PharMerica CORP
Form 10-Q
November 06, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

or

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

For the transition period from _____ to _____ .

Commission File Number: 001-33380

PHARMERICA CORPORATION
(Exact name of registrant as specified in its charter)

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

(502) 627-7000
(Registrant's Telephone Number, Including Area Code)

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

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

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

Accelerated filer xNon-accelerated filer ¨

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

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

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

| Class of Common Stock | Outstanding at October 31, 2014 |
|---|---|
| Common stock, $0.01 par value | 32,724,509 shares |

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
For the Three and Nine Months Ended September 30, 2013 and 2014
(Unaudited)
(In millions, except share and per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2014 | 2013 | 2014 |
| Revenues | $ 436.8 | $470.2 | $1,307.4 | $1,371.0 |
| Cost of goods sold | 357.6 | 387.2 | 1,061.3 | 1,126.1 |
| Gross profit | 79.2 | 83.0 | 246.1 | 244.9 |
| Selling, general and administrative expenses | 55.5 | 56.0 | 167.7 | 171.1 |
| Amortization expense | 3.7 | 4.9 | 11.7 | 13.6 |
| Merger, acquisition, integration costs and other charges | 1.1 | 3.8 | 6.6 | 10.3 |
| Settlement, litigation and other related charges | 17.2 | 1.1 | 17.4 | 28.9 |
| Restructuring and impairment charges | 1.0 | 0.1 | 1.0 | 3.2 |
| Hurricane Sandy disaster costs | 0.1 | - | (0.2) | 0.1 |
| Operating income | 0.6 | 17.1 | 41.9 | 17.7 |
| Interest expense, net | 2.6 | 2.1 | 8.1 | 6.9 |
| Loss on extinguishment of debt | – | 4.3 | – | 4.3 |
| Income (loss) before income taxes | (2.0) | 10.7 | 33.8 | 6.5 |
| Provision for income taxes | 4.2 | 2.2 | 19.3 | 2.9 |
| Net income (loss) | $ (6.2) | $8.5 | $14.5 | $3.6 |
| | | | | |
| Earnings (loss) per common share: | | | | |
| Basic | $ (0.21) | $0.28 | $0.49 | $0.12 |
| Diluted | $ (0.21) | $0.28 | $0.48 | $0.12 |
| | | | | |
| Shares used in computing earnings (loss) per common share: | | | | |
| Basic | 29,655,201 | 30,073,133 | 29,645,380 | 29,944,875 |
| Diluted | 29,655,201 | 30,595,302 | 29,950,379 | 30,502,928 |

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
As of December 31, 2013 and September 30, 2014
(Unaudited)
(In millions, except share and per share amounts)

| | (As Adjusted) December 31, 2013 | September 30, 2014 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 24.2 | $ 7.1 |
| Accounts receivable, net | 199.4 | 213.7 |
| Inventory | 110.2 | 133.4 |
| Deferred tax assets, net | 36.9 | 38.5 |
| Income taxes receivable | 1.9 | 3.4 |
| Prepaids and other assets | 38.8 | 70.0 |
| | 411.4 | 466.1 |
| Equipment and leasehold improvements | 179.4 | 190.6 |
| Accumulated depreciation | (117.6) | (120.3) |
| | 61.8 | 70.3 |
| Goodwill | 282.0 | 321.5 |
| Intangible assets, net | 136.3 | 184.1 |
| Other | 9.3 | 3.5 |
| | $ 900.8 | $ 1,045.5 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $ 78.8 | $ 75.5 |
| Salaries, wages and other compensation | 38.7 | 37.3 |
| Current portion of long-term debt | 12.5 | 2.8 |
| Other accrued liabilities | 21.0 | 16.8 |
| | 151.0 | 132.4 |
| Long-term debt | 218.8 | 358.1 |
| Other long-term liabilities | 49.8 | 72.4 |
| Deferred tax liabilities, net | 18.7 | 9.9 |
| Commitments and contingencies (See Note 5) | | |
| Stockholders' equity: | | |
| Preferred stock, $0.01 par value per share; 1,000,000 shares authorized and no shares issued, December 31, 2013 and September 30, 2014 | - | - |
| Common stock, $0.01 par value per share; 175,000,000 shares authorized; 31,954,264 and 32,720,327 shares issued as of December 31, 2013 and September 30, 2014, respectively | 0.3 | 0.3 |
| Capital in excess of par value | 380.2 | 391.9 |

| | | |
|---|---|---|
| Retained earnings | 110.2 | 113.8 |
| Treasury stock at cost, 2,416,971 and 2,617,305 shares at December 31, 2013 and September 30, 2014, respectively | (28.2) | (33.3) |
| | 462.5 | 472.7 |
| | $ 900.8 | $ 1,045.5 |

See accompanying Notes to Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Three and Nine Months Ended September 30, 2013 and 2014
(Unaudited)
(In millions)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2014 | 2013 | 2014 |
| Cash flows provided by (used in) operating activities: | | | | |
| Net income (loss) | $ (6.2) | $8.5 | $14.5 | $3.6 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | | |
| Depreciation | 4.9 | 4.9 | 14.5 | 14.5 |
| Amortization | 3.7 | 4.9 | 11.7 | 13.6 |
| Merger, acquisition, integration costs and other charges | - | - | - | 2.5 |
| Hurricane Sandy disaster costs | 1.8 | - | 0.2 | - |
| Stock-based compensation and deferred compensation | 2.4 | 1.8 | 6.4 | 5.7 |
| Amortization of deferred financing fees | 0.6 | 0.5 | 1.6 | 1.8 |
| Deferred income taxes | 3.5 | (4.0) | 6.4 | (3.3) |
| Loss (gain) on disposition of equipment | 0.4 | - | 0.3 | (0.1) |
| Loss (gain) on acquisition/disposition | - | 0.1 | - | (0.2) |
| Loss on debt extinguishment | - | 4.3 | - | 4.3 |
| Other | (0.2) | - | 0.1 | 0.1 |
| Change in operating assets and liabilities: | | | | |
| Accounts receivable, net | 4.5 | (1.7) | 14.8 | 10.4 |
| Inventory | 42.9 | 14.9 | 65.4 | (16.3) |
| Prepaids and other assets | (1.3) | (15.1) | (0.3) | (26.2) |
| Accounts payable | 11.7 | (2.4) | 3.8 | (22.9) |
| Salaries, wages and other compensation | (4.5) | 5.2 | (7.2) | (2.7) |
| Other accrued and other long-term liabilities | 18.7 | (5.7) | 18.9 | 16.6 |
| Change in income taxes payable (receivable) | (4.8) | 3.7 | 1.3 | (0.4) |
| Excess tax benefit from stock-based compensation | - | (0.2) | (0.4) | (3.4) |
| Net cash provided by (used in) operating activities | 78.1 | 19.7 | 152.0 | (2.4) |
| | | | | |
| Cash flows provided by (used in) investing activities: | | | | |
| Purchase of equipment and leasehold improvements | (6.9) | (6.2) | (20.9) | (19.0) |
| Acquisitions, net of cash acquired | (4.1) | (107.2) | (4.6) | (124.8) |
| Cash proceeds from sale of assets | - | - | 0.1 | 0.1 |
| Cash proceeds from dispositions | - | - | - | 0.4 |
| Net cash used in investing activities | (11.0) | (113.4) | (25.4) | (143.3) |
| | | | | |
| Cash flows provided by (used in) financing activities: | | | | |
| Repayments of long-term debt | (3.1) | (225.0) | (9.4) | (231.3) |
| Borrowings of long-term debt | - | 225.0 | - | 225.0 |
| Net activity of long-term revolving credit facility | (19.6) | 92.0 | (71.7) | 135.9 |

| | | | | |
|---|---|---|---|---|
| Payment of debt issuance costs | - | (2.7) | - | (2.7) |
| Issuance of common stock | - | 0.4 | 0.4 | 3.4 |
| Treasury stock at cost | (4.4) | (0.2) | (6.3) | (5.1) |
| Excess tax benefit from stock-based compensation | - | 0.2 | 0.4 | 3.4 |
| Other | 0.1 | - | 0.1 | - |
| Net cash (used in) provided by financing activities | (27.0) | 89.7 | (86.5) | 128.6 |
| | | | | |
| Change in cash and cash equivalents | 40.1 | (4.0) | 40.1 | (17.1) |
| Cash and cash equivalents at beginning of period | 12.3 | 11.1 | 12.3 | 24.2 |
| | | | | |
| Cash and cash equivalents at end of period | $ 52.4 | $7.1 | $52.4 | $7.1 |
| | | | | |
| Supplemental information: | | | | |
| Cash paid for interest | $ 2.0 | $1.9 | $6.6 | $5.6 |
| Cash paid for taxes | $ 5.5 | $1.0 | $11.9 | $5.7 |

See accompanying Notes to Condensed Consolidated Financial Statements

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PHARMERICA CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
For the Nine Months Ended September 30, 2014
(Unaudited)
(In millions, except share amounts)

| | Common Stock | | Capital in Excess of Par | Retained | Treasury | |
|---|---|---|---|---|---|---|
| | Shares | Amount | Value | Earnings | Stock | Total |
| Balance at December 31, 2013 | 29,537,293 | $ 0.3 | $380.2 | $ 110.2 | $ (28.2 ) | $462.5 |
| Net income | | | | 3.6 | | 3.6 |
| Exercise of stock options and tax components of stock-based awards, net | 278,350 | - | 6.4 | - | - | 6.4 |
| Vested restricted stock units | 288,076 | - | - | - | - | - |
| Vested performance stock units | 199,637 | - | - | - | - | - |
| Treasury stock at cost | (200,334 ) | - | - | - | (5.1 ) | (5.1 ) |
| Stock-based compensation -non-vested restricted stock | - | - | 4.8 | - | - | 4.8 |
| Stock-based compensation -stock options | - | - | 0.5 | - | - | 0.5 |
| Balance at September 30, 2014 | 30,103,022 | $ 0.3 | $391.9 | $ 113.8 | $ (33.3 ) | $472.7 |

See accompanying Notes to Condensed Consolidated Financial Statements
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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
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## NOTE 1—ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Nature of Business

PharMerica Corporation (together with its subsidiaries, the "Corporation") is a pharmacy services company that services healthcare facilities, provides pharmacy management services to hospitals, provides specialty infusion services to patients outside a hospital setting, and offers the only national oncology pharmacy in the United States. The Corporation is the second largest institutional pharmacy services company in the United States based on revenues and customer licensed beds under contract, operating 104 institutional pharmacies, 14 specialty infusion pharmacies, and 5 specialty oncology pharmacies in 45 states. The Corporation's customers are typically institutional healthcare providers, such as skilled nursing facilities, nursing centers, assisted living facilities, hospitals, individuals receiving in-home care and other long-term alternative care providers. The Corporation is generally the primary source of supply of pharmaceuticals to its customers. The Corporation also provides pharmacy management services to 89 hospitals in the United States.

### Operating Segments

The Corporation consists of three operating segments: institutional pharmacy, specialty infusion services and specialty oncology pharmacy. Management believes the nature of the products and services are similar, the payers for the products and services are common among the segments and all segments operate in the healthcare regulatory environment. In addition, the segments are economically similar. Accordingly, management has aggregated the three operating segments into one reporting segment.

### Principles of Consolidation

All intercompany transactions have been eliminated.

### Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States ("U.S. GAAP") for complete financial statements. Accordingly, the accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of the Corporation and related footnotes for the year ended December 31, 2013, included in the Corporation's Annual Report on Form 10-K. The balance sheet as of December 31, 2013 has been derived from the audited consolidated financial statements adjusted for acquisition related measurement period adjustments.

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

### Use of Estimates

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. GAAP which requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities

and disclosure of contingent liabilities as of the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates are involved in collectability of accounts receivable, revenue recognition, inventory valuation, supplier rebates, the valuation of long-lived assets and goodwill, and accounting for income taxes. Actual amounts may differ from these estimates.

Fair Value of Financial Instruments

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

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
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NOTE 1—ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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

The financial liabilities recorded at fair value at December 31, 2013 and September 30, 2014 are set forth in the tables below (dollars in millions):

| As of December 31, 2013 | Asset/(Liability) | Level 1 | Level 2 | Level 3 | Valuation Technique |
|---|---|---|---|---|---|
| Financial Liabilities | | | | | |
| Deferred Compensation Plan | $ (6.9) | $ - | $(6.9) | $- | A |
| Contingent Consideration | (0.7) | - | - | (0.7) | C |
| Mandatorily Redeemable Interest | (8.2) | - | - | (8.2) | C |

| As of September 30, 2014 | Asset/(Liability) | Level 1 | Level 2 | Level 3 | Valuation Technique |
|---|---|---|---|---|---|
| Financial Liabilities | | | | | |
| Deferred Compensation Plan | $ (7.7) | $ - | $(7.7) | $- | A |
| Contingent Consideration | (1.8) | - | - | (1.8) | C |
| Mandatorily Redeemable Interest | (7.5) | - | - | (7.5) | C |

The deferred compensation plan liability represents an unfunded obligation associated with the deferred compensation plan offered to eligible employees and members of the Board of Directors of the Corporation. The fair value of the liability associated with the deferred compensation plan is derived using pricing and other relevant information for investments in phantom shares of certain available investment options, primarily mutual funds. This liability is classified as other long-term liabilities in the accompanying condensed consolidated balance sheet.

The contingent consideration represents future earn-outs associated with the Corporation's acquisition of an institutional pharmacy business purchased in 2013 and an infusion business purchased in 2014. The fair values of the liabilities associated with the contingent consideration were derived using the income approach with unobservable inputs, which included future gross profit forecasts and present value assumptions, and there was little or no market data. The Corporation assessed the fair values of the liabilities as of the acquisition date and will assess quarterly thereafter until settlement. This liability is classified as other long-term liabilities in the accompanying condensed consolidated balance sheet.

The mandatorily redeemable interest represents a future obligation associated with the Corporation's acquisition of a specialty pharmacy business purchased on December 6, 2013. The mandatorily redeemable interest is classified as a long-term liability and was measured at fair value as of December 31, 2013 and September 30, 2014. The fair value was derived using the income approach with unobservable inputs, which included a future gross profit forecast and

present value assumptions, and there was little or no market data.

There were no transfers between the three-tier fair value hierarchy levels during the periods presented.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, and accounts payable approximate fair value because of the short-term maturity of these instruments. The Corporation's debt approximates fair value due to the terms of the interest being set at variable market interest rates (Level 2).

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 1—ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accounts Receivable and Allowance for Doubtful Accounts

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

The Corporation has an established a process to determine the adequacy of the allowance for doubtful accounts, which relies on analytical tools, specific identification, and benchmarks to arrive at a reasonable allowance. No single statistic or measurement determines the adequacy of the allowance for doubtful accounts. The Corporation monitors and reviews trends by payer classification along with the composition of the Corporation's aging accounts receivable. This review is focused primarily on trends in private and other payers, PDP's, dual eligible co-payments, historic payment patterns of long-term care institutions, and monitoring respective credit risks. In addition, the Corporation analyzes other factors such as revenue days in accounts receivables, denial trends by payer types, payment patterns by payer types, subsequent cash collections, and current events that may impact payment patterns of the Corporation's long-term care institution customers. Accounts receivable are written off after collection efforts have been completed in accordance with the Corporation's policies.

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

| | (As Adjusted) December 31, 2013 | September 30, 2014 |
|---|---|---|
| Institutional healthcare providers | $ 160.9 | $ 164.2 |
| Medicare Part D | 31.1 | 36.9 |
| Private payer and other | 29.7 | 31.3 |
| Insured | 20.0 | 23.1 |
| Medicaid | 11.9 | 11.7 |
| Medicare | 2.5 | 3.9 |
| Allowance for doubtful accounts | (56.7) | (57.4) |
| | $ 199.4 | $ 213.7 |

| | | |
|---|---|---|
| 0 to 60 days | 55.5 % | 57.3 % |
| 61 to 120 days | 18.8 | 16.9 |
| Over 120 days | 25.7 | 25.8 |
| | 100.0% | 100.0% |

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

| | Beginning Balance | Charges to Costs and Expenses | Write-offs | Ending Balance |
|---|---|---|---|---|
| Allowance for doubtful accounts: | | | | |
| Year ended December 31, 2013 | $ 56.4 | $ 22.7 | $ (22.4) | $ 56.7 |
| Nine months ended September 30, 2014 | $ 56.7 | $ 16.6 | $ (15.9) | $ 57.4 |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 1—ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Goodwill and Other Intangibles

Goodwill represents the excess purchase price of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. The Corporation's policy is to perform a qualitative assessment on goodwill impairment to determine whether it is more likely than not (defined as having a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. As a result of the Corporation being notified during June 2013 that it will lose its largest customer effective December 31, 2013, the Corporation performed the first step of the two step analysis for the pharmacy services reporting unit during the quarter ended December 31, 2013 and determined that an impairment of goodwill did not occur as a result of this triggering event. The Corporation's fair value as calculated for the step one analysis was approximately 65% greater than current book value.

There have been no impairment triggering events during 2014.

The Corporation's finite-lived intangible assets are comprised primarily of trade names, customer relationship assets, limited distributor relationships, doctors and insurer relationships and non-compete agreements. Finite-lived intangible assets are amortized on a straight-line basis over the course of their lives ranging from 5 to 20 years. For impairment reviews, intangible assets are reviewed on a specific pharmacy basis or as a group of pharmacies depending on the intangible assets under review. The Corporation's goodwill and intangible assets are further described in Note 3.

Restructuring and Impairment Charges

Restructuring and impairment charges in the condensed consolidated financial statements represent amounts expensed for purposes of realigning corporate and pharmacy locations.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Corporation accrues for tax obligations as required by facts and circumstances in the various regulatory environments. Deferred tax assets and liabilities are more fully described in Note 9.

Mandatorily Redeemable Interest

The Corporation acquired 37.5% of the membership interests of OncoMed Specialty, LLC ("Onco") while also obtaining control of the business. As further discussed in Note 2, the subsidiary is consolidated in the Corporation's condensed consolidated financial statements and the mandatorily redeemable interest is classified as debt within other long-term liabilities in the condensed consolidated balance sheets.

Measurement Period Adjustments

For the nine months ended September 30, 2014, the Corporation has adjusted certain amounts on the condensed consolidated balance sheet as of December 31, 2013 as a result of measurement period adjustments related to the 2013 acquisitions (See Note 2).

Recently Issued Accounting Pronouncements

On May 28, 2014, the FASB issued Accounting Standard Update ("ASU") No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for the Corporation on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Corporation is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Corporation has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

On August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40); Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern, which requires management of the Corporation to evaluate whether there is substantial doubt about the Company's ability to continue as a going concern. ASU 2014-15 is effective for the Company in our first quarter of fiscal 2017, with early adoption permitted. The Corporation does not expect this standard to have an impact on the condensed consolidated financial statements upon adoption.

PHARMERICA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 2—ACQUISITIONS

2014 Acquisitions

During the nine months ended September 30, 2014, the Corporation completed acquisitions of four long-term care businesses and one infusion business (collectively the "2014 Acquisitions"), none of which were individually significant to the Corporation. The 2014 Acquisitions required cash payments of approximately $114.1 million. The resulting amount of goodwill and identifiable intangibles related to these transactions in the aggregate were $39.5 million and $61.4 million, respectively. The Corporation believes the resulting amount of goodwill reflects its expectation of synergistic benefits of the acquisitions. Tax deductible goodwill associated with the 2014 Acquisitions was $29.4 million as of September 30, 2014. The net assets and operating results of the 2014 Acquisitions have been included in the Company's consolidated financial statements from their respective dates of acquisition.

Amounts contingently payable related to the 2014 Acquisitions, representing payments originating from an earn-out provision of the infusion acquisition, were $1.1 million as of September 30, 2014.

The amounts recognized as of the acquisition dates for the 2014 Acquisitions, on a combined basis, for assets acquired and liabilities assumed are as follows:

| | Amounts Recognized as of Acquisition Date (1) | Measurement Period Adjustments | Amounts Recognized as of Acquisition Date (As Adjusted) |
|---|---|---|---|
| Accounts receivable | $ 25.2 | $ - | $ 25.2 |
| Inventory | 6.7 | 0.2 | 6.9 |
| Deferred tax assets - current | 3.0 | - | 3.0 |
| Other current assets | 3.1 | - | 3.1 |
| Equipment and leasehold improvements | 4.2 | - | 4.2 |
| Other long-term assets | - | - | - |
| Deferred tax assets - long-term | 4.1 | - | 4.1 |
| Identifiable intangibles | 61.4 | - | 61.4 |
| Goodwill | 39.7 | (0.2) | 39.5 |
| | 147.4 | - | 147.4 |
| Current liabilities | 26.4 | - | 26.4 |
| Deferred tax liabilities - long-term | - | - | - |
| Other long-term liabilities | 6.9 | - | 6.9 |
| | 33.3 | - | 33.3 |
| Total purchase price, less cash acquired | $ 114.1 | $ - | $ 114.1 |

(1) Per the purchase price allocations on a combined basis

The acquisitions on a combined basis had a $10.5 million impact on the consolidated revenues and $0.5 million impact on consolidated net income for the nine months ended September 30, 2014.

Pro Forma

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

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NOTE 2—ACQUISITIONS (Continued)

The unaudited pro forma results, includes the historical results of the Corporation as well as the effect of the acquisitions assuming the acquisitions occurred on January 1, 2013. The results may not be indicative of future results and do not include any synergistic benefits which the Corporation may realize. Assuming an effective tax rate exclusive of discrete items for the three and nine months ended September 30, 2013 and 2014, the pro forma results would be as follows (dollars in millions, except per share amounts):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2014 | 2013 | 2014 |
| Revenues | $494.9 | $513.0 | $1,484.1 | $1,521.9 |
| Net income | $(7.1) | $5.7 | $12.9 | $(2.0) |
| Earnings per common share: | | | | |
| Basic | $(0.24) | $0.19 | $0.44 | $(0.06) |
| Diluted | $(0.24) | $0.19 | $0.43 | $(0.06) |

2013 Acquisitions

During the year ended December 31, 2013, the Corporation completed five acquisitions of long-term care businesses (the "2013 Acquisitions"), none of which were, individually or in the aggregate significant to the Corporation. The 2013 Acquisitions of businesses required cash payments of approximately $25.8 million, of which $10.7 million was paid in 2014. The resulting amount of goodwill and identifiable intangibles related to these transactions in the aggregate were $8.0 million and $10.3 million, respectively. The net assets and operating results of acquisitions have been included in the Company's consolidated financial statements from their respective dates of acquisition.

Amounts contingently payable related to the 2013 Acquisitions, representing payments originating from earn-out provisions, were $0.7 million as of December 31, 2013 and September 30, 2014.

On December 6, 2013, the Corporation through one of its wholly owned subsidiaries, acquired 37.5% of the issued share capital of Onco for $10.8 million, net of cash acquired. The Corporation's primary purpose in acquiring Onco was to continue to expand pharmacy services through the addition of specialty pharmacy services. The purchase price, as determined by an independent valuation of 100% of Onco, was allocated to the net tangible and identifiable intangible assets based upon their fair values on December 6, 2013 which resulted in identifiable intangible assets of $17.3 million and goodwill of $4.6 million. The Corporation believes the resulting amount of goodwill reflects its expectation of the synergistic benefits of the acquisition. Provisions in the acquisition agreement include a mandatorily redeemable interest whereby the Corporation is required to purchase the remaining capital of Onco on the fifth anniversary of the agreement, if not purchased earlier under the provisions of the acquisition agreement. The Corporation is accounting for the mandatorily redeemable interest of $7.5 million as a debt obligation and subsequently measuring that obligation at fair value. Changes in the fair value of the related debt will be recorded as interest expense in our condensed consolidated statements of operations for the respective periods. In addition, net operating profit or loss of Onco subsequent to the acquisition is recognized based upon the Corporation's ownership interest. In addition, Onco's results are consolidated by the Corporation with 62.5 % of the net operating profit or loss subsequent to the acquisition recognized as an adjustment to interest expense on the mandatorily redeemable interest.

Total measurement period adjustments for the nine months ended September 30, 2014 resulted in a net adjustment to goodwill of $0.6 million and were related to the 2013 Acquisitions and Onco.

Other

For the three months ended September 30, 2013 and September 30, 2014, the Corporation incurred $1.0 million and $3.7 million, respectively, and $4.5 million and $10.0 million for the nine months ended September 30, 2013 and September 30, 2014, respectively, of acquisition-related costs, which have been classified as a component of merger, acquisition, integration costs and other charges .

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NOTE 3—GOODWILL AND INTANGIBLES

As of December 31, 2013, as adjusted, and September 30, 2014 the carrying amount of goodwill was $282.0 million and $321.5 million, respectively.

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

| Finite Lived Intangible Assets | (As Adjusted) Balance at December 31, 2013 | Additions | Balance at September 30, 2014 |
|---|---|---|---|
| Customer and other relationships | $ 121.2 | $ 56.4 | $ 177.6 |
| Trade name | 60.2 | 2.0 | 62.2 |
| Non-compete agreements | 16.9 | 3.0 | 19.9 |
| Sub Total | 198.3 | 61.4 | 259.7 |
| Accumulated amortization | (62.0) | (13.6) | (75.6) |
| Net intangible assets | $ 136.3 | $ 47.8 | $ 184.1 |

Amortization expense relating to finite-lived intangible assets was $3.7 million and $4.9 million for the three months ended September 30, 2013 and 2014, respectively. Amortization expense relating to finite-lived intangible assets was $11.7 million and $13.6 million for the nine months ended September 30, 2013 and 2014, respectively.

NOTE 4—CREDIT AGREEMENT

On September 17, 2014, the Corporation entered into a credit agreement by and among the Corporation, the lenders named therein (the "Lenders"), Bank of America, N.A., as administrative agent, JP Morgan Chase Bank N.A., as syndication agent, and U.S. Bank, National Association, Citibank, N.A., MUFG Union Bank, N.A., BBVA Compass Bank and SunTrust Bank as co-documentation agents (the "Credit Agreement"). The Credit Agreement replaced the $450.0 million five-year credit agreement dated as of May 2, 2011, among the Corporation, Citibank, N.A., as Administrative Agent, and certain lenders (the "Prior Credit Agreement"). The Credit Agreement consists of a $225.0 million term loan facility and a $310.0 million revolving credit facility. The terms and conditions of the Credit Agreement are customary to facilities of this nature.

As a result of the payoff of the Prior Credit Agreement, the Corporation recorded a loss on debt extinguishment of $4.3 million in the Condensed Consolidated Statement of Operations during the three months ended September 30, 2014. The loss recorded consisted primarily of deferred financing fees associated with the Prior Credit Agreement.

As of September 30, 2014, $225.0 million was outstanding under the term loan facility and $135.9 million was outstanding under the revolving credit facility. Indebtedness under the Credit Agreement matures on September 17, 2019, at which time the commitments of the Lenders to make revolving loans also expire.

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

| | December 31, | September 30, |
|---|---|---|

| Credit Agreement: | 2013 | 2014 |
|---|---|---|
| Term Debt - payable to lenders at LIBOR plus applicable margin (1.95% as of September 30, 2014), matures September 17, 2019 | $ - | $ 225.0 |
| Term Debt - payable to lenders at LIBOR plus applicable margin (2.67% as of December 31, 2013), terminated September 17, 2019 | 231.3 | |
| Revolving Credit Facility payable to lenders, interest at LIBOR plus applicable margin (1.90% as of September 30, 2014), matures September 17, 2019 | - | 135.9 |
| Revolving Credit Facility payable to lenders, interest at base rate plus applicable margin (4.75% as of December 31, 2013), terminated September 17, 2019 | - | - |
| Total debt | 231.3 | 360.9 |
| Less: Current portion of long-term debt | 12.5 | 2.8 |
| Total long-term debt | $ 218.8 | $ 358.1 |

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NOTE 4—CREDIT AGREEMENT (Continued)

The Corporation's indebtedness has the following maturities for the remaining life of the Credit Agreement (dollars in millions):

| Year Ending December 31, | Term Debt | Revolving Credit Facility | Total Maturities |
|---|---|---|---|
| 2014 | $- | $ - | $ - |
| 2015 | 5.6 | - | 5.6 |
| 2016 | 11.3 | - | 11.3 |
| 2017 | 11.3 | - | 11.3 |
| 2018 | 11.3 | - | 11.3 |
| 2019 | 185.5 | 135.9 | 321.4 |
| | $225.0 | $ 135.9 | $ 360.9 |

The Credit Agreement provides for the issuance of letters of credit which, when issued, reduce availability under the revolving credit facility. The aggregate amount of letters of credit outstanding as of September 30, 2014 was $2.5 million. After giving effect to the letters of credit, total availability under the revolving credit facility was $171.6 million as of September 30, 2014.

Borrowings under the Credit Agreement bear interest at a floating rate equal to, at the Corporation's option, a base rate plus a margin between 0.50% and 1.25% per annum, or a Eurodollar Rate plus a margin between 1.50% and 2.25% per annum, in each case depending on the leverage ratio of the Corporation as defined by the Credit Agreement. The base rate is the greater of the prime lending rate in effect on such day, the federal funds effective rate plus 0.50%, and the Eurodollar Rate plus 1.00%. The Credit Agreement also provides for letter of credit fees between 1.50% and 2.25% on the letter of credit exposure, depending on the leverage ratio of the Corporation, and 0.125% on the actual daily amount available to be drawn under such letter of credit. The Corporation will also pay fronting fees on the aggregate letter of credit exposure at a rate separately agreed upon between the Corporation and the issuing bank. The Credit Agreement also provides for a commitment fee payable on the unused portion of the revolving credit facility, which shall accrue at a rate per annum ranging from 0.25% to 0.35%, depending on the leverage ratio of the Corporation.

The Credit Agreement contains customary affirmative and negative covenants, as well as customary events of default. The Credit Agreement also requires the Corporation to satisfy an interest coverage ratio and a leverage ratio. The interest charge coverage ratio as of the last day of any fiscal quarter can be no less than: 3.00:1.00. The Leverage Ratio as of the last day of any fiscal quarter of the Corporation cannot exceed 3.75:1.00, subject to certain exceptions for permitted acquisitions. In addition, capital expenditures (other than those funded with proceeds of asset sales or insurance) are restricted in any fiscal year to 5.0 % of revenues.

The Corporation was compliant with all debt covenant requirements at September 30, 2014.

The obligations under the Credit Agreement are guaranteed by certain domestic subsidiaries of the Corporation and secured by liens on substantially all of the Corporation's assets.

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NOTE 5—COMMITMENTS AND CONTINGENCIES

Legal Action and Regulatory

The Corporation maintains liabilities for certain of its outstanding investigations and litigation. In accordance with the provisions of U.S. GAAP for contingencies, the Corporation accrues for a liability when it is probable that such a liability has been incurred and the amount of the loss can be reasonably estimated. The Corporation is the subject of certain investigations and is a defendant in a number of cases, including those discussed below.

On April 15, 2013, the U.S. Department of Justice, through the U.S. Attorney's Office for the Eastern District of Virginia, filed a complaint in the United States District Court for the Eastern District of Virginia against the Corporation's two pharmacies in Virginia Beach, Virginia and Fredericksburg, Virginia alleging that these two pharmacies failed to comply with the Controlled Substances Act ("CSA") by dispensing Schedule II drugs without a proper prescription. The parties reached a settlement in December 2013 and filed a stipulation for dismissal of the case in January 2014. Under the settlement, the Corporation paid a $1.0 million fine and will enter into a Memorandum of Agreement ("MOA") with the DEA through which it will agree to certain CSA compliance obligations. The precise terms of the MOA are currently being negotiated between the parties. In connection with the settlement, the Corporation did not admit liability for the alleged CSA violations.

On June 10, 2013, the United States District Court for the Eastern District of Wisconsin unsealed two consolidated qui tam complaints filed in 2009 and 2011 by relators who are former employees of the Corporation and a company acquired by the Corporation. The United States, acting through the U.S. Attorney's Office in Wisconsin, intervened in part and declined to intervene in part and filed its complaint in intervention on August 9, 2013, when the matter was formally brought to the Corporation's attention. The Government's complaint seeks statutory fines for the Corporation's alleged dispensing of Schedule II controlled substances without a valid prescription in violation of the CSA. It also seeks monetary damages and equitable relief alleging that this conduct caused false claims to be submitted in violation of the Federal False Claims Act (the "FCA"). The Corporation moved to dismiss the government's complaint for failure to state a claim upon which relief may be granted but the Court denied the Corporation's motion on September 3, 2014. With regard to the portion of the relators' complaint on which the Government did not intervene, on November 15, 2013, the relators dismissed their claims against the Corporation alleging that the Corporation submitted false claims to Medicare Part D and to Medicaid for drugs in connection with which the Corporation allegedly received kickbacks from the manufacturer in the form of market share rebates and other remuneration, all in violation of the Federal Anti Kickback Statute (the "AKS/FCA" claims). The United States stipulated to the dismissal of those and other non-intervened counts, and the Court approved the dismissal without prejudice of those counts on November 20, 2013. The relators pursued their claim under the retaliatory termination provisions of the FCA. On September 3, 2014, the Court denied the Corporation's motion to dismiss the relators' retaliatory termination claim. The Corporation intends to vigorously defend itself in both matters.

On October 29, 2013, a complaint was filed in the United States District Court for the Southern District of Florida by Pines Nursing Homes (77), Inc. as a putative class action against the Corporation. The complaint alleged that the Corporation sent unsolicited advertisements promoting the Corporation's goods or services by facsimile to individuals or entities, and that such communications did not include an opt-out clause, all in violation of the federal Telephone Consumer Protection Act ("TCPA"). The Complaint did not specify the amount of damages sought, but the TCPA provides a statutory remedy of $500 per facsimile communication sent in violation of the statute, which may be trebled in the event of a willful violation. On August 18, 2014, the Corporation entered into a Settlement Agreement with the putative class and class counsel resolving all claims raised in the complaint. The parties moved on

September 8, 2014 for, among other things, certification of the putative class for the purposes of effectuating the settlement and preliminary approval of the parties' settlement, and have requested a hearing on that motion. No hearing has yet been set on that motion and the Corporation awaits a decision on the motion for preliminary approval of the settlement.

On November 12, 2013, a relator, Fox Rx, Inc. ("Fox"), on behalf of the U.S. Government and various state governments and the District of Columbia, filed a complaint in the United States District Court for the Southern District of New York against the Corporation alleging that the Corporation violated the FCA by submitting false claims to Fox, other Medicare Part D sponsors and to Medicaid, by allegedly billing for expired drugs or for brand drugs when generic drugs should have been substituted. Following the U.S. Government's decision to decline to intervene in the case, the complaint was unsealed and served on the Corporation. The Corporation moved to dismiss the complaint on February 28, 2014 and on August 12, 2014, the court granted the Corporation's motion. On September 10, 2014, Fox filed its notice of appeal but subsequently filed a stipulation of dismissal and the appeal was dismissed on September 30, 2014.

On November 20, 2013 the complaint filed by a relator, Robert Gadbois, on behalf of the U.S. Government and various state governments, was unsealed by the United States District for the District of Rhode Island against the Corporation alleging that the Corporation dispensed controlled and non-controlled substances in violation of the CSA and that, as a result, the dispenses were not eligible for payment and that the claims the Corporation submitted to the Government were false within the meaning of the FCA. The U.S. Government and the various state governments have declined to intervene in this case. The case therefore has been unsealed and the relator served the Second Amended Complaint on the Corporation. On October 3, 2014, the Corporation's motion to dismiss was granted by the court. The relator has appealed the court's decision. The Corporation intends to continue to defend the case vigorously.

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NOTE 5—COMMITMENTS AND CONTINGENCIES (Continued)

On March 4, 2011, a relator, Mark Silver, on behalf of the U.S. Government and various state governments, filed a complaint in the United States District for the District of New Jersey against the Corporation alleging that the Corporation violated the FCA and Federal Anti-Kickback Statute through its agreements to provide prescription drugs to nursing homes under certain Medicare and Medicaid programs. On February 19, 2013, the U.S. Government declined to intervene in the case. The complaint has been amended several times, most recently on November 12, 2013, and thereafter served upon the Corporation. On December 6, 2013, the Corporation moved to dismiss the amended complaint for failure to state a claim upon which relief may be granted and on September 29, 2014, the court denied its motion with regard to the substantive argument, but granted the motion in part by limiting the relevant time period. The Corporation believes the allegations are meritless and intends to vigorously defend itself against these allegations.

On January 31, 2014, a relator, Frank Kurnik, on behalf of the U.S. Government and various state governments served its complaint filed in the United States District for the District of South Carolina alleging that the Corporation solicited and received remuneration in violation of the Federal Anti-Kickback Statute from drug manufacturer Amgen in exchange for preferring and promoting Amgen's drug Aranesp over a competing drug called Procrit. The U.S. Government and the various states declined to intervene in the case. On April 7, 2014, the Corporation moved to dismiss the complaint and on July 23, 2014, the motion was denied. The Corporation believes the allegations are meritless and intends to vigorously defend itself against these allegations.

The U.S. Department of Justice, through the U.S. Attorney's Office for the Western District of Virginia, is investigating whether the Corporation's activities in connection with the agreements it had with the manufacturer of the pharmaceutical Depakote violated the False Claims Act or the Anti-Kickback Statute. The Corporation is cooperating with this investigation and believes it has complied with all applicable laws and regulations. On May 29, 2014, the United States District Court for the Western District of Virginia entered an order unsealing two previously partially sealed qui tam complaints, entitled United States, et al., ex rel. Spetter v. Abbott Laboratories. Inc., Omnicare, Inc., and PharMerica Corp., No. 1:07-cv-00006 and United States, et al., ex rel. McCoyd v. Abbott Laboratories, Omnicare, Inc., PharMerica Corp., and Miles White, No. 1:07-cv-0008, and the United States' Notice of Intervention in the cases. The complaints allege violations of the False Claims Act from activities in connection with agreements the Corporation had with the manufacturer of the pharmaceutical Depakote that allegedly violated the Anti-Kickback Statute. The Corporation believes the allegations are meritless and intends to vigorously defend itself.

On September 10, 2014, the Corporation filed a Complaint in Jefferson Circuit Court in Louisville, Kentucky against AmerisourceBergen Drug Corporation ("ABDC") for breach of the Amended Prime Vendor Agreement ("Amended PVA"). The Corporation subsequently filed a First Amended Complaint asserting additional breaches of the Amended PVA and filed a motion seeking a preliminary injunction enjoining ABDC from instituting certain drug substitution programs. On September 10, 2014, ABDC filed suit in the Court of Chancery of the State of Delaware seeking a declaration that it is not in breach of the Amended PVA. The amounts disputed by ABDC generally relate to certain rebates owed by ABDC under the Amended PVA, which are approximately $8.5 million for the second quarter of 2014 and $12.3 million for the third quarter of 2014 and are likely to be of an approximately similar magnitude as the third quarter 2014 in future quarters. The Corporation has moved to dismiss the Delaware proceeding for lack of subject matter jurisdiction or, in the alternative, to dismiss or stay the action pending resolution of the Kentucky action. ABDC has filed a motion to stay the Kentucky action. The Corporation intends to vigorously pursue its claims in whichever (or both) action proceeds. The Corporation believes the aggregate amount of its claims currently approximate $20.8 million as of September 30, 2014 which is reflected as a receivable and included in

prepaids and other assets in the accompanying unaudited condensed consolidated balance sheets. At this time, the Corporation is unable to determine the ultimate impact of these litigation proceedings on its consolidated financial condition, results of operations, or liquidity. The litigation proceedings with ABDC could continue for an extended period of time, likely longer than 18 months. Although the Corporation is confident in the merits of its case, until the resolution or settlement of such proceedings, the Corporation cannot provide any assurances about the collectability of the disputed amounts owed by ABDC.

On March 6, 2012, a relator, Fox, a former Part D Plan Sponsor, filed a complaint against the Corporation in the United States District Court for the Southern District of Ohio. Fox filed an amended complaint on October 2, 2012. The case was transferred to the United States District Court for the Western District of Virginia on March 27, 2013. Fox alleges that the Corporation engaged in a variety of schemes relating to the dispensing of atypical antipsychotics and the drug Depakote, including allegedly dispensing drugs for unapproved uses, allegedly receiving illegal kickbacks in the form of rebates, and other alleged violations. Fox also alleges that the Corporation improperly inflated dispensing fees by splitting prescriptions into partial fills. Fox alleges that these activities caused the subsequent claims submitted to Medicare and Medicaid to be rendered false within the meaning of the federal FCA and various state analogues. The United States declined to intervene on September 8, 2014 and the case was unsealed on September 10, 2014, at which time the Court ordered Fox to serve the complaint upon the Corporation. Fox has until January 8, 2015 to serve the Corporation with the complaint but has not yet done so. The Corporation intends to vigorously defend itself if and when Fox serves the complaint.

In addition, the Corporation is involved in certain legal actions and regulatory investigations arising in the ordinary course of business. At September 30, 2014, the Corporation had accrued approximately $40.1 million related to the legal actions and investigations.

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**NOTE 5—COMMITMENTS AND CONTINGENCIES (Continued)**

California Medicaid

On August 14, 2013, the California Department of Health Care Service ("DHCS") announced its intent to implement a ten (10) percent reimbursement reduction for numerous healthcare providers, including long term care pharmacies. Originally, the DHCS received federal approval for the reduction effective June 1, 2011, but the DHCS had been prevented from implementing the reductions due to a court injunction. The United States Court of Appeals for the Ninth Circuit denied the plaintiffs' motion for a stay of mandate, allowing for the implementation of the reimbursement reduction.

The DHCS implemented the reduction prospectively beginning in the first quarter of 2014, however the reduction did not have a significant impact on the Corporation's results of operations. In addition, the DHCS will begin recouping a percentage of provider payments representing a ten (10) percent reduction on certain drug reimbursements retroactive to June 1, 2011. These retroactive recoveries have not yet been announced by DHCS. The Corporation has previously recorded a $3.3 million liability and reduction of revenue which represents its best estimate of the expected amount of recoveries from June 1, 2011 through December 31, 2013.

FUL and AMP Changes

The reimbursement rates for pharmacy services under Medicaid are determined on a state-by-state basis subject to review by CMS and applicable federal law. Although Medicaid programs vary from state to state, they generally provide for the payment of certain pharmacy services, up to the established limits, at rates determined in accordance with each state's regulations. Federal regulations and the regulations of certain states establish "upper limits" for reimbursement of certain prescription drugs under Medicaid (these upper limits being the "FUL").

The 2010 Health Care Reform Legislation amended the Deficit Reduction Act of 2005 ("DRA") to change the definition of the FUL by requiring the calculation of the FUL as no less than 175 % of the weighted average, based on utilization, of the most recently reported monthly Average Manufacturer's Price ("AMP") for pharmaceutically and therapeutically equivalent multi-source drugs available through retail community pharmacies nationally. In addition, the definition of AMP changed to reflect net sales only to drug wholesalers that distribute to retail community pharmacies and to retail community pharmacies that directly purchase from drug manufacturers. Further, the 2010 Health Care Reform Legislation continues the current statutory exclusion of prompt pay discounts offered to wholesalers and adds three (3) other exclusions to the AMP definition: i) bona fide services fees; ii) reimbursement for unsalable returned goods (recalled, expired, damaged, etc.); and iii) payments from and rebates/discounts to certain entities not conducting business as a wholesaler or retail community pharmacy. In addition to reporting monthly, the manufacturers are required to report the total number of units used to calculate each monthly AMP. Centers for Medicare and Medicaid Services ("CMS") will use this information when it establishes FULs as a result of the new volume-weighted requirements pursuant to the 2010 Health Care Reform Legislation.

In September 2011, CMS issued the first draft FUL reimbursement files for multiple source drugs, including the draft methodology used to calculate the FULs in accordance with the Health Care Legislation. CMS continues to release monthly data and a three-month rolling average and is expected to do so going forward. CMS has not posted monthly AMPs for individual drugs, but only posted the weighted average of monthly AMPs in a FUL group and the calculation methodology.

The Office of Information and Regulatory Affairs website provides no date for when the final rule will be released. CMS will continue to post draft monthly FULs. The Corporation will continue to analyze the draft monthly, including the relationship of those FULs to the National Average Drug Acquisition pricing.

Medicare Part D Changes

In a May 23, 2014 Final Rule entitled "Medicare Program: Contract Year 2015 Policy and Technical Changes to the Medicare Advantage and the Medicare Prescription Drug Benefit Programs," CMS finalized a requirement that effective June 1, 2015, all prescribers of Part D covered drugs must be enrolled as Medicare providers (or be granted a valid opt-out affidavit on file with a Part A or Part B Medicare Administrative Contractor) in order for a claim to be covered under Medicare Part D. CMS also finalized several specific requirements to reduce prescriber fraud, waste, and abuse. The Corporation is unable to evaluate the full impact of these changes on its business at this time.

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**NOTE 5—COMMITMENTS AND CONTINGENCIES (Continued)**

Acquisitions

The Corporation has historically acquired the stock or assets of businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, medical and general professional liabilities, workers' compensation liabilities, previous tax liabilities, and unacceptable business practices. Although the Corporation institutes policies designed to conform practices to its standards following completion of acquisitions, there can be no assurance that the Corporation will not become liable for past activities that may later be asserted to be improper by private plaintiffs or government agencies. While the Corporation generally seeks to obtain indemnification from prospective sellers covering such matters, there can be no assurance that any such matter will be covered by indemnification, or if covered, that such indemnification will be adequate to cover potential losses and fines. In the ordinary course of business, the Corporation enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction such as business acquisitions and disposals of an operating facility. These indemnifications may cover claims against employment-related matters, governmental regulations, environmental issues, tax matters, as well as customer, third party payer, supplier, and contractual relationships. Obligations under these indemnities generally would be initiated by a breach of the terms of the contract or by a third party claim or event.

Prime Vendor Agreement

On January 25, 2013 the Corporation renegotiated its Amended PVA with ABDC effective January 1, 2013. The Amended PVA modified the previous agreement, which was set to expire September 30, 2013 and extended its term until September 30, 2016.

The Amended PVA requires the Corporation to purchase certain levels of brand and non-injectable generic drugs from ABDC. The Amended PVA does provide the flexibility for the Corporation to contract with other suppliers. If the Corporation fails to adhere to the contractual purchase provisions, ABDC has the ability to increase the Corporation's drug pricing under the terms of the Amended PVA.

The Corporation and ABDC are parties to certain legal proceedings with respect to the Amended PVA as further described above.

Employment Agreements

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

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

provide additional payments or benefits or both upon a termination of employment in connection with a change in control. Additionally, the vesting of certain equity based grants made to certain executive officers accelerate upon the occurrence of a change in control.

NOTE 6—MERGER, ACQUISITION, INTEGRATION COSTS AND OTHER CHARGES

Merger, acquisition, integration costs and other charges combined were $1.1 million and $3.8 million for the three months ended September 30, 2013 and 2014, respectively, and $6.6 million and $10.3 million for the nine months ended September 30, 2013 and 2014, respectively.

The merger, integration costs and other charges component for the three months ended September 30, 2013 and 2014 were $0.1 million and $0.1 million, respectively, and $2.1 million and $0.3 million for the nine months ended September 30, 2013 and 2014, respectively. These costs primarily represent employee related and facility costs associated with consolidating past acquisitions. The acquisition related costs component for the three months ended September 30, 2013 and 2014 were $1.0 million and $3.7 million, respectively, and $4.5 million and $10.0 million for the nine months ended September 30, 2013 and 2014, respectively. These costs primarily represent severance and other payments associated with former employees, professional fees, lease costs and other duplicative costs associated with current and future acquisitions.

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NOTE 7—RESTRUCTURING COSTS AND OTHER CHARGES

In July 2013, the Corporation commenced the implementation of its restructuring plan as a result of the loss of two of the Corporation's significant customers, Kindred Healthcare ("Kindred") and Golden Living. The plan is a major initiative primarily designed to optimize operational efficiency while ensuring that the Corporation remains well-positioned to serve its clients and achieve sustainable, long-term growth. The Corporation's restructuring plan includes steps to rightsize its cost structure by adjusting its workforce and facility plans to reflect anticipated business needs.

The Corporation recorded restructuring costs and other related charges of approximately of $1.0 million and $0.1 million during the three months ended September 30, 2013 and 2014, respectively, and $1.0 million and $3.2 million during the nine months ended September 30, 2013 and 2014, respectively. The restructuring charges primarily included severance pay, the buy-out of employment agreements, lease terminations, and other exit-related asset disposals, professional fees and facility exit costs.

The following table presents the components of the Corporation's restructuring liability (dollars in millions):

| | Balance at December 31, 2013 | Accrual | Utilized Amounts | Balance at September 30, 2014 |
|---|---|---|---|---|
| Employee Severance and related costs | $ 1.8 | $ 2.1 | $ (3.5) | $ 0.4 |
| Facility costs | 0.8 | 1.1 | (0.7) | 1.2 |
| | $ 2.6 | $ 3.2 | $ (4.2) | $ 1.6 |

The liability at September 30, 2014 represent amounts not yet paid relating to actions taken in connection with the program (primarily lease payments and severance costs).

NOTE 8—COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS

Treasury Stock Purchases

In August 2010, the Board of Directors authorized a share repurchase of up to $25.0 million of the Corporation's common stock, of which $10.5 million was used. On July 2, 2012 the Board of Directors authorized an increase to the remaining portion of the existing share repurchase program that allows the Corporation to again repurchase up to a maximum of $25.0 million of the Corporation's common stock. Approximately $19.7 million remained available under the program as of September 30, 2014. Share repurchases under this authorization may be made in the open market through unsolicited or solicited privately negotiated transactions, or in such other appropriate manner, and are funded from available cash. The amount and timing of the repurchases, if any, would be determined by the Corporation's management and would depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. Common stock acquired through the share repurchase program would be held as treasury shares and may be used for general corporate purposes, including reissuance in connection with acquisitions, employee stock option exercises or other employee stock plans. The share repurchase program does not have an expiration date and may be limited, terminated or extended at any time without prior notice. During the nine months ended September 30, 2014, the Corporation did not repurchase shares of common stock under

the share repurchase program.

The Corporation may redeem shares from employees upon the vesting of the Corporation's stock awards for minimum statutory tax withholding purposes. The Corporation redeemed 200,334 shares of certain vested awards for an aggregate price of approximately $5.1 million during the nine months ended September 30, 2014. These shares have also been designated by the Corporation as treasury stock.

As of September 30, 2014, the Corporation had a total of 2,617,305 shares held as treasury stock.

PHARMERICA CORPORATION

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NOTE 8—COMMON STOCK, PREFERRED STOCK, TREASURY STOCK, STOCK-BASED COMPENSATION AND OTHER BENEFITS (Continued)

Stock Option Activity

Stock options were not granted to officers and employees during 2013 or the nine months ended September 30, 2014. The following table summarizes option activity for the periods presented:

| | Number of Shares | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Term | Aggregate Intrinsic Value (in millions) |
|---|---|---|---|---|
| Outstanding shares at December 31, 2013 | 1,289,573 | $ 14.63 | 2.9 years | $ 8.9 |
| Exercised | (278,350) | 14.77 | | |
| Canceled | (87,799) | 12.67 | | |
| Expired | (859) | 14.41 | | |
| Outstanding shares at September 30, 2014 | 922,565 | $ 14.63 | 2.3 years | $ 9.0 |
| Exercisable shares at September 30, 2014 | 827,016 | $ 15.06 | 2.2 years | $ 7.7 |

Nonvested Shares

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

| | Number of Shares | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Outstanding shares at December 31, 2013 | 1,096,674 | $ 13.47 |
| Granted - Restricted Stock Units | 196,126 | 25.58 |
| Granted - Performance Share Units | 247,290 | 20.01 |
| Forfeited | (102,591) | 15.67 |
| Vested | (487,713) | 12.37 |
| Outstanding shares at September 30, 2014 | 949,786 | $ 18.00 |

The weighted average remaining term and intrinsic value of non-vested shares as of September 30, 2014 was 2.6 years and $23.2 million, respectively.

NOTE 9—INCOME TAXES

The provision for income taxes is based upon the Corporation's estimate of annual taxable income or loss for each respective accounting period. The following table summarizes our provision for income taxes for the periods

presented (dollars in millions):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2014 | 2013 | 2014 |
| Provision (benefit) for income taxes | $4.2 | $2.2 | $19.3 | $2.9 |
| Total provision as a percentage of pre-tax income (loss) | NM* | 21.0% | 57.1% | 45.3% |

*NM - Not Meaningful

The provision for income taxes for the nine months ended September 30, 2013 and 2014 was significantly impacted by the Corporation's $17.4 million and $28.9 million of settlement, litigation and other related charges, respectively. The Corporation has concluded that the charges in each period will be partially non-tax deductible and has accounted for the absence of a tax benefit as a discrete item in the tax provision calculation. The partial non-deductibility of the charges resulted in an increase in the tax provision for the nine months ended September 30, 2013 and 2014 of approximately $6.6 million and $2.0 million, respectively. Also included in the discrete items for the three and nine month periods ended September 30, 2013 and 2014 is the impact of the true up of the provision to the respective tax returns. Excluding the impact of the discrete tax items, the provision for income taxes as a percentage of pre-tax income before the charges would have been 38.1 % and 37.0% for the nine months ended September 30, 2013 and 2014, respectively. The decrease in the rate from the prior year, after excluding the impact of the discrete items, was a result of net deductible permanent differences for the nine months ended September 30, 2014.

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NOTE 9—INCOME TAXES (Continued)

The Corporation derives a current federal and state income tax benefit from the impact of deductions associated with the amortization of tax deductible goodwill acquired through business combinations. The tax basis of the Corporation's tax deductible goodwill was approximately $128.5 million and $149.1 million at December 31, 2013 (as adjusted) and September 30, 2014, respectively. The future tax benefits of the tax-deductible goodwill are included in the Corporation's deferred tax assets.

The Corporation recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Corporation also recognizes as deferred tax assets the future tax benefits from net operating loss carryforwards. As of September 30, 2014, the Corporation has $5.2 million ($1.8 million tax benefit) of federal net operating loss carryforwards recorded related to a 2013 acquisition and $24.8 million ($8.7 million deferred tax benefit) related to a 2014 acquisition. The Corporation's ability to utilize these loss carryovers is limited, but the Corporation expects that it will be able to use the recorded amount which takes into account the limitations of the carryforwards and has not recorded any valuation allowance for the associated deferred tax asset. The Corporation has state net operating loss carryforwards representing a tax benefit of $7.2 million and valuation allowances totaling $4.1 million. The net operating losses have carryforward periods ranging from 1 to 20 years depending on the taxing jurisdiction.

A valuation allowance is provided for the Corporation's deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized. The Corporation recognized deferred tax assets totaling $18.2 million at December 31, 2013 and $28.6 million at September 30, 2014, net of state valuation allowances of $4.1 million.

As of December 31, 2013 and September 30, 2014, the Corporation had no reserves recorded for unrecognized tax benefits for U.S. federal and state tax jurisdictions.

The federal statute of limitations remains open for tax years 2011 through 2013.
State tax jurisdictions generally have statutes of limitation ranging from three to five years. The Corporation is generally no longer subject to state and local income tax examinations by tax authorities for years before 2008. The state income tax impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification of IRS settlement to the states.

PHARMERICA CORPORATION

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NOTE 10—EARNINGS (LOSS) PER SHARE

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2014 | 2013 | 2014 |
| Numerator: | | | | |
| Numerator for basic and earnings (loss) per diluted share - net income (loss) | $(6.2) | $8.5 | $14.5 | $3.6 |
| Denominator: | | | | |
| Denominator for basic earnings (loss) per share - weighted average shares | 29,655,201 | 30,073,133 | 29,645,380 | 29,944,875 |
| Effective of dilutive securities (stock options, restricted stock units and performance share units) | - | 522,169 | 304,999 | 558,053 |
| Denominator for earnings (loss) per diluted share - adjusted weighted average shares | 29,655,201 | 30,595,302 | 29,950,379 | 30,502,928 |
| Basic earnings (loss) per share | $(0.21) | (b) $0.28 | $0.49 | $0.12 |
| Earnings (loss) per diluted share | $(0.21) | (b) $0.28 | $0.48 | $0.12 |
| Unexercised employee stock options and unvested restricted shares excluded from the effect of dilutive securities above (a)(b) | 1,917,486 | 465,377 | 2,028,557 | 481,844 |

(a) These unexercised employee stock options, unvested restricted shares and performance shares that have not yet met performance conditions are not included in the computation of diluted earnings (loss) per share because to do so would be anti-dilutive for the periods presented.

Stock options and restricted shares and units granted by the Corporation are treated as potential common shares outstanding in computing earnings per diluted share. Performance share units are treated as potential common shares outstanding in computing earnings per diluted share only when the performance conditions are met.

Common shares repurchased by the Corporation reduce the number of basic shares used in the denominator for basic and diluted earnings (loss) per share.

(b) The diluted loss per share for the three months ended September 30, 2013 does not include the effects of potential common shares because its inclusion would be anti-dilutive due to the net loss for the period.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

- the Corporation's access to capital, credit ratings, indebtedness, and ability to raise additional financings and operate under the terms of the Corporation's debt obligations;
- anti-takeover provisions of the Delaware General Corporation Law, which in concert with our certificate of incorporation and our by-laws could delay or deter a change in control;
- the effects of adverse economic trends or intense competition in the markets in which we operate;
- the Corporation's risk of loss of revenues due to a customer or owner of skilled nursing facility entering the institutional pharmacy business;
- the effects of the loss of a large customer and the Corporation's ability to adequately restructure its operations to offset the loss;
- the demand for the Corporation's products and services;
- the risk of retaining existing customers and service contracts and the Corporation's ability to attract new customers for growth of the Corporation's business;
- the effects of renegotiating contract pricing relating to significant customers and suppliers, including the hospital pharmacy business which is substantially dependent on service provided to one customer;
- the impacts of cyber security risks and/or incidents;
- the effects of a failure in the security or stability of our technology infrastructure, or the infrastructure of one or more of our key vendors, or a significant failure or disruption in service;
- the effects of an increase in credit risk, loss or bankruptcy of or default by any significant customer, supplier, or other entity relevant to the Corporation's operations;
- the Corporation's ability to successfully pursue the Corporation's development and acquisition activities and successfully integrate new operations and systems, including the realization of anticipated revenues, economies of scale, cost savings, and productivity gains associated with such operations;
- the Corporation's ability to control costs, particularly labor and employee benefit costs, rising pharmaceutical costs, and regulatory compliance costs;
- the effects of healthcare reform and government regulations, including interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare and institutional pharmacy services industries including the dispensing of antipsychotic prescriptions;
- changes in the reimbursement rates or methods of payment from Medicare and Medicaid and other third party payers to both us and our customers;
-

- the potential impact of state government budget shortfalls and their ability to pay the Corporation and its customers for services provided;
- the Corporation's ability, and the ability of the Corporation's customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;
- the effects of changes in the interest rate on the Corporation's outstanding floating rate debt instrument and the increases in interest expense, including increases in interest rate terms on any new debt financing;
- the Corporation's ability to successfully refinance its debt arrangements to decrease interest rates;
- further consolidation of managed care organizations and other third party payers;
- political and economic conditions nationally, regionally, and in the markets in which the Corporation operates;
- natural disasters, war, civil unrest, terrorism, fire, floods, tornadoes, earthquakes, hurricanes, epidemic, pandemic, catastrophic event or other matters beyond the Corporation's control;
- increases in energy costs, including state and federal taxes, and the impact on the costs of delivery expenses and utility expenses;
- elimination of, changes in, or the Corporation's failure to satisfy pharmaceutical manufacturers' rebate programs;
- the Corporation's ability to attract and retain key executives, pharmacists, and other healthcare personnel;
- the Corporation's risk of loss not covered by insurance;
- the outcome of litigation to which the Corporation is a party from time to time, including adverse results in material litigation or governmental inquiries including the possible insufficiency of any accruals established by the Corporation from time to time;
- changes in accounting rules and standards, audits, compliance with the Sarbanes-Oxley Act, and regulatory investigations;
- changes in market conditions that would result in the impairment of goodwill or other assets of the Corporation;
- changes in market conditions in which we operate that would influence the value of the Corporation's stock;
- the uncertainty as to the long-term value of the Corporation's common stock;
- the Corporation's ability to anticipate a shift in demand for generic drug equivalents and the impact on the financial results including the negative impact on brand drug rebates;
- the effect on prescription volumes and the Corporation's net revenues and profitability if the safety risk profiles of drugs increase or if drugs are withdrawn from the market, including as a result of manufacturing issues, or if prescription drugs transition to over-the-counter products;
- the effects on the Corporation's results of operations related to interpretations of accounting principles by the SEC staff that may differ from those of management;
- the potential impact of the litigation proceedings with AmerisourceBergen Drug Company regarding the Amended Prime Vendor Agreement;
- changes in tax laws and regulations;
- the effects of changes to critical accounting estimates; and
- other factors, risks and uncertainties referenced in the Corporation's filings with the Commission, including the "Risk Factors" set forth in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

YOU ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON ANY FORWARD-LOOKING STATEMENTS, ALL OF WHICH SPEAK ONLY AS OF THE DATE OF THIS QUARTERLY REPORT. EXCEPT AS REQUIRED BY LAW, WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR RELEASE ANY REVISIONS TO THESE FORWARD-LOOKING STATEMENTS TO REFLECT ANY EVENTS OR CIRCUMSTANCES AFTER THE DATE OF THIS QUARTERLY REPORT OR TO REFLECT THE OCCURRENCE OF UNANTICIPATED EVENTS. ALL SUBSEQUENT WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS ATTRIBUTABLE TO US OR ANY PERSON ACTING ON THE CORPORATION'S BEHALF ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THE CAUTIONARY STATEMENTS CONTAINED OR REFERRED TO IN THIS SECTION AND IN OUR RISK FACTORS SET FORTH IN PART I, ITEM 1A OF THE CORPORATION'S ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2013 AND IN OTHER REPORTS FILED WITH THE SEC BY THE CORPORATION.

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General

The condensed consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this quarterly report on Form 10-Q as of and for the three and nine months ended September 30, 2014, reflect the financial position, results of operations, and cash flows of the Corporation.

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

Institutional Pharmacy Business

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

We offer prescription and non-prescription pharmaceuticals to our customers through unit dose or modified unit dose packaging, dispensing, and delivery systems, typically in a 14 to 30 day supply. Unit dose medications are packaged for dispensing in individual doses as compared to bulk packaging used by most retail pharmacies. The customers we serve prefer the unit dose delivery system over the bulk delivery system employed by retail pharmacies because it improves control over the storage and ordering of drugs and reduces errors in drug administration in healthcare facilities. Nursing staff in our customers' facilities administer the pharmaceuticals to individual patients and residents. The Corporation also utilizes an on-site dispensing system, with real time data transfer between the system and the Corporation, which provides timely medication administration in emergency and first dose situations. We also offer clinical pharmacy programs that encompass a wide range of drug therapy and disease management protocols, including protocols for anemia treatment, infectious diseases, wound care, nutritional support, renal dosing, and therapeutic substitution.

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

Hospital Pharmacy Management Services

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

business is comprised of a few customers, of which, our largest service is to the majority of the Kindred hospitals.

Consultant Pharmacist Services

Federal and state regulations mandate that long-term care facilities, in addition to providing a source of pharmaceuticals, retain consultant pharmacist services to monitor and report on prescription drug therapy in order to maintain and improve the quality of resident care. On September 30, 2008, the United States Department of Health and Human Services Office of Inspector General ("OIG") published OIG Supplemental Compliance Program Guidance for Nursing Homes. With quality of care being the first risk area identified, the supplemental guidance is part of a series of recent government efforts focused on improving quality of care at skilled nursing and long-term care facilities. The guidance contains compliance recommendations and an expanded discussion of risk areas. The guidance stressed that facilities must provide pharmaceutical services to meet the needs of each resident and should be mindful of potential quality of care problems when implementing policies and procedures on proper medication management. It further stated that facilities can reduce risk by educating staff on medication management and improper pharmacy kickbacks for consultant pharmacists and that facilities should review the total compensation paid to consultant pharmacists to ensure it is not structured in a way that reflects the volume or value of particular drugs prescribed or administered to residents.

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We provide consultant pharmacist services to approximately 67% of our patients serviced. The services offered by our consultant pharmacists include:

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

Medical Records

The Corporation provides medical records services, which includes the completion and maintenance of medical record information for patients in the Corporation's customers' facilities. The medical records services include:

- Real-time access to medication and treatment administration records, physician order sheets and psychotropic drug monitoring sheets;
- Online ordering to save time and resources;
- A customized database with the medication profiles of each resident's medication safety, efficiency and regulatory compliance;
- Web-based individual patient records detailing each prescribed medicine; and
- Electronic medical records to improve information to make it more legible and instantaneous.

Specialty Infusion Services

The Corporation provides specialty infusion services focused on providing complex pharmaceutical products and clinical services to patients in client facilities, hospice, and outside of hospital or nursing home settings. We offer high-touch clinical services to patients with acute or chronic conditions. The delivery of specialty infusion therapy requires comprehensive planning and monitoring which is provided through our registered nursing staff. Our nursing staff performs an initial patient assessment, provides therapy specific training and education, administers therapy and monitors for potential side effects. We also provide extensive clinical monitoring and patient follow-up to ensure patient therapy adherence and proactively manage patients' conditions. An in-network strategy facilitates easier decision-making for referral sources and provides us with the ability to pre-authorize patients, auto adjudicate, and bill electronically, enabling faster prescription turnaround.

Specialty Oncology Pharmacy

We provide dispensing of oncology drugs, care management and other related services to patients, oncology practices, and hospitals. These services encompass drug procurement and delivery, inventory management, and prescription administration and coordination with the patient, oncology practice and payer. We procure oncology drugs from manufacturers and wholesalers on behalf of oncologists and patients, handle administrative tasks related to prescription dispensing, distribute drugs directly to patients or to oncology practices, and are reimbursed by payers and patients. These services offer physicians an alternative to the traditional buy-and-bill distribution model, allowing them to outsource drug procurement, inventory management, and prescription administration.

Suppliers/Inventory

We obtain pharmaceutical and other products from ABDC and other contracts negotiated directly with pharmaceutical manufacturers for discounted prices. While the loss of a supplier could adversely affect our business if alternate sources of supply are unavailable, numerous sources of supply are generally available to us.

We seek to maintain an on-site inventory of pharmaceuticals and supplies to ensure delivery to our customers. ABDC maintains local distribution facilities in most geographic markets in which we operate. In addition, we have established our own distribution center and supply many of our pharmacies with select products from that location that commenced in the fourth quarter of 2013.

The Corporation and ABDC are parties to certain legal proceedings with respect to the Amended PVA as further described in Note 5.

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Brand to Generic Conversions

The following table summarizes the material brand-to-generic conversions expected to occur in 2014 through 2017:

| 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|
| Celebrex (4Q) | Actonel (1Q) | Advair Diskus (3Q)* | Tamiflu (2Q) |
| Copaxone (4Q) | Welchol (1Q) | Crestor (3Q) | |
| Invega (4Q) | Abilify (2Q)* | Azilect (4Q) | |
| Nasonex (4Q) | Nexium (2Q) | Humira (4Q) | |
| Nuedexta (4Q) | Fazaclo (2Q) | Seroquel XR (4Q) | |
| Renvela (4Q) | Renagel (2Q) | Zetia (4Q) | |
| Restasis (4Q) | Zyvox (2Q)* | | |
| Voltaren (4Q) | Aggrenox (3Q) | | |
| | Namenda IR (3Q)* | | |
| | Gleevec (3Q) | | |
| | Qvar (3Q) | | |
| | Avodart (4Q) | | |
| | Combivent (4Q) | | |
| | Pataday (4Q) | | |
| | Patanol (4Q) | | |

(Number in parentheses refers to the expected quarter of conversion)
* These represent the most significant brand-to-generic conversions

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

Supplier and Manufacturer Rebates

We currently receive rebates from certain manufacturers and distributors of pharmaceutical products for achieving targets of market share or purchase volumes. Rebates are designed to prefer, protect, or maintain a manufacturer's products that are dispensed by the pharmacy under its formulary. Rebates for brand name products are generally based upon achieving a defined market share tier within a therapeutic class and can be based on either purchasing volumes or actual prescriptions dispensed. Rebates for generic products are more likely to be based on achieving purchasing volume requirements.

2010 Health Care Reform Legislation

The Patient Protection and Affordable Care Act and the reconciliation law known as Health Care and Education Affordability Reconciliation Act (combined we refer to both Acts as the "2010 Health Care Reform Legislation") were enacted in March 2010. State participation in the expansion of Medicaid under the 2010 Health Care Reform Legislation is voluntary. Three key provisions of the 2010 Health Care Reform Legislation that are relevant to the Corporation are: (i) the gradual modification to the calculation of the Federal Upper Limit ("FUL") for drug prices and the definition of Average Manufacturer's Price ("AMP"), (ii) the closure, over time, of the Medicare Part D coverage gap, which is otherwise known as the "Donut Hole," and (iii) short cycle dispensing. Regulations under the 2010 Health Care Reform Legislation are expected to continue being drafted, released, and finalized throughout the next several years. The Office of Information and Regulatory Affairs website states that the final AMP rule was expected June 2014, but to date has not been released. Further, CMS has stated that AMP-based FULs will not be published in July 2014 as previously announced. Pending the promulgation of these regulations, the Corporation is unable to fully evaluate the impact of the 2010 Health Care Reform Legislation.

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FUL and AMP Changes

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

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

In September 2011, CMS issued the first draft FUL reimbursement files for multiple source drugs, including the draft methodology used to calculate the FULs in accordance with the Health Care Legislation. CMS continues to release monthly data and a three-month rolling average and is expected to do so going forward. CMS has not posted monthly AMPs for individual drugs, but only posted the weighted average of monthly AMPs in a FUL group and the calculation methodology.

The Office of Information and Regulatory Affairs website states that the final AMP were not finalized in July 2014 as previously announced and provides no date for when the final rule will be released. CMS will continue to post draft monthly FULs. The Corporation will continue to analyze the draft monthly, including the relationship of those FULs to the National Average Drug Acquisition pricing.

Part D Coverage Gap

Starting on January 1, 2011, the Medicare Coverage Gap Discount Program (the "Program") requires drug manufacturers to provide a 50% discount on the negotiated ingredient cost to certain Medicare Part D beneficiaries for certain drugs and biologics purchased during the coverage gap (this is exclusive of the pharmacy dispensing fee). In addition, the 2010 Health Care Reform Legislation requires Medicare to close or eliminate the coverage gap entirely by fiscal year 2020 by gradually reducing the coinsurance percentage for both drugs covered and not covered by the Program for each applicable beneficiary.

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

Short Cycle Dispensing

Pursuant to the 2010 Health Care Reform Legislation, Prescription Drug Plans ("PDPs") are required, under Medicare Part D and Medicare Advantage prescription drug plans ("Medicare Advantage" or "MAPDs") to utilize specific, uniform dispensing techniques, such as weekly, daily, or automated dose dispensing, when dispensing covered Medicare Part D drugs to beneficiaries who reside in a long-term care facility to reduce waste associated with 30 to 90 day prescriptions for such beneficiaries. Pursuant to CMS issued regulation, beginning January 1, 2013, pharmacies dispensing to long-term care facilities must dispense no more than 14-day supplies of brand-name oral solid medications covered by Medicare Part D. The Corporation fully implemented short cycle dispensing on January 1, 2013. The impact of short cycle dispensing has not had a material adverse impact on the Corporation's results of

operations.

Medicare Part D Changes

In a May 23, 2014 Final Rule entitled "Medicare Program: Contract Year 2015 Policy and Technical Changes to the Medicare Advantage and the Medicare Prescription Drug Benefit Programs," CMS finalized a requirement that, effective June 1, 2015, all prescribers of Part D covered drugs must be enrolled as Medicare providers (or be granted a valid opt-out affidavit on file with a Part A or Part B Medicare Administrative Contractor) in order for a claim to be covered under Medicare Part D. CMS also finalized several specific requirements to reduce prescriber fraud, waste, and abuse. The Corporation is unable to evaluate the full impact of these changes on its business at this time.

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Critical Accounting Estimates

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

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

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

Allowance for doubtful accounts and provision for doubtful accounts

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

Our quarterly provision for doubtful accounts included in our condensed consolidated statements of operations is as follows (dollars in millions):

| | Amount | | % of Revenues | | | Amount | % of Revenues | |
|---|---|---|---|---|---|---|---|---|
| 2013 | | | | | 2014 | | | |
| First Quarter | $ 5.3 | * | 1.2 | % | First Quarter | $ 5.6 | 1.2 | % |
| Second Quarter | 5.2 | | 1.2 | | Second Quarter | 5.7 | 1.3 | % |
| Third Quarter | 5.2 | | 1.2 | | Third Quarter | 5.3 | 1.1 | % |
| Fourth Quarter | 6.8 | | 1.5 | | | | | |

*Excludes a $0.2 million expense related to Hurricane Sandy for the First Quarter of 2013.

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

| | 2013 | 2014 |
|---|---|---|
| First Quarter | 41.6 | 37.7 |
| Second Quarter | 41.6 | 37.0 |
| Third Quarter | 39.8 | 36.7 |
| Fourth Quarter | 39.0 | - |

The following table shows our summarized aging categories by quarter:

| | 2013 | | | | 2014 | | |
|---|---|---|---|---|---|---|---|
| | First | Second | Third | Fourth | First | Second | Third |
| 0 to 60 days | 58.0% | 58.0 % | 56.5 % | 55.5 % | 56.7% | 53.9 % | 57.3 % |
| 61 to 120 days | 15.8 | 18.2 | 18.0 | 18.8 | 17.7 | 17.3 | 16.9 |
| Over 120 Days | 26.2 | 23.8 | 25.5 | 25.7 | 25.6 | 28.8 | 25.8 |

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

| 2013 | Allowance | Gross Accounts Receivable | % of Gross Accounts Receivable | | 2014 | Allowance | Gross Accounts Receivable | % of Gross Accounts Receivable | |
|---|---|---|---|---|---|---|---|---|---|
| First Quarter | $ 55.8 | $ 262.1 | 21.3 | % | First Quarter | $ 57.7 | $ 243.9 | 23.7 | % |
| Second Quarter | 54.8 | 249.5 | 22.0 | | Second Quarter | 60.3 | 248.4 | 24.3 | |
| Third Quarter | 54.6 | 243.1 | 22.5 | | Third Quarter | 57.4 | 271.1 | 21.2 | |
| Fourth Quarter | 56.7 | 256.6 | 22.1 | | | | | | |

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

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

| | Three Months Ended September 30, | | | | | | Nine Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2013 | | | 2014 | | | 2013 | | | 2014 | | |
| | Amount | % of Revenues | | Amount | % of Revenues | | Amount | % of Revenues | | Amount | % of Revenues | |
| Medicare Part D | $207.5 | 47.5 | % | $214.6 | 45.6 | % | $604.0 | 46.2 | % | $618.2 | $ 45.1 | % |
| Institutional healthcare providers | 128.0 | 29.3 | | 110.4 | 23.5 | | 394.0 | 30.1 | | 337.3 | 24.6 | |
| Medicaid | 34.8 | 8.0 | | 39.5 | 8.4 | | 114.6 | 8.8 | | 122.9 | 9.0 | |
| Private and other | 19.9 | 4.6 | | 19.5 | 4.1 | | 57.7 | 4.4 | | 59.0 | 4.3 | |
| Commercial insurer | 27.2 | 6.2 | | 64.8 | 13.8 | | 78.1 | 6.0 | | 173.1 | 12.6 | |
| Medicare | 3.7 | 0.8 | | 5.9 | 1.3 | | 11.1 | 0.8 | | 16.3 | 1.2 | |
| Hospital management fees | 15.7 | 3.6 | | 15.5 | 3.3 | | 47.9 | 3.7 | | 44.2 | 3.2 | |
| Total | $436.8 | 100.0 | % | $470.2 | 100.0 | % | $1,307.4 | 100.0 | % | $1,371.0 | 100.0 | % |

Inventory and cost of drugs dispensed

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

As of December 31, 2013 (as adjusted) and September 30, 2014, our inventories on our accompanying condensed consolidated balance sheets were $110.2 million and $133.4 million, respectively.

The inventory days on hand were as follows for the periods presented:

| | 2013 | 2014 |
|---|---|---|
| First Quarter | 25.4 | 26.0 |
| Second Quarter | 29.6 | 35.1 |
| Third Quarter | 18.1 | 31.7 |
| Fourth Quarter | | |