		47.7
Tax valuation allowance:					
Year ended December 31, 2009	8.1	0.2		67.9	76.2
Year ended December 31, 2008	12.5	(0.6)	(3.8)		8.1
Year ended December 31, 2007	12.0	0.5			12.5

* Represents opening balances of businesses acquired in the period.

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SUPPLEMENTARY DATA (UNAUDITED)

Selected unaudited quarterly consolidated financial data and market price information are shown below (in millions except per share data):

	For Three Month Periods Ended			
	Dec. 31, 2009	Sept. 30, 2009	June 30, 2009	Mar. 31, 2009
Net revenues	$ 785.7	$ 662.1	$ 677.8	$ 667.4
Operating expenses	685.5	551.4	586.3	585.9
Operating income	100.2	110.7	91.5	81.5
Provision for income taxes	32.8	39.3	37.6	30.9
Net income	$ 56.9	$ 63.0	$ 53.0	$ 49.1
Basic earnings per share	$ 0.52	$ 0.61	$ 0.51	$ 0.48
Diluted earnings per share	$ 0.51	$ 0.55	$ 0.46	$ 0.43
Market price per share:				
High	$ 40.25	$ 37.20	$ 33.97	$ 32.95
Low	$ 33.88	$ 32.61	$ 28.06	$ 23.05

	For Three Month Periods Ended			
	Dec. 31, 2008	Sept. 30, 2008	June 30, 2008	Mar. 31, 2008
Net revenues	$ 645.2	$ 640.7	$ 622.7	$ 626.9
Operating expenses	555.0	553.7	523.7	544.9
Operating income	90.2	87.0	99.0	82.0
Provision for income taxes	30.2	23.0	35.5	31.2
Net income	$ 56.4	$ 71.1	$ 60.3	$ 50.6
Basic earnings per share	$ 0.55	$ 0.69	$ 0.59	$ 0.49
Diluted earnings per share	$ 0.50	$ 0.62	$ 0.53	$ 0.45
Market price per share:				
High	$ 29.65	$ 31.38	$ 32.70	$ 29.56
Low	$ 20.17	$ 26.66	$ 25.03	$ 23.90

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EXHIBIT INDEX

Exhibit No.	Description
2.1	Agreement and Plan of Merger by and among Watson Pharmaceuticals, Inc., Water Delaware, Inc. and Andrx Corporation dated March 12, 2006, is incorporated by reference to Exhibit 2.1 to the Company s March 13, 2006 Form 8-K.
2.2	Share Purchase Agreement dated as of June 16, 2009, by and among Robin Hood Holdings Limited, Watson Pharmaceuticals, Inc., certain shareholders of Robin Hood Holdings Limited, and Anthony Selwyn Tabatznik, solely in his capacity as the Shareholders Representative, is incorporated by reference to Exhibit 2.1 to the Company s June 16, 2009 Form 8-K.
2.3	First Amendment to Share Purchase Agreement, dated as of November 26, 2009, by and among Robin Hood Holdings Limited, Arrow Pharmaceutical Holdings Ltd., Cobalt Laboratories, Inc., Arrow International Ltd., Arrow Supplies Ltd., Watson Pharmaceuticals, Inc., Watson Pharma S.À.R.L., Watson Cobalt Holdings, LLC, the shareholders of Robin Hood Holdings Limited, and Anthony Selwyn Tabatznik, solely in his capacity as Shareholders Representative, is incorporated by reference to Exhibit 2.2 to the Company s November 26, 2009 Form 8-K.
3.1	Articles of Incorporation of the Company and all amendments thereto are incorporated by reference to Exhibit 3.1 to the Company s June 30, 1995 Form 10-Q and to Exhibit 3.1(A) to the Company s June 30, 1996 Form 10-Q.
3.2	Second Amended and Restated Bylaws of Watson Pharmaceuticals, Inc. are incorporated by reference to Exhibit 3.1 to the Company s March 5, 2009 Form 8-K.
3.3	Certificate of Designations for Series A Preferred Stock is incorporated by reference to Exhibit 3.1 to the Company s November 26, 2009 Form 8-K.
4.1	Indenture between the Company and Wells Fargo Bank, N.A., as trustee, dated as of August 24, 2009, is incorporated by reference to Exhibit 4.1 to the Company s August 18, 2009 Form 8-K.
4.2	First Supplemental Indenture between the Company and Wells Fargo Bank, N.A., as trustee, dated as of August 24, 2009, including the forms of the Company s 5.000% Senior Notes due 2014 and 6.125% Senior Notes due 2019, is incorporated by reference to Exhibit 4.2 to the Company s August 18, 2009 Form 8-K.
4.3	Shareholders Agreement, dated as of December 2, 2009, by and among Watson Pharmaceuticals, Inc., Quiver Inc. and Friar Tuck Limited, is incorporated by reference to Exhibit 4.1 to the Company s November 26, 2009 Form 8-K.
*10.1	1991 Stock Option Plan of the Company, as revised, is incorporated by reference to Exhibit 10.1 to the Company s June 30, 1995 Form 10-Q. Plan amendments are incorporated by reference to Exhibit 10.6(a) to the Company s June 30, 1996 Form 10-Q and by reference to Exhibit 10.6(a) to the Company s March 31, 1997 Form 10-Q.
*10.2	Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc. is incorporated by reference to Exhibit 10.1 to the Company s June 30, 2005 Form 10-Q. Second Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc. is incorporated by reference to Exhibit 10.1 to the Company s March 31, 2007 Form 10-Q.
*10.3	Form of Key Employee Agreement. The Company has entered into a Key Employee Agreement in substantially the form filed and incorporated by reference to Exhibit 10.4 to the Company s 2000 Form 10-K with certain of its executive officers, who include Edward F. Heimers, David A. Buchen, Gordon Munro and R. Todd Joyce. A copy of each of these individual s Key Employee Agreements will be provided to the Staff upon request.
*10.4	

	Key Employment Agreement entered into as of August 15, 2002 by and between Charles Ebert and the Company, is incorporated by reference to Exhibit 10.1 to the Company s September 30, 2002 Form 10-Q.
*10.5	Key Employment Agreement entered into as of September 5, 2006 by and between Thomas R. Russillo and the Company is incorporated by reference to Exhibit 10.1 to the Company s Form 8-K filed on September 7, 2006.
*10.6	Amendment to Watson Pharmaceuticals, Inc. Key Employment Agreement entered into as of December 29, 2008 by and between Thomas R. Russillo and the Company.
*10.7	Key Employment Agreement entered into as of December 11, 2006 by and between Thomas Giordano and the Company is incorporated by reference to Exhibit 10.6 to the Company s 2006 Form 10-K.

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Exhibit No.	Description
*10.8	Form of Amendment to Key Employee Agreement. On or about December 31, 2008, the Company entered into an Amendment to Key Employee Agreement in substantially the form attached hereto with certain of its Executive Officers, including Edward F. Heimers, Al Paonessa III, Thomas Giordano and Gordon Munro. A copy of each of these individual s Amendment to Key Employee Agreements will be provided to the Staff upon request.
*10.9	Form of Amendment to Key Employee Agreement. On or about December 31, 2008, the Company entered into an Amendment to Key Employee Agreement in substantially the form attached hereto with certain of its Executive Officers, including David A. Buchen and Charles Ebert. A copy of each of these individual s Amendment to Key Employee Agreements will be provided to the Staff upon request.
10.10	Credit Agreement by and among Watson Pharmaceuticals, Inc., Canadian Imperial Bank of Commerce, Wachovia Capital Markets, LLC, Wells Fargo Bank, National Association, Union Bank of California, N.A. and Sumitomo Mitsui Banking Corporation dated November 3, 2006 is incorporated by reference to Exhibit 10.1 to the Company s Form 8-K filed on November 6, 2006.
*10.11	2001 Incentive Award Plan Form of Notice of Grant and Signature Page for an Employee or a Consultant is incorporated by reference to Exhibit 10.15 to the Company s 2004 Form 10-K.
*10.12	2001 Incentive Award Plan Form of Notice of Grant and Signature Page for a Director is incorporated by reference to Exhibit 10.16 to Exhibit 10.16 to the Company s 2004 Form 10-K.
*10.13	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Non-Employee Director Restricted Stock Award is incorporated by reference to Exhibit 10.2 to the Company s June 30, 2005 Form 10-Q.
*10.14	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Non-Employee Director Option Grant is incorporated by reference to Exhibit 10.3 to the Company s June 30, 2005 Form 10-Q.
*10.15	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for an Employee Restricted Stock Award is incorporated by reference to Exhibit 10.4 to the Company s June 30, 2005 Form 10-Q.
*10.16	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for an Employee Stock Option Award is incorporated by reference to Exhibit 10.5 to the Company s June 30, 2005 Form 10-Q.
*10.17	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Vice-President and Above Stock Option Award is incorporated by reference to Exhibit 10.6 to the Company s June 30, 2005 Form 10-Q.
*10.18	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Vice-President and Above Restricted Stock Award is incorporated by reference to Exhibit 10.22 to the Company s 2006 Form 10-K.
+10.19	Distribution Agreement between Amphastar Pharmaceuticals, Inc. and Andrx Pharmaceuticals, Inc. dated as of May 2, 2005, is incorporated by reference to Exhibit 10.102 of Andrx Corporation s 2005 Form 10-K.
+	First Amendment to Distribution Agreement between Amphastar Pharmaceuticals, Inc. and Andrx Pharmaceuticals, Inc. d/b/a Watson Laboratories Florida dated August 15, 2008 is incorporated by reference to Exhibit 10.1 to the Company s September 30, 2008 Form 10-Q.
+10.20	Agreement to License and Purchase by and among Andrx Labs, LLC, Andrx Laboratories, Inc., Andrx Laboratories (NJ), Inc., Andrx EU Ltd. and First Horizon Pharmaceutical Corporation dated as of March 2, 2005, is incorporated by reference to Exhibit 10.100 to Andrx Corporation s March 31, 2005 Form 10-Q.

+10.21	Manufacturing and Supply Agreement between Andrx Pharmaceuticals, Inc. and First Horizon Pharmaceutical Corporation dated as of March 28, 2005, is incorporated by reference to Exhibit 10.101 to Andrx Corporation s March 31, 2005 Form 10-Q.
*10.22	Key Employee Agreement between Watson Pharmaceuticals, Inc. and Paul M. Bisaro, dated as of August 1, 2007, is incorporated by reference to Exhibit 10.2 to the Company s August 1, 2007 Form 8-K.
*10.23	Amendment to Watson Pharmaceuticals, Inc. Key Employee Agreement entered into as of December 22, 2008 by and between Paul M. Bisaro and the Company.
*10.24	Key Employee Agreement between Anda, Inc. and Al Paonessa III, dated as of August 2, 2007 is incorporated by reference to Exhibit 10.28 to the Company s 2007 Form 10-K.

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Exhibit No.	Description
10.25	Amendment No. 1, dated July 1, 2009, to the Credit Agreement dated November 3, 2006, by and among Watson Pharmaceuticals, Inc., Canadian Imperial Bank of Commerce, acting through its New York agency, as administrative agent, Wachovia Capital Markets, LLC, as syndication agent, a syndicate of lenders, and Wells Fargo Bank, National Association, Union Bank of California, N.A., Sumitomo Mitsui Banking Corporation, as documentation agents and the financial institutions from time to time party thereto, is incorporated by reference to Exhibit 10.1 to the Company s June 30, 2009 Form 10-Q.
*10.26	Second Amendment to Key Employee Agreement between Watson Pharmaceuticals, Inc. and Thomas R. Russillo, dated as of August 13, 2009, is incorporated by reference to Exhibit 10.1 to the Company s August 13, 2009 Form 8-K
*10.27	Key Employee Agreement entered into as of October 30, 2009 by and between R. Todd Joyce and the Company is incorporated by reference to Exhibit 10.1 to the Company s October 30, 2009 Form 8-K.
12.1	Statement regarding the computation of ratio of earnings to fixed charges is incorporated by reference to Exhibit 12.1 to the Company s August 17, 2009 Form S-3.
21.1	Subsidiaries of the Company.
23.1	Consent of PricewaterhouseCoopers LLP.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 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. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Compensation Plan or Agreement

\+ Confidential treatment has been requested with respect to certain portions of this exhibit. Omitted portions have been filed separately with the SEC.