

ALPHARMA INC
Form 10-Q
August 02, 2005

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 quarter ended
June 30, 2005

Commission file number 1-8593

Alpharma Inc.

(Exact name of registrant as specified in its charter)

Delaware

22-2095212

(State of Incorporation)

(I.R.S. Employer Identification No.)

One Executive Drive, Fort Lee, New Jersey 07024

(Address of principal executive offices) Zip Code

(201) 947-7774

(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 requirements for the past 90 days.

YES ☒

NO ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES ☒

NO ☐

Indicate the number of shares outstanding of each of the Registrant's classes of common stock as of July 19, 2005:

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Class A Common Stock, \$.20 par value - 41,410,485 shares
Class B Common Stock, \$.20 par value -- 11,872,897 shares

ALPHARMA INC.

INDEX

	<u>Page No.</u>
PART I	FINANCIAL INFORMATION
Item 1	Financial Statements (unaudited)
	Consolidated Condensed Balance Sheet as of June 30, 2005 and December 31, 2004
	3
	Consolidated Statement of Operations for the Three and Six Months Ended June 30, 2005 and 2004
	4
	Consolidated Condensed Statement of Cash Flows for the Six Months Ended June 30, 2005 and 2004
	5
	Notes to Consolidated Condensed Financial Statements
	6 - 31
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations
	32 - 45
Item 3	Quantitative and Qualitative Disclosures about Market Risk
	45
Item 4	Controls and Procedures
	45 - 47
PART II.	OTHER INFORMATION
Item 1	Legal Proceedings
	48
Item 6	Exhibits
	48
	Signatures
	49

ALPHARMA INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEET
(In thousands)
(Unaudited)

	June 30, <u>2005</u>	December 31, <u>2004</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$50,689	\$105,212
Accounts receivable, net	208,270	226,591
Inventories	238,885	310,004
Prepaid expenses and other current assets	<u>21,465</u>	<u>30,265</u>
Total current assets	519,309	672,072
Property, plant and equipment, net	428,335	457,296
Goodwill	448,638	478,621
Intangible assets, net	289,042	310,718
Other assets and deferred charges	<u>69,403</u>	<u>85,135</u>
Total assets	<u>\$1,754,727</u>	<u>\$2,003,842</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

Current portion of long-term debt	\$168,129	\$ 675,639
Short-term debt	256	16,096
Accounts payable	101,564	117,892
Accrued expenses	169,840	187,129

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Accrued and deferred income taxes	<u>49,405</u>	<u>43,650</u>
Total current liabilities	489,194	1,040,406
Long-term debt:		
Senior	363,366	--
Convertible subordinated notes	--	10,000
Deferred income taxes	33,253	34,685
Other non-current liabilities	32,426	35,109
Commitments and contingencies (see Note 15)		
Stockholders' equity:		
Class A Common Stock	8,375	8,256
Class B Common Stock	2,375	2,375
Additional paid-in capital	1,081,348	1,073,921
Unearned compensation	(10,230)	(7,443)
Accumulated deficit	(323,341)	(347,425)
Accumulated other comprehensive income	85,605	161,602
Treasury stock, at cost	<u>(7,644)</u>	<u>(7,644)</u>
))
Total stockholders' equity	<u>836,488</u>	<u>883,642</u>
Total liabilities and stockholders' equity	<u>\$1,754,727</u>	<u>\$2,003,842</u>

See notes to the consolidated condensed financial statements.

ALPHARMA INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS
(In thousands of dollars, except per share data)
(Unaudited)

	Three Months Ended <u>June 30,</u>		Six Months Ended <u>June 30,</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Total revenue	\$367,889	\$315,975	\$746,032	\$627,636
Cost of sales	<u>208,822</u>	<u>187,702</u>	<u>429,439</u>	<u>381,369</u>
Gross profit	159,067	128,273	316,593	246,267
Selling, general and administrative expenses	100,713	91,619	193,750	190,575
Research and development	18,137	22,769	41,019	38,466
Asset impairments and other - Aquatics	--	9,474	--	9,474
Goodwill impairment - adjustment of estimate	<u>--</u>	<u>--</u>	<u>815</u>	<u>--</u>
Operating income	40,217	4,411	81,009	7,752
Interest expense and amortization of debt issuance costs	(11,728)	(14,632)	(26,232)	(29,127)
Loss on extinguishment of debt	--	(1,934)	(1,884)	(2,795)
Other income, net	<u>2,160</u>	<u>13,009</u>	<u>2,228</u>	<u>20,720</u>
Income (loss) before income taxes	30,649	854	55,121	(3,450)
Provision (benefit) for income taxes	<u>10,623</u>	<u>260</u>	<u>26,281</u>	<u>(903)</u>
)	
Net income (loss)	<u>\$20,026</u>	<u>\$ 594</u>	<u>\$28,840</u>	<u>\$(2,547)</u>
Earnings per common share:				
Basic	<u>\$0.38</u>	<u>\$0.01</u>	<u>\$0.55</u>	<u>\$(0.05)</u>
Diluted	<u>\$0.38</u>	<u>\$0.01</u>	<u>\$0.55</u>	<u>\$(0.05)</u>
Dividends per common share	<u>\$0.045</u>	<u>\$0.045</u>	<u>\$0.09</u>	<u>\$0.09</u>

See notes to the consolidated condensed financial statements.

ALPHARMA INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENT OF CASH FLOWS
(In thousands of dollars)
(Unaudited)

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	Six Months Ended <u>June 30,</u>	
	<u>2005</u>	<u>2004</u>
Operating Activities:		
Net income (loss)	\$ 28,840	\$ (2,547)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	46,905	47,847
Amortization of loan costs	1,282	1,401
Interest accretion on convertible debt	3,455	3,230
Other non-cash items	6,913	16,713
Changes in assets and liabilities:		
Decrease in accounts receivable	11,801	3,741
Decrease (increase) in inventory	58,436	(26,901)
(Decrease) increase in accounts payable, accrued expenses and taxes payable	(7,996)	30,127
Decrease (increase) in prepaid expenses	8,219	(3,418)
Other, net	<u>(6,224)</u>	<u>945</u>
)	
Net cash provided by operating activities	<u>151,631</u>	<u>71,138</u>
Investing Activities:		
Capital expenditures	(16,410)	(18,717)
Purchase of intangible assets	(1,540)	(549)
Purchase of Wynco	--	(12,857)
Proceeds from sale of Wynco	=	<u>17,000</u>

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Net cash used in investing activities	(17,950)	<u>(15,123)</u>
Financing Activities:		
Dividends paid	(4,756)	(4,717)
Reduction of senior long-term debt	(157,714)	(144,246)
Net (reduction) advances under lines of credit	(15,799)	60,614
Proceeds from issuance of common stock and other	2,565	3,493
Purchase of treasury stock	--	(40)
(Decrease) increase in book overdraft	<u>(7,832)</u>	<u>2,188</u>
)	
Net cash used in financing activities	<u>(183,536)</u>	<u>(82,708)</u>
)	
Effects of exchange rate changes on cash and cash equivalents	<u>(4,668)</u>	<u>(816)</u>
))
(Decrease) in cash	(54,523)	(27,509)
Cash and cash equivalents at beginning of year	<u>105,212</u>	<u>58,623</u>
Cash and cash equivalents at end of period	<u>\$50,689</u>	<u>\$31,114</u>

See notes to the consolidated condensed financial statements.

1. General

The accompanying consolidated condensed financial statements include all adjustments (consisting only of normal recurring accruals) which are, in the opinion of management, considered necessary for a fair presentation of the results for the periods presented. These financial statements should be read in conjunction with the consolidated financial statements of Alpharma Inc. and Subsidiaries included in the Company's 2004 Annual Report on Form 10-K/A. The reported results for the six-month period ended June 30, 2005 are not necessarily indicative of the results to be expected for the full year. Certain amounts have been reclassified to conform with current presentations.

Proforma Stock Based Compensation

At June 30, 2005, the Company has stock-based employee compensation plans. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees", and related Interpretations. No stock-based employee compensation cost is reflected in net income for incentive stock options, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant. Compensation cost for restricted stock is recorded based on the market value on the date of grant. The fair value of restricted stock is charged to unearned compensation in Stockholders' Equity and amortized to expense over the requisite vesting periods. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation", as amended by FASB Statement No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", to stock-based employee compensation. No tax benefits were attributed to the stock-based employee compensation expense during the first half of 2005 because the Company maintained a valuation allowance on substantially all of the U.S. net deferred tax assets.

	Three Months Ended <u>June 30,</u>		Six Months Ended <u>June 30,</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Net income (loss), as reported	\$20,026	\$594	\$28,840	\$(2,547)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	1,193	511	1,960	844
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(2,081)</u>	<u>(1,415)</u>	<u>(3,774)</u>	<u>(2,723)</u>
Pro forma net income (loss)	<u>\$19,138</u>	<u>\$(310)</u>	<u>\$27,026</u>	<u>\$(4,426)</u>

Earnings (loss) per share:

Basic-as reported	<u>\$0.38</u>	<u>\$0.01</u>	<u>\$0.55</u>	<u>\$(0.05)</u>
Basic-pro forma	<u>\$0.37</u>	<u>\$(0.01)</u>	<u>\$0.52</u>	<u>\$(0.09)</u>
Diluted-as reported	<u>\$0.38</u>	<u>\$0.01</u>	<u>\$0.55</u>	<u>\$(0.05)</u>
Diluted-pro forma	<u>\$0.36</u>	<u>\$(0.01)</u>	<u>\$0.51</u>	<u>\$(0.09)</u>

The Company estimated the fair value, as of the date of grant, of options outstanding in the plan using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended <u>June 30,</u>		Six Months Ended <u>June 30,</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Expected life (years)	3.42	3.63	3.59	3.63
Expected future dividend yield (average)	1.61%	0.90%	1.44%	0.89%
Expected volatility	0.52	0.55	0.56	0.55

The risk-free interest rates for 2005 and 2004 were based upon U.S. Treasury instrument rates for the three months ended June 30, with maturity approximating the expected term. The weighted average interest rate in 2005 and 2004 amounted to 3.8% and 3.7%, respectively. The weighted average fair value of options granted during the three months ended June 30, 2005 and 2004 with exercise prices equal to fair market value on the date of grant was \$4.96 and \$9.25, respectively. The weighted average fair value of options granted during the six months ended June 30, 2005 and 2004 with exercise prices equal to fair market value on the date of grant was \$5.97 and \$9.36, respectively.

The Company's 2003 Omnibus Incentive Compensation Plan provides for the issuance of performance units that are valued based on the Company's Total Shareholder Return as compared to a market index of peer companies and the satisfaction of a free cash flow threshold. Each performance unit has a potential value between zero and \$200. As of June 30, 2005, approximately 79,529 performance units granted in 2004 are outstanding under this plan, which may result in cash payments based on performance during a three-year period ending December 31, 2006. The potential costs would be \$3,976 in 2006 if the Company is in the 50th percentile relative to the peer group and potentially up to \$15,906 if the Company is in the 90th percentile relative to the peer group. As of June 30, 2005, approximately 68,435 performance units granted in 2005 are outstanding under this plan, which may result in cash payments based on performance during a three-year period ending December 31, 2007. The potential costs would be \$3,422 in 2007 if the Company is in the 50th percentile relative to the peer group and potentially up to \$13,687 if the Company is in the 90th percentile relative to the peer group. In accordance with SFAS 5, "Accounting for Contingencies", the future

outcome of the Company's performance measured against peer companies is undeterminable, and therefore the Company has not established reserves for potential future costs. If the Company had made the computations as of June 30, 2005, the related liabilities would be zero.

2.

Liquidity and Capital Resources

In the fourth quarter of 2001, the Company completed the acquisition of the Faulding Oral Pharmaceuticals Business ("OPB") and entered into a \$900,000 credit facility ("2001 Credit Facility") to finance the acquisition and replace its previous credit agreement. The 2001 Credit Facility includes covenants that require it to maintain specified financial ratios and satisfy financial conditions consisting of a maximum total leverage ratio test, a maximum senior secured leverage ratio test, a minimum fixed charge coverage ratio test, a minimum interest coverage ratio test and a minimum net worth test. A breach of any of these covenants, if not cured or waived, could result in a default under the 2001 Credit Facility. If an event of default under the 2001 Credit facility occurs, the lenders under these facilities could elect to declare all amounts outstanding thereunder, together with accrued interest, to be immediately due and payable. The calculation of earnings before interest, taxes, depreciation and amortization ("EBITDA") on a rolling four quarter basis is important to many of these tests. These covenants have been amended from time to time, including amendments made in May and August, 2004 and March 2005.

Compliance with these financial covenants in 2005 is dependent on the Company's EBITDA as defined by the credit agreement, and therefore the Company's ability to generate increasing amounts of operating income, or on the Company's ability to reduce the amount of its outstanding debt. Since December 2001, the Company has reduced the amount of its outstanding debt and the size of the original facility by prepaying term debt of approximately \$375,000 and by lowering the revolving line of credit by \$150,000. On an overall basis, senior debt and total debt at June 30, 2005 were \$374,378 and \$531,751, respectively, compared to \$538,065 and \$701,735, respectively, at December 31, 2004.

The Company's EBITDA, as defined, is affected most directly by changes in operating income. The definition of EBITDA allows for the add back of non-cash charges, including goodwill impairment charges. Operating income in 2004 was negatively affected by business conditions in USG and by corrective actions related to the Company's response to FDA Form 483s issued for the Company's U.S. Human Pharmaceuticals plants in Baltimore (liquids) and Elizabeth (solid dose). The corrective action plans have included consulting and other costs and have resulted in lower production and significant rationalization of the liquids product line at the Baltimore plant and production delays and interruptions at the Elizabeth plant.

The FDA completed an inspection of the Company's Elizabeth solid dose site in December 2003 and advised the Company that, as a result of this inspection, product approvals relating to the Elizabeth site would be withheld pending a successful follow-up inspection. Major elements of the FDA compliance enhancement plan have been completed. In September 2004, the FDA inspected Elizabeth and has since advised the Company it is eligible for new product approvals. Since the September 2004 inspection, the Company has received six new product approvals. In the fourth quarter of 2004, the Company launched both its gabapentin capsules and tablets from the Elizabeth site. The Company anticipates it will be the subject of another FDA inspection at the Elizabeth site in 2005.

The Company expects to continue upgrading plant procedures at the Baltimore facility in accordance with the October 2002 corrective action plan and will continue to provide written monthly updates to the FDA. The plan anticipated

substantial completion of the corrective actions by the end of 2004, subject to the FDA's final review and satisfaction with the actions taken. Representatives of the Company and the Baltimore facility met with Baltimore FDA in the fourth quarter of 2004 to discuss progress on the corrective action plan and to clarify expectations and deliverables. The Company anticipates it will be the subject of another inspection at the Baltimore site in 2005.

While the Company has received no indications from the FDA, the total cost and timing of both the Elizabeth and Baltimore corrective action plans are subject to change based upon results of future inspections performed by the respective New Jersey and Baltimore Districts of the FDA. See Note 15 for further details.

In order to increase flexibility in complying with its financial covenants, the Company received an amendment to its 2001 Credit Facility in March 2005, which delayed the further tightening of certain financial covenants. The amendment provided at March 31, 2005, the interest coverage ratio requirement will increase from 3.00:1.00 to 3.25:1.00 and at March 31, 2006, the interest coverage ratio requirement will increase from 3.25:1.00 to 3.50:1.00 and remain thereafter. At March 31, 2005, the permitted leverage ratio decreased from 4.25:1.00 to 4.00:1.00 and at March 31, 2006, the permitted leverage ratio will decrease from 4.00:1.00 to 3.50:1.00 and remain thereafter. In addition, the amendment allows \$30,000 of cash restructuring expenses incurred from July 1, 2004 to December 31, 2005, to be excluded from the calculation of EBITDA. Regarding the net worth covenant, the amendment allowed up to \$250,000 for asset valuation impairment charges, which were incurred in the fourth quarter of 2004, to be added back to the calculated amount of net worth.

At December 31, 2004, the Company had certain violations of its debt covenants, that were unrelated to the financial covenants. In April and May 2005, the Company cured all such violations. At June 30, 2005, the Company had approximately \$78,600 of EBITDA flexibility on its tightest financial covenant at quarter end, the Interest Coverage Ratio.

The Company's operating plan for 2005 indicates continued difficult operating conditions in the U.S. Generic Pharmaceutical business. Based on the plan, the Company expects to remain in compliance with its financial covenants throughout 2005. Depending on actual results, the Company may need to consider additional actions to ensure continued compliance.

The Company believes it has a number of options available to provide it with increased financial flexibility, thereby ensuring continued compliance with its covenants. Certain of these options are entirely within the Company's control and others require actions of the bank group and/or a third party. Options include:

- Cash generated by the Company's international operations may be made available to fund U.S. investments under the American Jobs Creation Act of 2004 (the "Act"). The Board of Directors approved a plan and the Company repatriated \$147,000 of cash in extraordinary dividends, as defined in the Act during the first half of 2005. The tax impact of repatriating this \$147,000 was approximately \$9,500. The Company may adopt additional reinvestment plans under the Act and it currently estimates that it could increase the amount to be repatriated under the Act by up to \$288,000 (subject to Board of Directors approval) depending upon a number of factors, including the amount of foreign earnings and profits generated through 2005, but is subject to further U.S. Treasury guidance. The tax impact of repatriating this \$288,000 would be approximately \$18,500.
- Aggressive asset management, including both working capital reduction programs and controls over capital expenditures, to generate free cash flow to enable the Company to continue to repay outstanding debt. Capital expenditures and purchased intangibles were \$17,950 for the six months ended June 30, 2005 compared to

\$19,266 for the six months ended June 30, 2004.

- Selling certain assets. The Company continues to consider possible divestitures, which could be material. There is no guarantee any divestiture will be completed.
- Reduce subordinated convertible debt by issuing common stock. At June 30, 2005, the Company has \$157,373 of convertible Subordinated Notes outstanding that can be retired with the agreement of the holders by the exchange of common stock. On April 1, 2005, the Company repaid the 5.75% convertible Subordinated Notes (\$9,752 as of March 31, 2005). The Company's loan covenants also require that amounts outstanding of the 6.875% convertible debt (\$157,373 at June 30, 2005) be reduced to \$10,000 or less by December 1, 2005. The Company is planning for this requirement based on a number of scenarios. The Company expects to be successful in meeting this requirement.
- Obtaining additional amendments to the 2001 Credit Facility bank covenants to allow for certain of the actions noted above and to provide additional flexibility in the timing and application of the financial ratio tests. In October 2001, the Company borrowed \$622,000 from the bank group and at June 30, 2005 the amount outstanding was \$154,122 (a reduction of \$467,878). The Company has obtained amendments as follows:
 - In the fourth quarter of 2003, the bank group agreed to an amendment which allowed for specified asset sales, permitted exclusions of restructuring and refinancing charges of up to \$10,000 from EBITDA and the minimum net worth definitions, and amended the leverage ratios to delay the timing of further covenant restrictions.
 - In May 2004, the 2001 Credit Facility was amended to allow for certain actions associated with the Company's ability to achieve increased financial flexibility. The amendment included provisions enabling the Company to issue up to \$200,000 of senior subordinated notes to refinance the existing convertible notes, to prepay a local currency mortgage secured loan of approximately \$32,000, modify the requirements to prepay debt facilities with proceeds from the potential sale of certain assets/businesses, allow for certain covenant add-backs associated with gabapentin inventory and other minor items.
 - In August 2004, the 2001 Credit Facility was amended to reduce interest coverage from 3.50:1.00 to 3.00:1.00 and increase the permitted leverage ratio from 4.00:1.00 to 4.25:1.00 through and including December 31, 2004. At March 31, 2005, the interest coverage ratio increased from 3.00:1.00 to 3.25:1.00 and at June 30, 2005, the interest coverage ratio will increase from 3.25:1.00 to 3.50:1.00 and remain thereafter. At March 31, 2005, the permitted leverage ratio decreased from 4.25:1.00 to 4.00:1.00 and at June 30, 2005, the permitted leverage ratio will decrease from 4.00:1.00 to 3.50:1.00 and remain thereafter. In addition, the amendment allowed \$30,000 of cash restructuring expenses incurred from July 1, 2004 to December 31, 2004, to be excluded from the calculation of EBITDA.
 - In March 2005, the 2001 Credit Facility was amended to provide at March 31, 2005, the interest coverage ratio requirement increased from 3.00:1.00 to 3.25:1.00 and at March 31, 2006, the interest coverage ratio requirement will increase from

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3.25:1.00 to 3.50:1.00, and remain thereafter. At March 31, 2005, the permitted leverage ratio decreased from 4.25:1.00 to 4.00:1.00 and at March 31, 2006, the permitted leverage ratio will decrease from 4.00:1.00 to 3.50:1.00 and remain thereafter. In addition, the amendment allows \$30,000 of cash restructuring expenses incurred from July 1, 2004 to December 31, 2005 to be excluded from the calculation of EBITDA. The net worth covenant is reduced by up to \$250,000 of asset valuation impairment charges.

The Company believes that its performance in the reduction of the 2001 Credit Facility, and its previous experience in working with the bank group would assist it in obtaining future amendments, if necessary.

While the Company cannot assure its success in executing any of the above-noted actions, it will endeavor to take the actions necessary to maintain sufficient financial flexibility with its debt covenants to remain in compliance.

3. Inventories

Inventories consist of the following:

	June 30, <u>2005</u>	December 31, <u>2004</u>
Finished product	\$121,429	\$170,290
Work-in-process	50,004	69,804
Raw materials	<u>67,452</u>	<u>69,910</u>
	<u>\$238,885</u>	<u>\$310,004</u>

Included in the June 30, 2005 amounts are inventories related to one product, gabapentin, which was launched in the fourth quarter of 2004. At December 31, 2004, \$2,536 of gabapentin raw materials have been reclassified to prepaid expenses and other, as the cost of the raw materials was recoverable upon receipt of replacement inventory. Upon receipt, the raw materials were reclassified as inventory. See Note 15 for additional information regarding gabapentin.

4. Long-Term Debt

At December 31, 2004, the Company classified \$503,293 of its outstanding debt as current liabilities due to violations of certain debt covenants at December 31, 2004, that served to make the associated debt obligations callable. In April and May 2005, the Company cured all such violations and accordingly, the associated debt obligations are no longer callable and are classified as long-term at June 30, 2005. The December 31, 2004 proforma balances are presented above to classify the associated debt as long-term, as if the covenant violations had been cured as of December 31, 2004.

Long-term debt consists of the following:

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	June 30, <u>2005</u>	December 31, 2004 <u>(Proforma)</u>	December 31, 2004 <u>(Reported)</u>
Senior debt:			
U.S. Dollar Denominated:			
2001 Credit Facility			
Term A	\$25,117	\$ 51,792	\$ 51,792
Term B	129,005	225,177	225,177
Revolving Credit	=	<u>25,000</u>	<u>25,000</u>
	154,122	301,969	301,969
8.625% Senior Notes due 2011	<u>220,000</u>	<u>220,000</u>	<u>220,000</u>
Total senior long-term debt	374,122	521,969	521,969
Subordinated debt:			
3% Convertible Senior Subordinated Notes due 2006 (6.875% yield), including interest accretion	157,373	153,918	153,918
	=	<u>9,752</u>	<u>9,752</u>
5.75% Convertible Subordinated Notes due 2005			
Total subordinated debt	<u>157,373</u>	<u>163,670</u>	<u>163,670</u>
Total long-term debt	531,495	685,639	685,639
Less, current maturities	<u>168,129</u>	<u>172,346</u>	<u>675,639</u>
	<u>\$363,366</u>	<u>\$513,293</u>	<u>\$10,000</u>

The Company prepaid \$20 million and \$95 million of the Term A and Term B loans, respectively, in the first quarter of 2005. In the first and second quarters of 2004, the Company prepaid \$50 million and \$25 million of the Term A and Term B loans, respectively. As a result, the Company recognized pre-tax charges of \$1,884, \$861 and \$376 in the first quarter of 2005 and first and second quarters of 2004, respectively, as a loss on extinguishment of debt.

In May 2004, the Company's Norwegian subsidiary prepaid approximately \$32,000 of mortgage notes payable in Norwegian Kroner and recorded a loss of \$885 on extinguishment of debt.

On June 15, 2004, the Company repurchased and retired \$24,455 of 5.75% Convertible Subordinated Notes due April 1, 2005 (the "05 Notes"). As a result of the purchase, the Company recognized pre-tax charges of \$673 as a loss on extinguishment of debt.

The 2001 Credit Facility has several financial covenants including a total debt to EBITDA ratio, senior debt to EBITDA, fixed charge coverage ratio and an interest coverage ratio. In March 2005, an amendment was approved which permitted exclusions of: (i) cash restructuring charges of up to \$30,000 incurred from July 1, 2004 to December

31, 2005 from EBITDA, and (ii) up to \$250,000 of asset valuation impairment charges from the required amount of net worth. It also amended the interest coverage ratio and leverage ratios to delay the timing of further covenant restrictions (see Note 2).

5. Earnings Per Share

Basic earnings per share is based upon the weighted average number of common shares outstanding. Diluted earnings per share reflect the dilutive effect of stock options and convertible debt, when appropriate.

A reconciliation of weighted average shares outstanding from basic to diluted is, as follows:

(Shares in thousands)	Three Months Ended <u>June 30,</u>		Six Months Ended <u>June 30,</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Average shares outstanding -- basic	52,377	52,005	52,366	51,949
Stock options	<u>250</u>	<u>513</u>	<u>231</u>	<u>--</u>
Average shares outstanding -- diluted	<u>52,627</u>	<u>52,518</u>	<u>52,597</u>	<u>51,949</u>

The amount of dilution attributable to stock options, determined by the treasury stock method, depends on the average market price of the Company's common stock for each period. For the three months and six months ended June 30, 2005, stock options to purchase approximately 2,645,000 and 2,712,000 shares, respectively were not included in the computation of diluted EPS because the option price was greater than the average market price of the Class A Common shares. For the three months ended June 30, 2004, stock options to purchase approximately 1,646,000 shares were not included in the computation of diluted EPS because the option price was greater than the average market price of the class A common shares. For the six months ended June 30, 2004, stock options had an anti-dilutive effect and therefore stock options to purchase approximately 3,925,000 shares were not included in the diluted EPS calculation.

The following table summarizes stock options not included in the computation of diluted EPS:

	Three Months Ended <u>June 30,</u>		Six Months Ended <u>June 30,</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Excluded due to option price greater than market value	2,645	1,646	2,712	1,646
Excluded due to anti-dilution	--	--	--	2,279

For the three and six months ended June 30, 2005 and 2004, the effects of the 06 Notes (convertible into 3,809,343 common shares) were not included in the calculation of diluted EPS because the result was anti-dilutive.

The numerator for the calculation of basic EPS is net income (loss) for all periods. The numerator for the calculation of diluted EPS is net income plus an add back for interest expense and debt cost amortization, net of income tax effects, related to the convertible notes when applicable. No tax benefits were attributed to the interest expense related to the 5.75% Convertible Subordinated Notes during the first six months of 2005 because the Company maintained a valuation allowance on substantially all of the net deferred tax assets. As a result, the effects of the 05 Notes (convertible into 341,054 shares) were not included in the calculation of diluted EPS because the result was anti-dilutive. On April 1, 2005, the Company repaid the 5.75% convertible Subordinated Notes (\$9,752 as of March 31, 2005).

6. Goodwill and Intangible Assets:

Intangible assets consist principally of products rights, including regulatory and/or marketing approvals by relevant government authorities. All intangible assets are subject to amortization. Annual amortization expense based on current intangibles for the years 2005 through 2009 is currently estimated to be approximately \$35,100, \$34,300, \$32,100, \$29,300 and \$28,900, respectively.

Identifiable intangible assets are required to be tested for impairment whenever changes in events or circumstances indicate that its carrying amount may not be recoverable. In Germany, in 2003, one product important to the Company's German operations, Pentalong, was required to reprove safety and efficacy by November 2004. The Company has complied with this request, but has not yet received a response to its filing. If the data is not satisfactory to the government, the Company will be required to re-evaluate the carrying value of intangible assets totaling approximately \$15,000. The Company believes, but cannot assure, it will be successful.

Intangible assets and accumulated amortization are summarized as follows:

(Intangible assets, primarily products rights)

Net balance, December 31, 2004	\$310,718
Additions	1,540
Amortization	(17,654)
Translation adjustment	(4,594)
Impairments	<u>(968)</u>
Net balance, June 30, 2005	<u>\$289,042</u>
Accumulated amortization, June 30, 2005	<u>\$198,780</u>

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The changes in the carrying amount of goodwill attributable to the Company's reportable segments for the six months ended June 30, 2005 are, as follows:

	<u>IG</u>	<u>API</u>	<u>USG</u>	<u>BP</u>	<u>Total</u>
Balance December 31, 2004	\$329,963	\$6,392	\$28,293	\$113,973	\$478,621
Foreign exchange translation	(28,438)	(730)	--	--	(29,168)
Adjustment of impairment loss	--	--	<u>(815)</u>	--	<u>(815)</u>
Balance June 30, 2005	<u>\$301,525</u>	<u>\$5,662</u>	<u>\$27,478</u>	<u>\$113,973</u>	<u>\$448,638</u>

In the first quarter of 2004, the Company reorganized USHP into two reportable segments, US Generic Pharmaceuticals ("USG") and Branded Pharmaceuticals ("BP"). The goodwill of USHP was allocated between the new segments based on the relative fair values at the time of disaggregation.

The year-end 2004 long term USG plan reflected the impact of emerging external factors including the increasing number of competitors, including at times authorized generics, and recent experience with a product launch for which pricing was below raw material costs. The impact of these factors was significant in valuing the future contribution from future new product launches. The year-end assessment indicated an impairment of USG's goodwill. The Company engaged its independent valuation firm to perform the FAS 142 Step II valuation of USG. Based upon the FAS 142 Step II valuation work performed, the Company recorded an estimated impairment loss of \$260,000 as of December 31, 2004. This amount represented the Company's best estimate of the impairment loss. The Company and its independent valuation firm completed the FAS 142 Step II valuation in May 2005. As a result, the Company recorded an adjustment of \$815 in the first quarter of 2005, increasing the total impairment charge to \$260,815.

7. Reorganization, Refocus and other Actions

The Company has only included severance related to specific programs as management actions. Other severance charges not related to specific programs are not segregated from normal operations. The following table presents cash activity in the severance and closure and exit costs related accruals:

	<u>Severance</u>	<u>Other Closure and Exit Costs</u>
Balance, December 31, 2004	\$5,127	\$6,449

Charges	--	--
Adjustments	(1,577)	143
Payments	(835)	(443)
Translation adjustments	<u>(70)</u>	<u>(9)</u>
)		
Balance, June 30, 2005	<u>\$2,645</u>	<u>\$6,140</u>

The liabilities for accrued severance as of June 30, 2005 are reflected in accrued expenses. Adjustments to reduce accrued severance are primarily the result of attrition within the USG and IG segments. The Company expects to settle these liabilities over the next nine months, in cash.

The liabilities for other closure and exit costs as of June 30, 2005 primarily relate to demolition costs, payments related to a discontinued product, lease obligations and other contractually committed costs associated with facility closures announced in 2002. The Company expects to settle these liabilities over the next nine months.

8. Pension Plans and Postretirement Benefits:

U.S.

:

The net periodic benefit costs for the Company's pension plans and other postretirement plans are as follows:

	<u>Pension Benefits</u>		<u>Postretirement Benefits</u>	
	For the Three Months Ended June 30,		For the Three Months Ended June 30,	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Service cost	\$1,042	\$1,136	\$21	\$21
Interest cost	779	758	44	53

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Expected return on plan assets	(763)	(652)	--	--
Net amortization of transition obligations	--	2	--	1
Amortization of prior service cost	(17)	(17)	(31)	(31)
Recognized net actuarial (gain) loss	<u>98</u>	<u>147</u>	<u>12</u>	<u>23</u>
Net periodic benefit cost	<u>\$1,139</u>	<u>\$1,374</u>	<u>\$46</u>	<u>\$ 67</u>

	<u>Pension Benefits</u> For the Six Months Ended June 30,		<u>Postretirement Benefits</u> For the Six Months Ended June 30,	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Service cost	\$2,084	\$2,272	\$42	\$42
Interest cost	1,558	1,516	88	106
Expected return on plan assets	(1,526)	(1,304)	--	--
Net amortization of transition obligations	--	4	--	2
Amortization of prior service cost	(34)	(34)	(62)	(62)
Recognized net actuarial (gain) loss	<u>196</u>	<u>294</u>	<u>24</u>	<u>46</u>
Net periodic benefit cost	<u>\$2,278</u>	<u>\$2,748</u>	<u>\$ 92</u>	<u>\$134</u>

Employer contributions primarily include those amounts contributed directly to, or paid directly from, plan assets. The Company expects to contribute approximately \$4,000 to the U.S. pension plans in 2005. Through the second quarter, no contributions have been made.

Europe:

The net periodic benefit costs for the Company's pension plans are as follows:

	<u>For the Three Months</u> Ended June 30,		<u>For the Six Months</u> Ended June 30,	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Service cost	\$1,452	\$1,327	\$2,945	\$2,665

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Interest cost	1,099	1,027	2,228	2,065
Expected return on plan assets	(924)	(798)	(1,874)	(1,605)
Amortization of transition obligation	21	144	44	290
Amortization of prior service cost	48	27	94	54
Recognized net actuarial loss	<u>121</u>	<u>61</u>	<u>245</u>	<u>123</u>
Net periodic benefit cost	<u>\$1,817</u>	<u>\$1,788</u>	<u>\$3,682</u>	<u>\$3,592</u>

The Company expects to contribute approximately \$5,000 to the European pension plans in 2005. Through the second quarter, contributions of approximately \$1,870 have been made.

9. Sale of Subsidiaries - 2004

Wynco, LLC

On January 7, 2004, the Company purchased the outstanding 50% interest in its joint venture, Wynco, LLC ("Wynco"), an Animal Health distribution company. The purchase price was \$4,331, approximately \$900 of which is payable over three years, beginning on December 31, 2004. In connection with the acquisition, the Company assumed debt of approximately \$6,677. The investment was previously recorded in accordance with the equity method, with the original 50% interest included in the Company's Consolidated Statement of Operations. As of the date of purchase, the Company consolidated the results of Wynco in the Consolidated Statement of Operations and included all related assets and liabilities in the Consolidated Balance Sheet. Wynco first quarter 2004 revenues and operating losses were \$19,169 and (\$111), respectively. The Company considered this an immaterial acquisition.

On March 30, 2004, the Company sold its 100% interest in this distribution company for \$17,000. In connection with the sale, the Company recognized a charge within Other income (expense) of \$1,090 related to an intangible asset previously held. Excluding this charge, the Company has recognized a loss on the sale of \$433 for the year ended December 31, 2004. As part of the transaction, the Company entered into an Agency and Distribution Agreement and Logistics Services Agreement with the buyer. The operations of Wynco are not classified as discontinued operations, as the Company and Wynco will have significant continuing involvement.

Aquatic Animal Health Group

In July 2004, the Company completed the sale of its Aquatic Animal Health Group ("Aquatic"). This business was included in the Animal Health segment and manufactures and markets vaccines primarily for use in immunizing farmed fish (principally salmon) worldwide. During the second quarter of 2004, the Company reached agreement for the sale of Aquatic to the senior management of Aquatic. As of June 30, 2004, the pending sale was approved and was probable. A final purchase agreement was signed and the closing took place in July 2004.

In accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", at June 30, 2004, a loss of \$9,474 was recorded. In July 2004, the sale was consummated. Through December 31, 2004, proceeds

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of approximately \$4,400 were received and the loss on sale was increased to \$9,987, primarily due to a curtailment loss.

The loss does not include a potential earn out of up to approximately \$3,000 that is contingently payable over three years dependent on Aquatic's future profitability.

The operations of Aquatic are not classified as discontinued operations, as the Company and Aquatic will have significant continuing involvement. The Company and Aquatic will continue to manufacture certain products for each other for at least 3 years and the potential earn out is significant to the cash flows of Aquatic.

The results of Aquatic operations included in the Animal Health segment for the three and six months ended June 30, 2004, are summarized as follows:

	Three Months Ended June 30, <u>2004</u>	Six Months Ended June 30, <u>2004</u>
Revenues	\$ 3,006	\$ 5,836
Operating (loss)	\$ (1,412)	\$ (2,139)
Operating (loss) including impairments	\$(10,886)	\$(11,613)

10. Supplemental Data

	Three Months Ended <u>June 30</u>		Six Months Ended <u>June 30,</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Other income (expense), net:				
Metformin ER profit-sharing income	\$ --	\$8,789	\$ --	\$16,926
Loss on sale of Wynco	--	(223)	--	(1,523)
Gain on sale of ANDA	--	2,000	--	2,000
Sale of product license	--	4,000	--	4,000
Interest income	521	777	1,608	902
Foreign exchange gains (losses), net	119	(1,420)	(733)	(459)
Litigation settlements	1,000	--	1,000	--
Other, net	<u>520</u>	<u>(914)</u>	<u>353</u>	<u>(1,126)</u>

	<u>\$2,160</u>	<u>\$13,009</u>	<u>\$2,228</u>	<u>\$20,720</u>
--	----------------	-----------------	----------------	-----------------

Interest expense and amortization of debt costs:

Interest expense	\$(11,121)	\$(13,986)	\$(24,950)	\$(27,726)
Amortization of debt issuance costs	<u>(607)</u>	<u>(646)</u>	<u>(1,282)</u>	<u>(1,401)</u>
)		
	<u>\$(11,728)</u>	<u>\$(14,632)</u>	<u>\$(26,232)</u>	<u>\$(29,127)</u>

Supplemental cash flow information:

Other non-cash operating activities:

Asset impairment on sale of Aquatic		\$ --	\$9,474
Non-cash asset write-downs		4,138	4,788
Write-off of intangibles on sale of Wynco		--	1,090
Goodwill impairment - adjustment of estimate		815	--
Amortization of restricted shares		<u>1,960</u>	<u>1,361</u>
		<u>\$6,913</u>	<u>\$16,713</u>
Cash paid for interest		<u>\$25,086</u>	<u>\$24,515</u>
Cash paid (refunded) for income taxes, net		<u>\$10,554</u>	<u>\$ 764</u>

11. Reporting Comprehensive Income

SFAS 130, "Reporting Comprehensive Income" requires foreign currency translation adjustments and certain other items to be included in other comprehensive income (loss). Total comprehensive income (loss) amounted to approximately \$(17,346) and \$(11,302) for the three months ended June 30, 2005 and 2004, respectively and \$(47,157) and \$(23,849) for the six months ended June 30, 2005 and 2004, respectively. The only components of

accumulated other comprehensive income for the Company as of June 30, 2005 and December 31, 2004 are foreign currency translation adjustments.

12. Transactions with A.L. Industrier ASA

A.L. Industrier ASA ("ALI") is the beneficial owner of 100% of the outstanding shares of the Company's Class B Stock. The Class B Stock represents 22% of the total outstanding common stock as of June 30, 2005. ALI, a Norwegian company, is able to control the Company through its ability to elect more than a majority of the Board of Directors and to cast a majority of the votes in any non-class vote of the Company's stockholders.

Effective January 1, 2005, the Company and ALI entered into a new administrative service agreement whereby the Company provides limited administrative services to ALI. The new agreement replaced and reduced amounts due under the previous agreement. The agreement provides for payment of a fixed yearly fee of approximately \$64. This agreement was approved by the Company's Audit and Corporate Governance Committee.

13. Business Segment Information

The Company's businesses are organized in five reportable segments as follows; Active Pharmaceutical Ingredients ("API"), Branded Pharmaceuticals ("BP"), International Generics ("IG"), U.S. Generics ("USG"), and Animal Health ("AH"). Each business has a segment manager who reports to the CEO.

The operations of each segment are evaluated based on earnings before interest and taxes (operating income). Unallocated includes corporate expenses for administration, finance, legal and certain unallocated expenses including costs related to the implementation of a company-wide enterprise resource planning system and the amortization of restricted stock. Segment data includes immaterial inter-segment revenues which are eliminated in the consolidated accounts. No customer accounts for more than 10% of consolidated revenues.

	Three Months Ended June 30,			
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
	<u>Revenues</u>		<u>Operating Income</u>	
API	\$36,402	\$40,287	\$15,360	\$22,550
BP	23,500	17,991	2,253	2,783
IG	102,747	97,075	12,129	8,222
USG ⁽¹⁾	<u>128,238</u>	<u>100,846</u>	<u>6,968</u>	<u>(4,338)</u>

)

T o t a l H u m a n Pharmaceuticals	290,887	256,199	36,710	29,217
Animal Health	79,794	71,496	15,445	(4,204)
Elimination of profit-sharing income ⁽¹⁾	--	(8,789)	--	(8,789)
Unallocated and other eliminations	<u>(2,792)</u>	<u>(2,931)</u>	<u>(11,938)</u>	<u>(11,813)</u>
)))))
	<u>\$367,889</u>	<u>\$315,975</u>	<u>\$ 40,217</u>	<u>\$ 4,411</u>

(1) Profit-sharing income is included in USG and is classified as Other income in the Consolidated Statement of Operations.

Six Months Ended June 30,

	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
	<u>Revenues</u>		<u>Operating Income</u>	
API	\$71,375	\$73,993	\$29,894	\$40,880
BP	41,878	29,512	3,036	1,827
IG	196,628	187,843	19,301	11,629
USG ⁽¹⁾	<u>288,408</u>	<u>202,966</u>	<u>22,377</u>	<u>(7,769)</u>
))
T o t a l H u m a n Pharmaceuticals	598,289	494,314	74,608	46,567
Animal Health	154,278	155,988	29,179	(8)

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Elimination of profit-sharing income ⁽¹⁾	--	(16,926)	--	(16,926)
Unallocated and other eliminations	(6,535)	(5,740)	(22,778)	(21,881)
))))
	\$746,032	\$627,636	\$81,009	\$7,752

14. Income Taxes

Deferred tax assets are evaluated quarterly to assess the likelihood of realization, which is ultimately dependent upon generating future taxable income prior to the expiration of the net operating loss carryforwards. The Company has recorded certain U.S. federal deferred tax assets for which it has provided a full valuation allowance as of December 31, 2004. In this assessment, factors such as current and previous U.S. operating losses are given substantially more weight than the outlook for future profitability. The full valuation allowance on the U.S. federal deferred tax assets was determined to be appropriate at December 31, 2004 due to a change in certain available tax planning strategies and continuing domestic losses. As a result of these changes and continuing domestic losses, the Company no longer considers it more likely than not that these net U.S. federal deferred tax assets will be realized in the future and therefore, a full valuation allowance was required at December 31, 2004. At June 30, 2005, the Company continues to believe a full valuation allowance is required. Should it be determined in the future that it is more likely than not that these assets will be realized, the valuation allowance would be removed against some or all of the deferred tax assets.

The requirement for a full valuation allowance on U.S. earnings has an effect on the effective tax rate applied to pre-tax income in interim periods. As required in FASB Interpretation No. 18 "Accounting for Income Taxes in Interim Periods", the Company has estimated the full year effective tax rate for international operations at 29.6% and will not provide Federal income benefits on full year pre-tax losses that are currently estimated for U.S. operations.

Income tax expense for the six months ended June 30, 2005, is comprised of the following elements:

	<u>U.S.</u>	<u>International</u>	<u>Total</u>
Pre-tax income	<u>\$3,856</u>	<u>\$51,265</u>	<u>\$55,121</u>
Estimated tax			
International		15,175	15,175
U.S Federal	--		--
U.S. State	<u>1,756</u>	<u> </u>	<u>1,756</u>

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	1,756	15,175	16,931
Effective rate	45.5%	29.6%	30.7%
Tax on \$147,000 dividend repatriation	<u>7,718</u>	<u>1,632</u>	<u>9,350</u>
Tax expense			<u>\$26,281</u>
% of Pre-tax income			<u>47.7%</u>

The consolidated effective tax rate of 30.7% for the six months ended June 30, 2005, (before taxes on dividend repatriation), will not necessarily be indicative of the full year effective tax rate, due to shifts in the mix of U.S. and international pre-tax income and losses.

The American Jobs Creation Act of 2004 (the "Act") was signed into law on October 22, 2004. The Act provides for a temporary incentive for U.S. corporations to repatriate accumulated income earned outside the U.S. by allowing an 85% dividend-received deduction for certain dividends from controlled foreign corporations. The Board of Directors approved a plan and the Company repatriated \$147,000 of cash in extraordinary dividends, as defined in the Act, during the first half of 2005. The tax impact of repatriating this \$147,000 was approximately \$9,350. Alpharma may adopt additional reinvestment plans under the Act and it currently estimates that it could increase the amount to be repatriated under the Act by up to \$288,000 (subject to Board of Directors approval) depending upon a number of factors, including the amount of foreign earnings and profits generated through 2005, but is subject to further U.S. Treasury guidance. The tax impact of repatriating this \$288,000 would be approximately \$18,500.

15. Contingent Liabilities and Litigation

The Company is involved in various legal proceedings, of a nature considered normal to its business. It is the Company's policy to accrue for amounts related to these legal matters if it is probable that a liability has been incurred and an amount is reasonably estimable.

In the opinion of the Company, although the outcome of any legal proceedings cannot be predicted with certainty, the ultimate liability of the Company in connection with the following legal proceedings (other than the gabapentin litigation discussed below) will not have a material adverse effect on the Company's financial position but could be material to the results of operations or cash flows in any one accounting period.

Regulatory Compliance

During 2001, the Company received a substantial notice of inspection observations ("483 Report") from the FDA at its USG facility in Baltimore. The 483 Report recorded observed deviations from cGMPs. This inspection resulted in an assertion by the FDA that the Company was not in compliance with a 1992 Consent Decree requiring general compliance with cGMPs. In July 2002, the FDA conducted a follow-up inspection to the 2001 inspection of the Baltimore facility and in August 2002 issued a re-inspection report. In response to the 2002 FDA report, the Company submitted a comprehensive corrective action plan to the FDA in October 2002. The FDA has received monthly updates on the plant's progress against its corrective action plan and has continued to monitor the program. The FDA performed another inspection of the Baltimore facility in February of 2004 and issued a 483 Report. While the number and scope of the comments declined significantly from the Report received in August 2002, the FDA continues to focus on the facility's need to complete its corrective action plan. The Company expects to continue upgrading plant procedures at the Baltimore facility in accordance with the October 2002 corrective action plan and will continue to

provide written monthly updates to the FDA. Representatives of the Company and the Baltimore facility met with Baltimore FDA in the fourth quarter of 2004 to discuss progress on the corrective action plan and to clarify expectations and deliverables. The Company anticipates it will be the subject of another inspection in 2005 at which time the Company will be expected to demonstrate substantial compliance with cGMPs. No assurance can be given as to the outcome of this anticipated inspection. In April 2005, the FDA conducted a pre-approval inspection at the Elizabeth site in connection with two of the Company's pending ANDAs. As a result of this inspection the FDA issued a 483 Report. The number and scope of the comments in the 483 Report declined from prior 483 Reports. Additionally, the FDA recommended both products for approval.

Between November 2002 and January 2003, the FDA conducted a routine general inspection at the Company's Elizabeth plant. As a result of this inspection, the Company received an FDA 483 Report in January 2003 that recorded observed deviations from cGMPs. The Company submitted a comprehensive response in February 2003 and is currently taking actions to address the observations made by the FDA, in accordance with the response. The FDA performed a follow-up inspection in late 2003 and issued another 483 Report in December 2003 indicating continued deficiencies in compliance with FDA regulations. Certain product recalls were included in the original corrective action plan and were completed in 2002 and 2003. The Company completed a significant portion of its corrective actions in 2004, with the remainder estimated for completion by June 2007, subject to FDA's final review and satisfaction with the actions taken. During September 2004, the FDA completed a re-inspection of the Elizabeth facility and issued a 483 Report. The number and scope of the comments declined significantly. The Company has submitted its response and has corrected the observations. Prior to the September 2004 inspection, the Company's pending requests for new product approvals involving manufacturing at the Elizabeth plant had been withheld. As a result of this inspection, the Company became eligible to obtain new product approvals at the Elizabeth site. In the fourth quarter of 2004 the FDA issued four new ANDA product approvals involving products to be manufactured at the Elizabeth facility.

The total cost and timing of both the Baltimore and Elizabeth corrective action plans are subject to change based upon results of future inspections performed by the respective Baltimore and New Jersey Districts of the FDA. To assist with the implementation of corrective actions at the Baltimore and Elizabeth facilities, the Company has added significant internal and external personnel (largely quality and laboratory personnel) at both sites.

In October 2004, the FDA conducted a general inspection at the Company's Skoyen, Norway API plant. As a result of this inspection, the Company received a 483 Report in October that recorded observed deviations from cGMPs. The Company responded to the FDA in November 2004, with follow-up reports in January, February and July 2005. In May 2005, the FDA informed the Company that the deficiencies found during the inspection had been addressed satisfactorily and the site was classified as acceptable.

In May 2005, the FDA conducted a general inspection at the Company's Copenhagen, Denmark API plant. As a result of this inspection, the Company received a 483 Report on May 6 that recorded observed deviations from cGMPs. The Company adequately responded to the FDA in May 2005 and as a result, the FDA classified the site as acceptable.

In July 2005, the Medicines and Healthcare products Regulatory Agency (MHRA) conducted a routine pharmacovigilance inspection at the Company's Barnstaple UK IGx plant. The MHRA's final report is pending, however, it identified several major deviations from MHRA and European Union (EU) standards. The Company anticipates a final report within the next two months and will respond to the MHRA at that time. The effect, if any, of the MHRA inspection on the regulatory status of the Barnstaple site or the products manufactured at this site will not be known until the MHRA reacts to the Company's response to the MHRA's final report.

In response to the Company's submission to the FDA of its ANDAs filed under paragraph IV for gabapentin capsules and tablets, the Company was sued on June 11, 1998 with respect to capsules and on December 12, 1999 with respect to tablets, by Warner-Lambert Company, which is now owned by Pfizer Inc., in the U.S. District Court for the District of New Jersey for alleged patent infringement under two U.S. patents. The ANDAs submitted seek FDA approval to market the Company's gabapentin capsules and tablets prior to the expiration of Pfizer's patents. In the Company's ANDAs, the Company certified to Pfizer and to the FDA that its proposed generic gabapentin capsules and tablets will not infringe the patents and that the patents are believed to be invalid or unenforceable. The Company filed a motion for summary judgment in both the tablet and capsule litigations claiming non-infringement with respect to both Pfizer's patents. These motions have been decided in the Company's favor by the District Court.

During the initial lawsuits regarding gabapentin tablets and capsules, Pfizer received a third patent covering a gabapentin formulation with low chloride levels. After learning of this patent, the Company certified to the FDA under paragraph IV that the Company's proposed gabapentin capsule and tablet, as disclosed in its previously filed ANDAs, do not infringe this patent and this patent is invalid or unenforceable. In June 2000, Pfizer sued the Company in the U.S. District Court for the District of New Jersey for patent infringement under this third patent. The Company submitted to the court a motion for summary judgment that neither the capsule nor tablet product infringes this patent. This motion is under consideration by the Court and has not yet been ruled on. No trial date has been set for the gabapentin cases relating to the third patent.

In 2003, the Company received confirmation from the FDA that it has secured eligibility for 180-day market exclusivity on gabapentin 100 mg, 300 mg and 400 mg capsules. Exclusivity for this product was triggered in October 2004 for capsules and December 2004 for tablets when Purepac commenced commercial marketing of these gabapentin dosage forms. Concurrently with the Company's launch of gabapentin capsules and tablets, Pfizer launched its authorized gabapentin generic capsules and tablets. In April 2004, the Company entered into agreements with Teva Pharmaceutical Industries Ltd. ("Teva") which provided for Teva to share a portion of the Company's potential patent litigation risks regarding the launch of gabapentin and permit Teva to launch gabapentin (in addition to Alpharma's ability to launch), within the Company's exclusivity period. The agreement provides for certain payments to the Company (estimated to be approximately \$64,000 at June 30, 2005) based on Teva's net sales during the exclusivity period.

Based upon the Company's launch of its gabapentin product prior to a final decision in the Pfizer patent infringement litigation, there is the possibility that the Company may be liable for monetary damages if the Company is ultimately found to infringe the patent. Such damages could include profits allegedly lost by Pfizer as a result of the Company's entry into the gabapentin market. An award to Pfizer on the theory of lost profits would be material to the Company, even after considering the value of the Teva risk sharing contained in the above-described April 2004 agreement.

On September 15, 2004, Ivax Pharmaceuticals ("Ivax") filed a lawsuit against the FDA in the U.S. District Court for the District of Columbia seeking final approval for its gabapentin capsules ANDA and its gabapentin tablets ANDA. The Company intervened in this matter to protect its interests. On September 17, 2004, the District Court ruled against Ivax's request for final product approval, effectively keeping intact the Company's entitlement to exclusivity on both the gabapentin capsule and tablet products. On September 21, 2004, Ivax appealed the case. Before the appeal was decided, on February 10, 2005, the Company entered into a Settlement Agreement pursuant to which Ivax agreed to dismiss its litigation. In return, the Company agreed to selectively waive its exclusivity for gabapentin capsules and tablets effective as of March 23, 2005 and April 29, 2005, respectively. As a result, Ivax was eligible to receive final FDA approval for its gabapentin capsule and tablet products on such dates and, if received, would be permitted to enter into the gabapentin capsule and tablet markets on those dates, prior to the lapse of the Company's first-to-file exclusivity period. On March 23, 2005, Ivax received final FDA approval for its gabapentin capsules and immediately launched the product and on May 2 2005, Ivax launched its gabapentin tablet products.

From time to time, the Company may engage in other "at-risk" launches, where the Company has not at present been, but may be sued by the brand name drug manufacturer company for alleged patent infringement. In the United States and in certain other countries, such lawsuits could seek lost profit damages which, if recovered, could be material to the Company.

SEC Investigation

In June 2002, the SEC notified the Company that it had commenced a formal investigation of the circumstances surrounding the 2000 and 2001 restatements of its financial statements. Deposition and document discovery is underway.

Serious Fraud Office Investigation

In June 2003, the Company received a request for certain information from the United Kingdom Office of Serious Fraud. The Serious Fraud Office ("SFO") requested documents related to the Company's dealings with several of its competitors with respect to activities in certain specified antibiotic drugs and warfarin during the late 1990s. The Company has received further requests for information and has responded to these requests. Additionally, a number of former and existing employees of the Company have been interviewed. The Company has been informed by the SFO that it has initiated a criminal investigation of possible violation of laws by the Company and two of its former UK executives. If the Company is found guilty it could be subject to a fine in an amount not limited by statute.

Medicaid Litigation

Nevada, Alabama, Florida, Illinois, Massachusetts, Kentucky and over 20 local jurisdictions have begun investigations of or commenced litigation against the Company, along with other pharmaceutical manufacturers and distributors, based upon allegations that fraudulent Average Wholesale Prices were reported for varying numbers of years and products under governmental Medicaid reimbursement programs. Such lawsuits vary somewhat in the damages alleged but generally seek statutory and civil penalties, including in certain lawsuits disgorgement of profits and treble damages from each defendant as may be determined at trial. Currently no litigation has proceeded beyond the discovery stage.

Perrigo Agreement Litigation

The Federal Trade Commission, in conjunction with various State Attorneys General, completed a formal investigation of the facts and circumstances surrounding a 1998 agreement with Perrigo Inc. under which the Company inter alia: (i) renounced its 180 day Hatch-Waxman marketing exclusivity for a certain product and (ii) granted a license under a patent related to the product in return for royalty payments from Perrigo. In 2004, the Company entered into a settlement with the FTC and the States whereby the Company agreed to pay \$2,500 to the FTC and \$750,000 to the States. Five private lawsuits alleging antitrust, unfair competition and restraint of trade have been filed against the Company in connection with this matter - two in the District of Columbia and three in California. The cases in each jurisdiction have been consolidated. The plaintiffs are seeking treble damages in response to the claims. The Company is in the process of responding to the claims made in the lawsuits.

Chicken Litter Litigation

The Company has been named in a lawsuit which alleges that one of its AH products causes chickens to produce manure that contains arsenic which when used as agricultural fertilizer by chicken farmers, causes a variety of diseases in the plaintiffs (who allegedly live in close proximity to such farm fields). The Company has filed a claim with its insurance carrier and the carrier has responded by reserving its rights to later reject such claim. In addition to the potential for personal injury damages to the plaintiffs, there is the possibility of an adverse customer reaction to the allegations in the lawsuit. The plaintiffs are also requesting that the Company be enjoined from the future sale of

the product at issue. The Company is in the initial stages of discovery and intends to vigorously defend against these allegations. Worldwide sales of this product were approximately \$24,000 in 2003, \$23,300 in 2004 and \$10,800 in the first two quarters of 2005.

Brazilian Tax Claims

The Company is the subject of several tax claims by the Brazilian authorities relating to the operations of the Company's Animal Health business in Brazil since 1999. During the second quarter of 2005, one claim was dismissed on summary judgment, with no right of appeal, reducing the outstanding aggregate claims to \$7,600. The Company believes it has meritorious defenses and intends to vigorously defend its position against these claims.

Other Commercial Disputes

The Company is engaged in disputes with several suppliers, customers and distributors regarding certain obligations with respect to contracts under which the Company obtains raw materials and under which the Company supplies finished products. Given the fact that these disputes will most probably be resolved over more than one year, management does not believe that the disputes in the aggregate will be material to the Company's financial position. However, they could be material to the Company's results of operations or cash flows in the period in which resolution occurs.

In July 2004, the Company settled outstanding litigation with a contract manufacturer who had supplied product to the Company in prior years and received a \$5,300 settlement payment.

Other Litigations

The Company and its subsidiaries are, from time to time, involved in other litigation arising out of the ordinary course of business. It is the view of management, after consultation with counsel, that the ultimate resolution of all other pending suits on an individual basis should not have a material adverse effect on the consolidated financial position results of operations of the Company or cash flows of the Company.

16. Guarantor and Financial Information

The following financial information is presented to segregate the parent and certain of its wholly-owned subsidiaries which are guarantors under the Senior Unsecured Notes due 2011 from non-guarantor subsidiaries. The guarantors will jointly and severally, and fully and unconditionally, guarantee the Company's obligation under the Notes. The consolidating financial information presents the Consolidating Balance Sheet as of June 30, 2005 and December 31, 2004 and the related Statements of Operations and Cash Flows for the six months ended June 30, 2005 and 2004 for:

- Alparma Inc., the parent;
- The guarantor subsidiaries;
- The nonguarantor subsidiaries; and
- The Company on a consolidated basis.

The information includes elimination entries necessary to consolidate Alparma Inc., the parent, with guarantor and nonguarantor subsidiaries.

Investments in subsidiaries are accounted for by the parent using the equity method of accounting. The guarantor and nonguarantor subsidiaries are presented on a combined basis. The principal elimination entries eliminate investments in subsidiaries and intercompany balances and transactions.

Separate financial statements for the guarantor subsidiaries and the nonguarantor subsidiaries are not presented because management believes that such financial statements would not be meaningful to investors.

ALPHARMA INC.
Consolidating Balance Sheet
As of June 30, 2005
(in thousands)

	<u>Parent</u>	<u>Guarantor Subsidiaries</u>	<u>Nonguarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated Total</u>
Current assets:					
Cash and cash equivalents	\$18,572	\$1,722	\$30,395	\$ --	\$50,689
Accounts receivable, net	32,756	83,064	92,450	--	208,270
Inventories	41,156	83,209	121,012	(6,492)	238,885
Prepaid expenses and other	22,027	(12,679)	10,573	1,544	21,465
Intercompany receivables	<u>1,334,798</u>	<u>2,007,133</u>	<u>1,068,880</u>	<u>(4,410,811)</u>	--
Total current assets	1,449,309	2,162,449	1,323,310	(4,415,759)	519,309
Property, plant & equipment, net	108,037	131,908	188,390	--	428,335

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Goodwill	4,257	140,447	305,936	(2,002)	448,638
Intangible assets, net	39,176	150,302	99,564	--	289,042
Investment in subsidiaries	101,320	385,072	--	(486,392)	--
Other assets and deferred charges	<u>26,042</u>	<u>34</u>	<u>43,327</u>	<u>--</u>	<u>69,403</u>
Total assets	<u>\$1,728,141</u>	<u>\$2,970,212</u>	<u>\$1,960,527</u>	<u>\$(4,904,153)</u>	<u>\$1,754,727</u>

Current liabilities:

Short term debt	\$ --	\$ --	\$ 256	\$ --	\$ 256
Long term debt, current portion	157,373	10,756	--	--	168,129
Accounts payable and accrued expenses	56,556	119,283	96,216	(651)	271,404
Accrued and deferred income taxes	(224)	26,194	24,486	(1,051)	49,405
Intercompany payables	<u>491,575</u>	<u>2,843,417</u>	<u>1,075,819</u>	<u>(4,410,811)</u>	<u>--</u>
Total current liabilities	705,280	2,999,650	1,196,777	(4,412,513)	489,194
Long term debt:					
	220,000	143,366	--	--	363,366

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Senior					
Convertible subordinated notes	--	--	--	--	--
Deferred income taxes	(39,790)	40,706	32,337	--	33,253
Other non-current liabilities	6,163	347	25,916	--	32,426
Stockholders' equity:					
Preferred stock	--	--	--	--	--
Class A Common Stock	8,375	--	--	--	8,375
Class B Common Stock	2,375	--	--	--	2,375
Additional paid-in-capital	1,081,348	12,347	496,608	(508,955)	1,081,348
Deferred stock cost	(10,230)	--	--	--	(10,230)
Retained earnings	(323,341)	(226,204)	140,613	85,591	(323,341)
Accumulated other comprehensive loss	85,605	--	68,276	(68,276)	85,605
Treasury stock, at cost	<u>(7,644)</u>	=	=	=	<u>(7,644)</u>

				<u>(491,640)</u>	
Total stockholders' equity	<u>836,488</u>	<u>(213,857)</u>	<u>705,497</u>)	<u>836,488</u>
Total liabilities & stockholders' equity	<u>\$1,728,141</u>	<u>\$2,970,212</u>	<u>\$1,960,527</u>	<u>\$(4,904,153)</u>	<u>\$1,754,727</u>

ALPHARMA INC.
Consolidating Balance Sheet
As of December 31, 2004
(in thousands)

	<u>Parent</u>	<u>Guarantor Subsidiaries</u>	<u>Nonguarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated Total</u>
Current assets:					
Cash and cash equivalents	\$1,614	\$774	\$102,824	\$ --	\$105,212
Accounts receivable, net	32,851	97,588	96,152	--	226,591
Inventories	51,997	133,994	134,732	(10,719)	310,004
Prepaid expenses and other	33,239	(13,414)	7,677	2,763	30,265
Intercompany receivables	<u>1,972,659</u>	<u>700,973</u>	<u>1,193,641</u>	<u>(3,867,273)</u>	<u>--</u>
Total current assets	2,092,360	919,915	1,535,026	(3,875,229)	672,072
Property, plant & equipment, net	112,353	137,035	207,908	--	457,296
Goodwill	4,475	141,262	335,104	(2,220)	478,621
Intangible assets, net	40,960	159,487	110,271	--	310,718

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Investment in subsidiaries	112,319	534,611	--	(646,930)	--
	<u>30,528</u>	<u>531</u>	<u>54,076</u>	<u>--</u>	<u>85,135</u>
Other assets and deferred charges					
	<u>\$2,392,995</u>	<u>\$1,892,841</u>	<u>\$2,242,385</u>	<u>\$(4,524,379)</u>	<u>\$2,003,842</u>
Total assets					
Current liabilities:					
	\$ --	\$16,000	\$ 96	\$ --	\$16,096
Short term debt					
	373,670	301,969	--	--	675,639
Long term debt, current portion					
Accounts payable and accrued expenses	60,387	138,831	103,373	2,430	305,021
Accrued and deferred income taxes	6,248	11,918	25,484	--	43,650
	<u>1,092,428</u>	<u>1,603,303</u>	<u>1,171,542</u>	<u>(3,867,273)</u>	<u>--</u>
Intercompany payables					
	1,532,733	2,072,021	1,300,495	(3,864,843)	1,040,406
Total current liabilities					
Long term debt:					
	--	--	--	--	--
Senior					
	10,000	--	--	--	10,000
Convertible subordinated notes					
	(39,790)	40,705	33,770	--	34,685
Deferred income taxes					
	6,410	484	28,215	--	35,109
Other non-current liabilities					
Stockholders' equity:					
	8,256	--	--	--	8,256
Class A Common Stock					
	2,375	--	--	--	2,375
Class B Common Stock					
	1,073,921	12,347	490,547	(502,894)	1,073,921
Additional paid-in-capital					
	(7,443)	--	--	--	(7,443)
Deferred stock cost					

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Retained earnings	(347,425)	(232,716)	246,104	(13,388)	(347,425)
	161,602	--	143,254	(143,254)	161,602
Accumulated other comprehensive loss					
	<u>(7,644)</u>	=	=	=	<u>(7,644)</u>
Treasury stock, at cost					
))	
	<u>883,642</u>	<u>(220,369)</u>	<u>879,905</u>	<u>(659,536)</u>	<u>883,642</u>
Total stockholders' equity)		
Total liabilities & stockholders' equity	<u>\$2,392,995</u>	<u>\$1,892,841</u>	<u>\$2,242,385</u>	<u>\$(4,524,379)</u>	<u>\$2,003,842</u>

ALPHARMA INC.
Consolidating Statement of Income
For the Six Months Ended June 30, 2005
(in thousands)

	<u>Parent</u>	<u>Guarantor Subsidiaries</u>	<u>Nonguarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated Total</u>
Total revenue	\$174,316	\$325,114	\$308,481	\$(61,879)	\$746,032
Cost of sales	<u>115,254</u>	<u>206,315</u>	<u>169,749</u>	<u>(61,879)</u>	<u>429,439</u>
Gross profit	59,062	118,799	138,732	--	316,593
Operating expenses	<u>53,829</u>	<u>92,644</u>	<u>89,111</u>	--	<u>235,584</u>
Operating income (loss)	5,233	26,155	49,621	--	81,009
Interest expense - 3rd parties	(18,456)	(7,543)	(233)	--	(26,232)

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Other income (expense), net	(4,046)	2,443	1,947	--	344
Equity in earnings of subsidiaries	<u>46,228</u>	<u>39,450</u>	<u>--</u>	<u>(85,678)</u>	<u>--</u>
Income (loss) before taxes	28,959	60,505	51,335	(85,678)	55,121
Provision (benefit) for income taxes	<u>119</u>	<u>14,277</u>	<u>11,885</u>	<u>--</u>	<u>26,281</u>
Net income (loss)	<u>\$28,840</u>	<u>\$46,228</u>	<u>\$39,450</u>	<u>\$(85,678)</u>	<u>\$28,840</u>

ALPHARMA INC.
Consolidating Statement of Income
For the Six Months Ended June 30, 2004
(in thousands)

	<u>Parent</u>	<u>Guarantor Subsidiaries</u>	<u>Nonguarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated Total</u>
Total revenue	\$162,984	\$230,377	\$307,387	\$(73,112)	\$627,636
				<u>(73,112)</u>	
Cost of sales	<u>113,793</u>	<u>169,447</u>	<u>171,241</u>)	<u>381,369</u>
Gross profit	49,191	60,930	136,146	--	246,267
Operating expenses	<u>46,962</u>	<u>86,976</u>	<u>104,577</u>	<u>--</u>	<u>238,515</u>
	2,229	(26,046)	31,569	--	7,752

Operating
income

Interest expense - 3rd parties	(18,073)	(9,724)	(1,330)	--	(29,127)
Other income (expense), net	(2,472)	20,405	(8)	--	17,925
				<u>(38,750)</u>	
Equity in earnings of subsidiaries	<u>15,868</u>	<u>22,882</u>	=)		=
Income (loss) before taxes	(2,448)	7,517	30,231	(38,750)	(3,450)
		<u>(8,351)</u>			<u>(903)</u>
Provision (benefit) for income taxes	<u>99</u>)		<u>7,349</u>	=)	
Net Income (loss)	<u>\$(2,547)</u>	<u>\$15,868</u>	<u>\$22,882</u>	<u>\$(38,750)</u>	<u>\$(2,547)</u>

Alpharma Inc.
Consolidating Statement of Cash Flows
For the Six Months Ended June 30, 2005

(In thousands of dollars)

	<u>Parent</u>	<u>Guarantor</u>	<u>Non-Guarantor</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net cash provided by (used in) operating activities	<u>\$27,178</u>	<u>\$180,411</u>	<u>\$(55,958)</u>	<u>\$ --</u>	<u>\$151,631</u>
Investing Activities					
Capital expenditures	(1,449)	(3,521)	(11,440)	--	(16,410)
	(976)	--	(564)	--	(1,540)

Purchase of businesses &
intangibles, net of cash
required

Proceeds from sale of
Wynco

== == == == ==

Net cash used in
investing activities

(2,425) (3,521) (12,004) -- (17,950)

Financing Activities:

Increase (decrease) in
short-term debt

-- (16,000) 201 -- (15,799)

Reduction of senior
long-term debt

(9,867) (147,847) -- -- (157,714)

Proceeds from senior
long-term debt

Proceeds from employee
stock option
and stock purchase plan
and other

2,565 -- -- -- 2,565

Increase (decrease) in
book overdraft

70 (7,902) -- -- (7,832)

Change in intercompany
dividends &
investment in
subsidiaries

4,193 (4,193) -- -- --

Dividends paid

(4,756) == == == (4,756)

Net cash provided by
(used in)
financing activities

(7,795) (175,942) 201 -- (183,536)

Net cash flows from
exchange rate
changes

-- -- (4,668) -- (4,668)

Increase (decrease) in cash

16,958 948 (72,429) -- (54,523)

Cash and cash equivalents at
beginning of
year

1,614 774 102,824 == 105,212

\$18,572 \$1,722 \$30,395 \$ -- \$50,689

Cash and cash equivalents at
end of period

Alpharma Inc.
Consolidating Statement of Cash Flows
For the Six Months Ended June 30, 2004

(In thousands of dollars)

	<u>Parent</u>	<u>Guarantor</u>	<u>Non-Guarantor</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net cash provided by (used in) operating activities	<u>\$28,238</u>	<u>\$26,146</u>	<u>\$16,754</u>	<u>\$--</u>	<u>\$71,138</u>
Investing Activities					
Capital expenditures	(1,230)	(5,996)	(11,491)	--	(18,717)
Purchase of businesses & intangibles, net of cash required	--	(12,857)	(549)	--	(13,406)
Proceeds from sale of Wynco	--	<u>17,000</u>	--	--	<u>17,000</u>
Net cash used in investing activities	<u>(1,230)</u>	<u>(1,853)</u>	<u>(12,040)</u>	--	<u>(15,123)</u>
)))))
Financing Activities:					
Increase (decrease) in short-term debt	--	10,500	114	--	10,614
Reduction of senior long-term debt	--	(86,262)	(32,520)	--	(118,782)
Proceeds from senior long-term debt	--	50,000	--	--	50,000

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Proceeds from employee stock option and stock purchase plan and other	3,342	111	--	--	3,453
Increase (decrease) in book overdraft	539	1,649	--	--	2,188
Reduction of convertible debt	(24,455)	--	--	--	(24,455)
Payment of debt issuance costs	(1,009)	--	--	--	(1,009)
Change in intercompany dividends & investment in subsidiaries	4,216	(4,216)	--	--	--
Dividends paid	<u>(4,717)</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>(4,717)</u>
))	
Net cash (used in) financing activities	(22,084)	(28,218)	(32,406)	--	(82,708)
Net cash flows from exchange rate changes	--	44	(860)	--	(816)
Increase (decrease) in cash	4,924	(3,881)	(28,552)	--	(27,509)
Cash and cash equivalents at beginning of year	<u>(3,372)</u>	<u>5,105</u>	<u>56,890</u>	<u>--</u>	<u>58,623</u>
Cash and cash equivalents at end of period	<u>\$ 1,552</u>	<u>\$ 1,224</u>	<u>\$28,338</u>	<u>\$ --</u>	<u>\$31,114</u>

17. Recent Accounting Pronouncements

In December 2004, the FASB revised its SFAS No. 123 ("SFAS No. 123R"), "Accounting for Stock-Based Compensation." The revision establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services, particularly transactions in which an entity obtains employee services in share-based payment transactions. The revised statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost is to be recognized over the period during which the

employee is required to provide service in exchange for the award. Changes in fair value during the requisite service period are to be recognized as compensation cost over that period. The provisions of the revised statement are effective for financial statements issued for the first fiscal year beginning after June 15, 2005. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The Company is evaluating the requirements of SFAS 123R and expects that the adoption of SFAS 123R will have a material impact on the Company's consolidated results of operations and earnings per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and it has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

In November 2004, the FASB issued FASB Statement No. 151, "Inventory Costs". Statement 151 amends the guidance in ARB No. 43, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). ARB 43 previously stated that under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges. This statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal." In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. Statement 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, with early application permitted. The Company is currently evaluating the effects of Statement 151 may have on its financial statements.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions" ("SFAS 153"). SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, "Accounting for Nonmonetary Transactions," and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for the fiscal periods beginning after June 15, 2005 and application is prospective. The Company is currently evaluating the effect that the adoption of SFAS 153 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

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

(In millions, except per share data)

2004 Divestitures

In January 2004, the Company purchased the outstanding 50% interest in its joint venture, Wynco, LLC, ("Wynco"), an Animal Health distribution company, for \$11.0 million. The Company has included the results of operations of Wynco in its Statement of Operations until March 30, 2004, when it was sold for

approximately \$17.0 million. The sale resulted in a loss of approximately \$1.3 million. Wynco's revenues for the first quarter of 2004 were \$19.2 million, gross profit was \$3.2 million, operating expenses were \$3.3 million and operating losses were (\$0.1) million.

In July 2004, the Company announced that it completed the sale of the Aquatic Animal Health operations ("Aquatic") of its Animal Health business to an employee group. The Aquatic operations, which are headquartered in Oslo, Norway, manufacture and market vaccines primarily for use in immunizing farmed fish worldwide. The sales price was approximately \$4.4 million and was based on the working capital of the Aquatic business. The Company recorded a pre-tax non-cash loss of \$9.5 million (diluted loss per share of \$0.13) in the second quarter of 2004 to record the impairment of the Aquatic carrying value. In the third quarter, the loss was increased by \$0.5 million (diluted loss per share of \$0.14 in total) to reflect a pension curtailment loss related to the Aquatic employees. Aquatic operations included in the Animal Health segment for the three and six months ended June 30, 2004, are summarized as follows:

(\$ in millions)	Three Months Ended June 30, <u>2004</u>	Six Months Ended June 30, <u>2004</u>
Revenues	\$ 3.0	\$5.8
Operating income (loss) including impairment	\$(10.9)	\$(11.6)

The operations of Aquatic and Wynco were not classified as discontinued operations, as the Company has significant continuing involvement with both divested companies.

Results of Continuing Operations - Six months ended June 30, 2005

Total revenue increased \$118.4 million (19%) for the six months ended June 30, 2005 compared to 2004. Foreign exchange increased revenues by approximately \$10.0 million (2%) and the inclusion of Wynco and Aquatics, increased 2004 revenues by approximately \$25.0 million. Excluding foreign exchange and the inclusion of Wynco and Aquatic results, revenues increased approximately 22%. Operating income was \$81.0 million in 2005 compared to \$7.8 million in 2004. Diluted earnings (loss) per share was \$0.55 in 2005 compared to a (\$0.05) in 2004.

The following summarizes revenues and operating income by segment:

Six Months Ended June 30,	Revenues		Operating Income (loss)	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Active Pharmaceutical Ingredients ("API")	\$71.4	\$74.0	\$29.9	\$40.9
Branded Pharmaceuticals ("BP")	41.9	29.5	3.0	1.8

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International Generics ("IG")	196.6	187.8	19.3	11.6
US Generics ("USG") ⁽¹⁾	<u>288.4</u>	<u>203.0</u>	<u>22.4</u>	<u>(7.8)</u>
Total Human Pharmaceuticals	598.3	494.3	74.6	46.5
Animal Health (AH) - base	154.3	131.0	29.2	11.7
Wynco and Aquatics	=	<u>25.0</u>	=	<u>(11.7)</u>
Total AH	154.3	156.0	29.2	--
Profit sharing income ⁽¹⁾	--	(16.9)	--	(16.9)
Unallocated and Eliminations)	<u>(6.6)</u>	<u>(5.8)</u>	<u>(22.8)</u>	<u>(21.8)</u>
Total	<u>\$746.0</u>	<u>\$627.6</u>	<u>\$81.0</u>	<u>\$ 7.8</u>

(1) In 2004, profit sharing income of \$16.9 million is included in USG segment revenues and operating income and is classified as other income in the Consolidated Statement of Operations.

Revenues

Revenues in API decreased \$2.6 million (4%) mainly as a result of price decreases on selected products in the U.S., offset by increased volume. Translation of revenues into the U.S. dollar increased API revenues by 1%.

BP revenues increased \$12.4 million (42%) relative to 2004 due primarily to increased volume. Sales force expansions mainly contributed to the increase.

IG revenues increased \$8.8 million (5%) due primarily to the impact of translating revenues into the U.S. dollar (\$7.6 million). Excluding currency impacts, revenues increased 1% primarily due to new product launches, offset by lower revenues due to price.

Revenues of USG products increased \$85.4 million due primarily to gabapentin sales, offset by volume and price declines of other products and the absence of metformin ER profit sharing revenues in 2005. In the fourth quarter 2004, USG launched gabapentin capsules and tablets pursuant to the Company's exclusivity granted under the Hatch-Waxman Act and has recorded revenues of \$118.3 million related to this product in the first half of 2005. The Company's exclusivity on gabapentin capsules ended in April 2005 and in June 2005 for tablets. In April 2005, a number of new competitors launched gabapentin products and prices declined. Sales of the Company's gabapentin

capsules and tablets are at lower prices and volumes than was recorded during the exclusivity period. USG revenues in the first half of 2004 include approximately \$16.9 million earned as a result of a profit sharing agreement on the launch of metformin ER in the fourth quarter of 2003. Such income is recorded as revenues for USG segment reporting purposes but is reclassified as other income in the Consolidated Statement of Operations.

As is customary in the industry, USG shipments to wholesale customers include price incentives. These incentives are offered reflecting the competitive nature of the markets, and prior to the fourth quarter of 2004, reflecting the Company's inability to supply new products to its wholesale customers as it resolves its FDA issues. The Company monitors its sales to wholesale customers to ensure that wholesale inventory levels are maintained at levels appropriate to satisfy market demand.

Inventories of generic products at certain wholesale customers generally range from 1 to 2 months supply, although some products exceed the range. Wholesale inventory levels have been reduced, beginning in the second half of 2004, as the Company limited incentives offered to wholesalers with the result that sales to wholesalers, except for the gabapentin product, were reduced. The information regarding inventory levels within the channel is derived from inventory management reports obtained at a cost from major wholesalers. This information is critical to estimates of deductions from gross revenues to reported net revenues.

Animal Health revenues, excluding Wynco and Aquatic revenues, increased \$23.3 million (18%) due primarily to increased sales in U.S. livestock and poultry markets (10%) and in the , European markets (3%), with the majority of plants operating at or near capacity, in addition to the impact of foreign exchange, 1%.

Gross Profit

On a Company-wide basis gross profit increased \$70.3 million in 2005 compared to 2004. As a percentage of sales, overall gross profit was 42.4% in 2005, versus 39.2% in 2004.

The increase in gross margin dollars results primarily from gabapentin sales in USG, and volume increases in BP and AH, offset partially by the USG profit sharing income in 2004 and pricing decreases in API.

Operating Expenses

On a consolidated basis, selling, general and administrative expenses increased \$3.2 million (2%) in 2005 as compared to 2004. Included in 2004, are Wynco and Aquatic expenses (\$3.3 million and \$2.8 million, respectively), and severance costs in 2004 of \$5.8 million, of which \$0.1 was incurred by API, \$1.3 million by BP, \$1.8 million by IG, \$0.5 million by USG, \$0.1 million by AH and \$2.0 million by Corporate. 2005 had severance charges totaling \$1.3 million, of which \$0.7 million was incurred by IG and \$0.6 million by API. Excluding these costs, selling, general and administrative expenses increased \$13.8 million due primarily to marketing campaigns and sales force expansions within BP (\$10.5 million).

Research and development expenses increased \$2.6 million in 2005 due primarily to a \$5.0 million product development fee paid under an agreement with an Indian pharmaceutical company, offset by decreases due to the timing of spending in USG.

Based upon the year-end FAS 142 Step II valuation work performed, the Company recorded an estimated goodwill impairment loss of \$260,000 as of December 31, 2004 related to its USG segment. This amount represented the Company's best estimate of the impairment loss as of December 31, 2004. The Company and its independent valuation firm completed the FAS 142 Step II valuation in May 2005. As a result, the Company recorded an adjustment of \$815 in the first half of 2005, increasing the total impairment charge to \$260,815.

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perating Income

Operating income increased by \$73.3 million. The Company believes the change in operating income can be approximated as follows:

	<u>API</u>	<u>BP</u>	<u>IG</u>	<u>USG</u>	<u>AH</u>	<u>Unal- located</u>	<u>Total</u>
2004 as reported	\$40.9	\$1.8	\$11.6	\$(7.8)	\$ --	\$(38.7)	\$7.8
2004 severance	0.1	1.3	1.8	0.5	0.1	2.0	5.8
2004 Metformin ER profit sharing agreement	--	--	--	(16.9)	--	16.9	--
Brand sales force and marketing program expansions	--	(10.5)	--	--	--	--	(10.5)
Goodwill impairment adjustment	--	--	--	(0.8)	--	--	(0.8)
Aquatic loss - 2004	--	--	--	--	9.5	--	9.5
Gabapentin sales	--	--	--	50.3	--	--	50.3
Research and development	(1.5)	(1.1)	--	(1.9)	2.3	(0.4)	(2.6)
Net margin improvement (decrease) due to volume, price, new products, foreign exchange and expenses	<u>(9.6)</u>	<u>11.5</u>	<u>5.9</u>	<u>(1.0)</u>	<u>17.3</u>	<u>(2.6)</u>	<u>21.5</u>
2005 as reported	<u>\$29.9</u>	<u>\$3.0</u>	<u>\$19.3</u>	<u>\$22.4</u>	<u>\$29.2</u>	<u>\$(22.8)</u>	<u>\$81.0</u>

The increase in net margin improvement is primarily attributed to improved operating performance by

the AH, BP and IG segments.

Interest Expense and Amortization of Debt Issuance Costs

Interest expense and amortization of debt issuance costs decreased \$2.9 million to \$26.2 million in 2005 due to decreased debt levels, and lower amortization of debt issuance costs, offset by higher interest rates and greater liquidated damages versus a year ago.

Loss on Extinguishment of Debt

The six months ended June 30, 2005 results include \$1.9 million of expense associated with the write-off of deferred loan costs compared with \$2.8 million of expense in first half 2004 results. In 2005 the Company prepaid \$115 million of bank term debt. In 2004, the Company prepaid \$75 million of bank term debt and \$32 million of mortgage notes payable and repaid \$24.5 million of the 5.75% Convertible Notes.

Other, Net

Other income (expense) netted to \$2.2 million in 2005 compared to \$20.7 million in 2004. First half 2005 includes interest income of \$1.6 million and \$1.0 million of income from a litigation settlement, offset by foreign exchange losses of \$0.7 million. First half 2004 includes \$16.9 million of income from a USG Metformin ER profit sharing agreement and income totaling \$6.0 million from the sale of a product license and an ANDA. A detail of Other income (expense) follows:

	Six Months Ended	
	June 30, <u>2005</u>	June 30, <u>2004</u>
Other income (expense), net:		
Interest income	\$1.6	\$ 0.9
Foreign exchange gains (losses), net	(0.7)	(0.5)
Loss on sale of Wynco	--	(1.5)
Litigation settlement	1.0	--
Metformin ER Profit Sharing Agreement	--	16.9
Sale of product license and ANDA	--	6.0
Other, net	<u>0.3</u>	<u>(1.1)</u>

)

\$2.2\$20.7**Tax Provision**

Deferred tax assets are evaluated quarterly to assess the likelihood of realization, which is ultimately dependent upon generating future taxable income prior to the expiration of the net operating loss carryforwards. The Company has recorded certain U.S. deferred tax assets for which it has provided a full valuation allowance as of December 31, 2004. In this assessment, factors such as current and previous U.S. operating losses are given substantially more weight than the outlook for future profitability. The full valuation allowance on the U.S. deferred tax assets was determined to be appropriate at December 31, 2004 due to a change in certain available tax planning strategies and continued U.S. losses. As a result, the Company no longer considers it more likely than not that these net U.S. deferred tax assets will be realized in the future and therefore, a full valuation allowance was required at December 31, 2004. At June 30, 2005, the Company continues to believe a full valuation allowance is required. Should it be determined in the future that it is more likely than not that these assets will be realized, the valuation allowance would be removed against some or all of the deferred tax assets.

The requirement for a full valuation allowance on U.S. earnings has an effect on the effective tax rate applied to pre-tax income in interim periods. As required in FASB Interpretation No. 18 "Accounting for Income Taxes in Interim Periods", the Company has estimated the full year effective tax rate for international operations at 29.6% and will not provide Federal income tax benefits on full year pre-tax losses that are currently estimated for U.S. operations.

Income tax expense for the six months ended June 30, 2005, is comprised of the following elements:

	<u>U.S.</u>	<u>International</u>	<u>Total</u>
Pre-tax income	<u>\$3.856</u>	<u>\$51.265</u>	<u>\$55.121</u>
Estimated tax			
International		15.175	15.175
U.S.Federal	--		--
U.S. State	<u>1.756</u>	<u>—</u>	<u>1.756</u>
	1.756	15.175	16.931
Effective rate	45.5%	29.6%	30.7%
Tax on \$147.0 million dividend repatriation	<u>7.718</u>	<u>1.632</u>	<u>9.350</u>

Tax expense	<u>\$26.281</u>
% of Pre-tax income	<u>47.7%</u>

Results of Continuing Operations - Three months ended June 30, 2005

Total revenue increased \$51.9 million (16%) for the quarter ended June 30, 2005 compared to 2004. In comparison to 2004, foreign exchange increased 2005 revenues by approximately \$5.2 million (2%) and the inclusion of second quarter sales of Aquatics, increased 2004 revenues by approximately \$3.0 million. Excluding foreign exchange and the inclusion of Aquatic results, revenues increased 16%. Operating income was \$40.2 million in 2005 compared to \$4.4 million in 2004. Diluted earnings (loss) per share was \$0.38 in 2005 compared to a \$0.01 in 2004.

The following summarizes revenues and operating income by segment:

Three Months Ended June 30,	Revenues		Operating Income (loss)	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Active Pharmaceutical Ingredients ("API")	\$36.4	\$40.3	\$15.4	\$22.6
Branded Pharmaceuticals ("BP")	23.5	18.0	2.3	2.8
International Generics ("IG")	102.7	97.1	12.1	8.2
				<u>(4.3)</u>
US Generics ("USG") ⁽¹⁾	<u>128.2</u>	<u>100.8</u>	<u>7.0</u>)
Total Human Pharmaceuticals	290.8	256.2	36.8	29.3
Animal Health (AH) - base	79.8	68.5	15.4	6.7
				<u>(10.9)</u>
Wynco and Aquatics	=	<u>3.0</u>	=)
Total AH	79.8	71.5	15.4	(4.2)
Profit sharing income ⁽¹⁾	--	(8.8)	-	(8.8)
	<u>(2.7)</u>	<u>(2.9)</u>	<u>(12.0)</u>	<u>(11.9)</u>

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Unallocated and))))
Eliminations			
Total	<u>\$367.9</u>	<u>\$316.0</u>	<u>\$40.2</u> <u>\$ 4.4</u>

(1) In 2004, profit sharing income of \$8.8 million is included in USG segment revenues and operating income and is classified as other income in the Consolidated Statement of Operations.

Revenues

Revenues in API decreased \$3.9 million (10%) mainly as a result of targeted price reductions on selected products in early 2005. Translation of revenues into the U.S. dollar increased API revenues by 1%.

BP revenues increased \$5.5 million (31%) relative to 2004 due primarily to increased volume. Sales force expansions mainly contributed to the increase.

IG revenues increased \$5.6 million (6%) due primarily to the impact of translating revenues into the U.S. dollar (\$3.7 million) and increased sales in the Nordic and UK markets. These increases were primarily attributable to increased sales of over-the-counter products and new product launches.

Revenues of USG products increased \$27.4 million due primarily to gabapentin sales, offset by volume and price declines of other products and the absence of metformin ER profit sharing revenues in 2005. In the fourth quarter 2004, USG launched gabapentin capsules and tablets pursuant to the Company's exclusivity granted under the Hatch-Waxman Act and recorded revenues of \$44.8 million related to this product in the second quarter of 2005. The Company's exclusivity on gabapentin capsules ended in April 2005 and in June 2005 for tablets. In April 2005, a number of new competitors launched gabapentin products and prices declined. Sales of the Company's gabapentin capsules and tablets are at lower prices and volumes than was recorded during the exclusivity period. USG revenues in the second quarter of 2004 include approximately \$8.8 million earned as a result of a profit sharing agreement on the launch of metformin ER in the fourth quarter of 2003. Such income is recorded as revenues for USG segment reporting purposes but is reclassified as other income in the Consolidated Statement of Operations.

As is customary in the industry, USG shipments to wholesale customers include price incentives. These incentives are offered reflecting the competitive nature of the markets, and prior to the fourth quarter of 2004, reflecting the Company's inability to supply new products to its wholesale customers as it resolves its FDA issues. The Company monitors its sales to wholesale customers to ensure that wholesale inventory levels are maintained at levels appropriate to satisfy market demand.

Inventories of generic products at certain USG wholesale customers generally range from 1 to 2 months supply, although some products exceed the range. Wholesale inventory levels have been reduced, beginning in the second half of 2004, as the Company limited incentives offered to wholesalers with the result that sales to wholesalers, except for the gabapentin product, were reduced. The information regarding inventory levels within the channel is derived from inventory management reports obtained at a cost from major wholesalers. This information is critical to estimates of deductions from gross revenues to reported net revenues.

Animal Health revenues, excluding Aquatic revenues, increased \$11.3 million (17%) due primarily to increased sales in U.S. livestock and poultry markets (6%) and in the European markets (6%), with the majority of plants operating at or near capacity, in addition to the impact of foreign exchange, 2%.

Gross Profit

On a Company-wide basis gross profit increased \$30.8 million in 2005 compared to 2004. As a percentage of sales, overall gross profit was 43.2% in 2005, versus 40.6% in 2004.

The increase in gross margin dollars results primarily from gabapentin sales in USG, and volume increases in AH, BP and IG, offset partially by the USG profit sharing income in 2004 and price decreases in API.

Operating Expenses

On a consolidated basis, selling, general and administrative expenses increased \$9.1 million (10%) in 2005 as compared to 2004. Expenses in 2004 include \$1.5 million related to the Aquatic operation that was sold in July 2004. Excluding these costs, selling, general and administrative expenses increased \$10.6 million, due primarily to marketing campaigns and sales force expansions within BP (\$5.2 million) and increased spending due mainly to timing in API, IG and USG (\$4.5 million), and the impact of foreign exchange (\$1.2 million).

Research and development expenses decreased \$4.6 million in 2005 due primarily to the timing of spending in USG.

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perating Income

Operating income increased by \$35.8 million. The Company believes the change in operating income can be approximated as follows:

	<u>API</u>	<u>BP</u>	<u>IG</u>	<u>USG</u>	<u>AH</u>	<u>Unal-located</u>	<u>Total</u>
2004 as reported	\$22.6	\$2.8	\$8.2	\$(4.3)	\$(4.2)	\$(20.7)	\$4.4
2004 Metformin ER Profit Sharing Agreement	--	--	--	(8.8)	--	8.8	--

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Brand sales force and marketing program expansions	--	(5.2)	--	--	--	--	(5.2)
Aquatic loss - 2004					9.5		9.5
Gabapentin sales	--	--	--	16.2	--	--	16.2
Research and development	(0.6)	(0.6)	0.4	4.3	1.4	(0.3)	4.6
Net margin improvement (decrease) due to volume, price, new products, foreign exchange and expenses	<u>(6.6)</u>	<u>5.3</u>	<u>3.5</u>	<u>(0.4)</u>	<u>8.7</u>	<u>0.2</u>	<u>10.7</u>
2005 as reported	<u>\$15.4</u>	<u>\$2.3</u>	<u>\$12.1</u>	<u>\$7.0</u>	<u>\$15.4</u>	<u>\$(12.0)</u>	<u>\$40.2</u>

The increase in operating income is primarily attributed to gabapentin sales by USG and improved operating performance by the AH and IG segments.

Interest Expense and Amortization of Debt Issuance Costs

Interest expense and amortization of debt issuance costs decreased \$2.9 million to \$11.7 million in 2005 due to decreased debt levels, and lower amortization of debt issuance costs, offset by higher interest rates.

Loss on Extinguishment of Debt

2004 results include \$1.9 million of expense associated with the write-off of deferred loan costs. In the second quarter of 2004, the Company prepaid \$25 million of bank term debt and \$32.0 million of mortgage notes payable and repaid \$24.5 million of the 5.75% Convertible Notes.

Other, Net

Other income (expense) netted to \$2.2 million in 2005 compared to \$13.0 million in 2004. First quarter 2005 includes income of \$1.0 million from a litigation settlement and interest income of \$0.5 million. Second quarter 2004 includes \$8.8 million of income from a USG Metformin ER profit sharing agreement and income totaling \$6.0 million from the sale of a product license and an ANDA. A detail of Other income (expense) follows:

Three Months Ended

June 30,	June 30,
<u>2005</u>	<u>2004</u>

Other income (expense), net:

Interest income	\$ 0.5	\$ 0.8
Foreign exchange gains (losses), net	0.1	(1.4)
Litigation settlement	1.0	--
Metformin ER profit sharing agreement	--	8.8
Sale of license and ANDA	--	6.0
Other, net	<u>0.6</u>	<u>(1.2)</u>
)	
	<u>\$ 2.2</u>	<u>\$13.0</u>

Tax Provision

Deferred tax assets are evaluated quarterly to assess the likelihood of realization, which is ultimately dependent upon generating future taxable income prior to the expiration of the net operating loss carryforwards. The Company has recorded certain U.S. deferred tax assets for which it has provided a full valuation allowance as of December 31, 2004. In this assessment, factors such as current and previous U.S. operating losses are given substantially more weight than the outlook for future profitability. The full valuation allowance on the U.S. deferred tax assets was determined to be appropriate at December 31, 2004 due to a change in certain available tax planning strategies and continued U.S. losses. As a result, the Company no longer considers it more likely than not that these net U.S. deferred tax assets will be realized in the future and therefore, a full valuation allowance was required at December 31, 2004. At June 30, 2005, the Company continues to believe a full valuation allowance is required. Should it be determined in the future that it is more likely than not that these assets will be realized, the valuation allowance would be removed against some or all of the deferred tax assets.

The requirement for a full valuation allowance on U.S. earnings has an effect on the effective tax rate applied to pre-tax income in interim periods. As required in FASB Interpretation No. 18 "Accounting for Income Taxes in Interim Periods", the Company has estimated the full year effective tax rate for international operations at 29.6% and will not provide Federal income tax benefits on full year pre-tax losses that are currently estimated for U.S. operations.

Income tax expense for the three months ended June 30, 2005, is comprised of the following elements:

	<u>U.S.</u>	<u>International</u>	<u>Total</u>
Pre-tax income	<u>\$2.237</u>	<u>\$28.412</u>	<u>\$30.649</u>

Estimated tax

International		8.449	8.449
U.S. Federal	--		--
U.S. State	<u>1.424</u>	<u>—</u>	<u>1.424</u>
	1.424	8.449	9.873
Effective rate	63.7%	29.7%	32.2%
Tax on \$12.0 million dividend repatriation	<u>0.618</u>	<u>0.132</u>	<u>0.75</u>
Tax expense			<u>\$10.623</u>
% of pre-tax income			<u>34.7%</u>

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Financial Condition

At December 31, 2004, the Company classified \$503.3 million of its outstanding debt as current liabilities due to violations of certain debt covenants at December 31, 2004, that served to make the associated debt obligations callable. In April and May 2005, the Company cured all such violations and accordingly, the associated debt obligations are no longer callable and are classified as long-term at June 30, 2005. The December 31, 2004 proforma balances are presented in the Notes to consolidated financial statements (see Note 4) to classify the associated debt as long-term, as if the covenant violations had been cured as of December 31, 2004. Accordingly, December 31, 2004 proforma amounts are noted below for comparative purposes.

At June 30, 2005, stockholders' equity was \$836.5 million compared to \$883.6 million at December 31, 2004. On a proforma basis, the ratio of long-term debt to equity was 0.43:1 at June 30, 2005 and 0.58:1 at December 31, 2004. The decrease in Stockholders' Equity in 2005 results primarily from the translation of foreign currencies into the U.S. dollar. At June 30, 2005, due primarily to the strengthening of the U.S. dollar against many other currencies, the Company has Accumulated Other Comprehensive Income of \$85.6 million compared to \$161.6 million at December 31, 2004.

Working capital at June 30, 2005, was \$30.1 million compared to proforma working capital of \$135.0 million at December 31, 2004. Working capital is defined as current assets less current liabilities. The decrease in working capital is primarily related to reductions in inventories (\$71 million) in the USG, AH and IG segments and reductions in accounts receivable (\$18 million) in the USG, BP and AH segments. The proforma current ratio was 1.06:1 at June 30, 2005 compared to 1.25:1 at December 31, 2004.

Cash flow from operations for the first six months of 2005 was \$151.6 million compared to \$73.3 million for the first six months of 2004. Improved results of operations and better working capital management drove the

improvements in operating cash flow. Net income for the first six months of 2005 increased by \$31 million over the comparable period in 2004 and accounts receivable and inventory balances decreased \$11.8 million and \$58.4 million, respectively, net of foreign currency, compared to December 31, 2004.

Balance sheet amounts decreased as of June 30, 2005 compared to December 2004 in U.S. Dollars as the functional currencies of the Company's principal foreign subsidiaries, the Norwegian Kroner, Danish Kroner, the Euro, and British Pound, declined versus the U.S. Dollar by approximately 8%, 13%, 13% and 6%, respectively. These decreases in balance sheet amounts impact to some degree the above mentioned ratios. The approximate decrease due to currency translation of selected captions was: accounts receivable \$6.5 million, inventories \$11.4 million, accounts payable and accrued expenses \$8.6 million, and total stockholder's equity \$76.0 million. The \$76.0 million decrease in stockholder's equity is included in other comprehensive income for the first six months of 2005 and results from the strengthening of the U.S. Dollar in 2005 against the major functional currencies of the Company's foreign subsidiaries.

In the fourth quarter of 2001, the Company completed the acquisition of the Faulding Oral Pharmaceuticals Business ("OPB") and entered into a \$900 million credit facility ("2001 Credit Facility") to finance the acquisition and replace its previous credit agreement. The 2001 Credit Facility includes covenants that require it to maintain specified financial ratios and satisfy financial conditions consisting of a maximum total leverage ratio test, a maximum senior secured leverage ratio test, a minimum fixed charge coverage ratio test, a minimum interest coverage ratio test and a minimum net worth test. A breach of any of these covenants, if not cured or waived, could result in a default under the 2001 Credit Facility. If an event of default under the 2001 Credit facility occurs, the lenders under these facilities could elect to declare all amounts outstanding thereunder, together with accrued interest, to be immediately due and payable. The calculation of EBITDA, as defined in the credit facility, on a rolling four quarter basis is important to many of these tests. These covenants have been amended from time to time, including amendments made in May and August 2004 and March 2005.

Compliance with these financial covenants in 2005 is dependent on the Company's EBITDA as defined by the credit agreement, and therefore the Company's ability to generate increasing amounts of operating income, or on the Company's ability to reduce the amount of its outstanding debt. Since December 2001, the Company has reduced the amount of its outstanding debt and the size of the original facility by prepaying term debt by \$375.0 million and by lowering the revolving line of credit by \$150.0 million. On an overall basis, senior debt and total debt at June 30, 2005 were \$374.4 million and \$531.8 million, respectively, compared to \$538.1 million and \$701.7 million, respectively, at December 31, 2004.

The Company's EBITDA, as defined, is affected most directly by changes in operating income. The definition of EBITDA allows for the add back of non-cash charges, including goodwill impairment charges. Operating income in 2004 was negatively affected by business conditions in USG and by corrective actions related to the Company's response to FDA Form 483s issued for the Company's U.S. Human Pharmaceuticals plants in Baltimore (liquids) and Elizabeth (solid dose). The corrective action plans have included consulting and other costs and have resulted in lower production and significant rationalization of the liquids product line at the Baltimore plant and production delays and interruptions at the Elizabeth plant.

The FDA completed an inspection of the Company's Elizabeth solid dose site in December 2003 and advised the Company that, as a result of this inspection, product approvals relating to the Elizabeth site would be withheld pending a successful follow-up inspection. Major elements of the FDA compliance enhancement plan have been completed. In September 2004, the FDA inspected Elizabeth and has since advised the Company it is eligible for new product approvals. Since the September 2004 inspection, the Company has received six new product approvals. In the

fourth quarter of 2004, the Company launched both its gabapentin capsules and tablets from the Elizabeth site. The Company anticipates it will be the subject of another FDA inspection at the Elizabeth site in 2005.

The Company expects to continue upgrading plant procedures at the Baltimore facility in accordance with the October 2002 corrective action plan and will continue to provide written monthly updates to the FDA. The plan anticipates substantial completion of the corrective actions by the end of 2004, subject to the FDA's final review and satisfaction with the actions taken. Representatives of the Company and the Baltimore facility met with Baltimore FDA in the fourth quarter of 2004 to discuss progress on the corrective action plan and to clarify expectations and deliverables. The Company anticipates it will be the subject of another inspection at the Baltimore site in 2005.

While the Company has received no indications from the FDA, the total cost and timing of both the Elizabeth and Baltimore corrective action plans are subject to change based upon results of future inspections performed by the respective New Jersey and Baltimore Districts of the FDA. See Note 15 for further details.

In order to increase flexibility in complying with its financial covenants, the Company received an amendment to its 2001 Credit Facility in March 2005, which delayed the further tightening of certain financial covenants. The amendment provided at March 31, 2005, the interest coverage ratio requirement will increase from 3.00:1.00 to 3.25:1.00 and at March 31, 2006, the interest coverage ratio requirement will increase from 3.25:1.00 to 3.50:1.00 and remain thereafter. The amendment also increased the permitted leverage ratio from 4.00:1.00 to 4.25:1.00 through and including December 31, 2004. At March 31, 2005, the permitted leverage ratio decreased from 4.25:1.00 to 4.00:1.00 and at March 31, 2006, the permitted leverage ratio will decrease from 4.00:1.00 to 3.50:1.00 and remain thereafter. In addition, the amendment allows \$30 million of cash restructuring expenses incurred from July 1, 2004 to December 31, 2005, to be excluded from the calculation of EBITDA. Regarding the net worth covenant, the amendment reduced the required amount of net worth by up to \$250 million for asset valuation impairment charges, which were incurred in the fourth quarter of 2004.

At December 31, 2004, the Company had certain violations of its debt covenants that were unrelated to the financial covenants. In April and May 2005, the Company cured all such violations. At June 30, 2005, the Company had approximately \$78.6 million of EBITDA flexibility on its tightest financial covenant at quarter end, the Interest Coverage Ratio.

The Company's operating plan for 2005 indicates continued difficult operating conditions and continued losses in the U.S. Generic Pharmaceutical business. Based on the plan, the Company expects to remain in compliance with its financial covenants throughout 2005. Depending on actual results, the Company may need to consider additional actions to ensure continued compliance.

The Company believes it has a number of options available to provide it with increased financial flexibility, thereby ensuring continued compliance with its covenants. Certain of these options are entirely within the Company's control and others require actions of the bank group and/or a third party. Options include:

- Cash generated by the Company's international operations may be made available to fund U.S. investments under the Act. The Board of Directors approved a plan and the Company repatriated \$147 million of cash in extraordinary dividends, as defined in the Act during the first half of 2005. The tax impact of repatriating this \$147 million was approximately \$9.5 million. The Company may adopt additional reinvestment plans under the Act and it currently estimates that it could increase the amount to be repatriated under the Act by up to \$288 million (subject to Board of Directors approval) depending upon a number of factors, including the amount of foreign earnings and profits generated through 2005, but is subject to further U.S. Treasury guidance. The tax impact of repatriating this \$288 million would be

approximately \$18.5 million.

- Aggressive asset management, including both working capital reduction programs and controls over capital expenditures, to generate free cash flow to enable the Company to continue to repay outstanding debt. Capital expenditures and purchased intangibles were \$18.0 million for the six months ended June 30, 2005 compared to \$19.3 million for the six months ended June 30, 2004.
- Selling certain assets. The Company continues to consider possible divestitures, which could be material. There is no guarantee any divestiture will be completed.
- Reduce subordinated convertible debt by issuing common stock. At June 30, 2005, the Company has \$157.4 million of convertible Subordinated Notes outstanding that can be retired with the agreement of the holders by the exchange of common stock. On April 1, 2005, the Company repaid the 5.75% convertible Subordinated Notes (\$9.8 million as of March 31, 2005). The Company's loan covenants also required that amounts outstanding of the 6.875% convertible debt (\$157.4 million at June 30, 2005) be reduced to \$10.0 million or less by December 1, 2005. The Company is planning for this requirement based on a number of scenarios. The Company expects to be successful in meeting this requirement.
- Obtaining additional amendments to the 2001 Credit Facility bank covenants to allow for certain of the actions noted above and to provide additional flexibility in the timing and application of the financial ratio tests. In October 2001, the Company borrowed \$622.0 million from the bank group and at June 30, 2005 the amount outstanding was \$154.1 million (a reduction of \$467.9 million). The Company has obtained amendments as follows:
 - In the fourth quarter of 2003, the bank group agreed to an amendment which allowed for specified asset sales, permitted exclusions of restructuring and refinancing charges of up to \$10.0 million from EBITDA and the minimum net worth definitions, and amended the leverage ratios to delay the timing of further covenant restrictions.
 - In May 2004, the 2001 Credit Facility was amended to allow for certain actions associated with the Company's ability to achieve increased financial flexibility. The amendment included provisions enabling the Company to issue up to \$200.0 million of senior subordinated notes to refinance the existing convertible notes, to prepay a local currency mortgage secured loan of approximately \$32.0 million, modify the requirements to prepay debt facilities with proceeds from the potential sale of certain assets/businesses, allow for certain covenant add-backs associated with gabapentin inventory and other minor items.
 - In August 2004, the 2001 Credit Facility was amended to reduce interest coverage from 3.50:1.00 to 3.00:1.00 and increase the permitted leverage ratio from 4.00:1.00 to 4.25:1.00 through and including December 31, 2004. At March 31, 2005, the interest coverage ratio increased from 3.00:1.00 to 3.25:1.00 and at June 30, 2005, the interest coverage ratio will increase from 3.25:1.00 to 3.50:1.00 and remain thereafter. At March 31, 2005, the permitted leverage ratio decreased from 4.25:1.00 to 4.00:1.00 and at June 30, 2005, the permitted leverage ratio will decrease from 4.00:1.00 to 3.50:1.00 and remain thereafter. In addition, the amendment allowed

\$30.0 million of cash restructuring expenses incurred from July 1, 2004 to December 31, 2004, to be excluded from the calculation of EBITDA.

- In March 2005, the 2001 Credit Facility was amended to provide that at March 31, 2005, the interest coverage ratio requirement increased from 3.00:1.00 to 3.25:1.00 and at March 31, 2006, the interest coverage ratio requirement will increase from 3.25:1.00 to 3.50:1.00, and remain thereafter. At March 31, 2005, the permitted leverage ratio decreased from 4.25:1.00 to 4.00:1.00 and at March 31, 2006, the permitted leverage ratio will decrease from 4.00:1.00 to 3.50:1.00 and remain thereafter. In addition, the amendment allows \$30 million of cash restructuring expenses incurred from July 1, 2004 to December 31, 2005 to be excluded from the calculation of EBITDA. The net worth covenant is reduced by up to \$250 million of asset valuation impairment charges.

The Company believes that its performance in the reduction of the 2001 Credit Facility, and its previous experience in working with the bank group would assist it in obtaining future amendments, if necessary.

While the Company cannot assure its success in executing any of the above-noted actions, it will endeavor to take the actions necessary to maintain sufficient financial flexibility with its debt covenants to remain in compliance.

Recent Accounting Pronouncements

Recent accounting pronouncements are detailed in Footnote 17.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Quantitative and Qualitative Disclosure - This information is included in Item 7a of the Company's Annual Report on Form 10-K/A for the fiscal year ended December 31, 2004.

Item 4. Controls and Procedures

(a) Disclosure Controls and Procedures

The Company has implemented and maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports the Company files or submits under the Securities Exchange Act of 1934, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms and that such information is accumulated and communicated to the Company's Chief Executive Officer ("CEO") and Executive Vice President and Chief Financial Officer ("CFO") as appropriate to allow timely decisions regarding disclosure. The disclosure procedures involve participation by various individuals in the Company who have access to material information relating to the operations of the Company. It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events.

The Company's CEO and CFO completed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Rule 13a-15 as of June 30, 2005. Based on this evaluation, they concluded that the Company's disclosure controls and procedures were not effective at the reasonable assurance level as of June 30, 2005, because of the material weaknesses described below.

(b) Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process that is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets of the Company,
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and the board of directors of the Company, and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, utilizing the criteria described in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). The objective of this assessment was to determine whether the Company's internal control over financial reporting was effective as of December 31, 2004.

A material weakness is a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. In the Company's assessment of the effectiveness of internal control over financial reporting as of December 31, 2004, it identified the following internal control deficiencies.

Effective controls to ensure the completeness and accuracy or the review and monitoring of customer discount reserves and certain accrual accounts affecting a number of accounts at our USG business, including revenues, accounts receivables and accrued expenses, were not maintained at December 31, 2004. This control deficiency resulted in audit adjustments to the fourth quarter 2004 financial statements. In addition, effective controls to ensure the completeness and accuracy of income tax account balances, including the determination of deferred income tax assets and liabilities, income taxes payable, and income tax expense, were not maintained at December 31, 2004 and we did not have effective controls in place to ensure that the Company's income tax accounts were periodically reconciled to supporting documentation. This control deficiency resulted in audit adjustments to the fourth quarter 2004 financial statements. Further, the Company did not have effective controls over the determination of proper segment disclosures in conformity with generally accepted accounting principles. Specifically, as a result of a first

quarter 2004 change in its internal reporting of financial information, the Company should have provided disaggregated segment disclosures for U.S. Generics and U.S. Branded Pharmaceuticals in its financial statements beginning in the first quarter of 2004. This control deficiency resulted in the Company restating its interim financial statements for 2004 to correct its segment disclosures. This control deficiency also resulted in an audit adjustment to the Company's year end 2004 financial statement segment disclosures and impacted the amount of the goodwill impairment charge recorded in the fourth quarter of 2004. The Company also did not maintain effective controls to ensure the appropriate review and monitoring of compliance with certain debt covenants at December 31, 2004. This control deficiency resulted in the Company failing to comply with certain debt covenants at December 31, 2004, which required the Company to restate its financial statements for the years ended December 31, 2004 and 2003, to reclassify certain of its debt from long-term to short-term and to revise certain of its disclosures with respect to debt covenant compliance. These control deficiencies could result in a misstatement in the aforementioned accounts and disclosures that would result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Therefore, management concluded that these control deficiencies constituted four material weaknesses in internal control over financial reporting as of December 31, 2004. Because of the material weaknesses described above, the Company's management concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2004, based on the criteria in "Internal Control - Integrated Framework" issued by the COSO.

(c) Changes in Internal Control over Financial Reporting

The Company has remediated the deficiency related to segment disclosure by instituting a more robust review process of disclosures required by generally accepted accounting principles.

The Company has implemented, or is in the process of implementing, the following remediation steps to address the other three material weaknesses:

To address the deficiency related to customer discount reserves and certain accrued liability accounts, increased focus has been placed on timely review, documentation, and evaluation of related account balances. The Company is recruiting an additional accounting manager who will be primarily dedicated to overseeing the controls related to the accounting for discounts to customers and customer related accrued liabilities. The Company has also implemented new accounts receivable software in the first quarter of 2005, which has automated the processing of customer remittances to allow for more timely resolution of differences. The new software has automated the matching of customer deductions with outstanding credits and improves the timeliness, completeness, and accuracy of processing customer deductions

To address the deficiency related to income taxes described above, the Company is reviewing its control policies for income tax accounting and has reemphasized the need for appropriate documentation to support management's financial statement assertions regarding income taxes, including the development of a tax reporting package and balance sheet analyses. In 2004, the company retained an independent public accounting firm to assist the Company in reviewing its international income tax accounts and tax provisions. In 2005, the Company expanded the scope of their services to include a quarterly review of its income tax accounts for major tax jurisdictions.

To address the deficiency related to the review and monitoring of compliance with debt covenants, the Company is instituting, for all its senior and subordinated debt agreements, a detailed process for monitoring and reviewing compliance.

The Company believes that, once fully implemented, these remediation steps will correct the remaining material weaknesses described above. In addition, management is developing remediation plans to address certain other control deficiencies which were not material weaknesses.

The Company has also recently experienced turnover in certain key financial management positions in the corporate tax, and in USG, AH, and IG financial management. The Company is currently recruiting for replacements for these positions and will be utilizing contract financial resources to supplement financial staffing during the transition period.

Other than as described above, there have not been any changes in the Company's internal control over financial reporting during the fiscal quarter ended June 30, 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Statements made in this Form 10-Q, are forward-looking statements made pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. Such statements involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward looking statements. Information on other significant potential risks and uncertainties not discussed herein may be found in the Company's filings with the Securities and Exchange Commission including its Form 10-K/A for the year ended December 31, 2004.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See Note 15 to the Company's Consolidated Condensed Financial Statement included in Part 1 of this Report for a discussion of material developments in the Company's legal proceedings.

Item 6. Exhibits

(a) Exhibits

- 10.1 Amendment No. 3 to Amended and Restated Supply Agreements between Purepac Pharmaceutical Co. and Plantex USA, Inc. dated as of April 1, 2005, is filed as an Exhibit to this Report.*
- 10.2 Master Development and Manufacturing Agreement between Purepac Pharmaceutical Co. and Shasun Chemicals and Drugs Limited, dated as of May 27, 2005, is filed as an Exhibit to this Report.*
- 10.3 Form of revised Restricted Stock Unit Award Agreement for Alpharma Inc.'s Board of Directors, effective March 8, 2004, is filed as an Exhibit to this Report.
- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 is filed as an Exhibit to this Report.
- 31.2

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Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 is filed as an Exhibit to this Report.

32.0 Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 are filed as an Exhibit to this Report.

* Portions of this Exhibit have been omitted pursuant to a request for confidential treatment.

SIGNATURES

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

Alpharma Inc.

(Registrant)

Date: August 2, 2005

/s/ Matthew Farrell

Matthew Farrell
Executive Vice President, Finance and
Chief Financial Officer

Date: August 2, 2005

/s/ Jeffrey S. Campbell

Jeffrey S. Campbell
Vice President, Finance