WIDEPOINT CORP
Form 10-Q
August 15, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 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 June 30, 2011

OR

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

For the transition period from _____ to _____

Commission file number 001-33035

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

Delaware	52-2040275
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
18W100 22nd St., Oakbrook Terrace, IL	60181
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (703) 349-2577

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

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company x

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

As of August 11, 2011, 62,930,873 shares of common stock, $.001 par value per share, were outstanding.

WIDEPOINT CORPORATION
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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

WIDEPOINT CORPORATION AND
SUBSIDIARIES CONDENSED
CONSOLIDATED BALANCE SHEETS

	June 30, 2011 (unaudited)	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$5,394,273	$5,816,303
Accounts receivable	4,733,151	7,794,913
Unbilled accounts receivable	1,319,227	3,059,665
Prepaid expenses and other assets	464,577	473,320
Current deferred income tax asset	492,385	412,801
Total current assets	12,403,613	17,557,002
Property and equipment, net	1,303,325	1,241,510
Goodwill	11,329,917	11,329,917
Other Intangibles, net	1,086,084	1,104,551
Noncurrent deferred income tax asset	3,116,705	3,116,705
Other assets	55,598	46,455
Total assets	$29,295,242	$34,396,140
Liabilities and stockholders' equity		
Current liabilities:		
Short term note payable	$59,344	$94,809
Accounts payable	4,303,476	7,725,727
Accrued expenses	1,491,634	2,643,613
Income taxes payable	-	143,450
Deferred revenue	107,008	294,541
Current portion of long-term debt	350,603	572,943
Current portion of deferred rent	30,406	20,835
Current portion of capital lease obligation	38,590	44,724
Total current liabilities	6,381,061	11,540,642
Long-term debt, net of current portion	506,532	564,490
Fair value of earnout liability	153,000	153,000
Deferred rent, net of current portion	84,205	98,702
Capital lease obligation, net of current portion	5,838	22,908
Total liabilities	$7,130,636	$12,379,742
Stockholders' equity:		
Common stock, $0.001 par value; 110,000,000 shares authorized; 62,930,873 and 62,690,873 shares issued and outstanding, respectively	62,931	62,691
Additional paid-in capital	69,005,250	68,754,353
Accumulated deficit	(46,903,575)	(46,800,646)
Total stockholders' equity	22,164,606	22,016,398

Total liabilities and stockholders' equity	$29,295,242	$34,396,140

The accompanying notes are an integral part of these condensed consolidated financial statements.

WIDEPOINT CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
	(unaudited)			
Revenues, net	$9,965,878	$12,452,120	$20,495,003	$23,615,176
Cost of sales (including amortization and depreciation of $171,161, $243,277, $354,801, and $469,562,respectively)	7,261,227	9,521,361	15,950,697	18,160,582
Gross profit	2,704,651	2,930,759	4,544,306	5,454,594
Sales and marketing	385,100	487,996	815,283	831,003
General and administrative (including shared-based compensation expense of $11,747, $27,565, $39,937, and $56,745 respectively)	1,877,145	1,882,721	3,743,951	3,714,532
Depreciation expense	58,777	48,743	106,371	98,477
Income/(loss) from operations	383,629	511,299	(121,299)	810,582
Interest income	2,481	2,231	6,673	8,845
Interest expense	(19,304)	(22,793)	(39,859)	(50,170)
Other expense	-	-	1,143	-
Net income/(loss) before income tax expense	$366,806	$490,737	$(153,342)	$769,257
Income tax expense/(benefit)	152,375	78,055	(50,413)	117,257
Net income/(loss)	$214,431	$412,682	$(102,929)	$651,980
Basic earnings/(loss) per share	$0.00	$0.01	$(0.00)	$0.01
Basic weighted average shares outstanding	62,916,422	61,375,333	62,857,309	61,375,333
Diluted earnings/(loss) per share	$0.00	$0.01	$(0.00)	$0.01
Diluted weighted average shares outstanding	64,142,707	63,299,155	62,857,309	63,163,824

The accompanying notes are an integral part of these condensed consolidated financial statements.

WIDEPOINT CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2011	2010
Cash flows from operating activities:		
Net (loss)/income	$(102,929)	$651,980
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income tax (benefit)/expense	(79,584)	78,445
Depreciation expense	167,735	144,644
Amortization of intangibles	293,438	423,395
Amortization of deferred financing costs	857	4,995
Share-based compensation expense	39,937	56,745
Loss on disposal of equipment	357	-
Changes in assets and liabilities (net of business combinations):		
Accounts receivable and unbilled accounts receivable	4,802,200	(1,704,854)
Prepaid expenses and other current assets	8,743	37,440
Other assets excluding deferred financing costs	(10,000)	7,917
Accounts payable and accrued expenses	(4,542,468)	(2,032,258)
Income taxes payable	(143,450)	-
Deferred revenue	(187,533)	(505,017)
Net cash provided by/ (used in) operating activities	$247,303	$(2,836,568)
Cash flows from investing activities:		
Purchase of subsidiary, net of cash acquired	-	(383,701)
Purchase of property and equipment	(230,657)	(19,092)
Software development costs	(274,971)	(35,593)
Proceeds from sales of office equipment	750	-
Net cash used in investing activities	$(504,878)	$(438,386)
Cash flows from financing activities:		
Principal payments on notes payable	(352,451)	(340,366)
Principal payments under capital lease Obligation	(23,204)	(58,386)
Proceeds from exercise of stock options	211,200	-
Net cash used in financing activities	$(164,455)	$(398,752)
Net decrease in cash	$(422,030)	$(3,673,706)
Cash and cash equivalents, beginning of period	$5,816,303	$6,238,788
Cash and cash equivalents, end of period	$5,394,273	$2,565,082
Supplementary Information:		
Cash paid for income tax	$201,763	$38,832
Cash paid for interest	$40,812	$46,929

The accompanying notes are an integral part of these condensed consolidated financial statements.

WIDEPOINT CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Nature of Operations

Organization

WidePoint Corporation ("WidePoint", the "Company," "we," "its," or "our") was incorporated in Delaware on May 30, 199
WidePoint is a provider of advanced, federally certified and other customized technology-based products and service solutions to both the government sector and commercial markets. Our advanced technology-based solutions enable organizations to deploy fully compliant IT services in accordance with government requirements and the demands of the commercial marketplace. We have grown through the merger with and acquisition of highly specialized regional IT consulting companies.

Our staff consists of business process and computer specialists who help our government and civilian customers augment and expand their resident technologic skills and competencies, drive technical innovation, and help develop and maintain a competitive edge in today's rapidly changing technological environment in business.

Nature of Operations

We provide our advanced technology-based products and solutions through three business segments. Our three business segments include: Wireless Mobility Management, Cyber Security Solutions, and Consulting Services and Products. These segments offer unique solutions and proprietary IP in mobile and wireless full life cycle management solutions; cyber security solutions with an expertise in identity assurance services utilizing certificate-based security solutions; and other associated IT consulting services and products in which we provide specific subject matter expertise in IT architecture and planning, software implementation services, IT outsourcing, and forensic informatics. Our three business segments are operated through six wholly-owned operational entities, including a development stage company. These entities' respective principal operations are described as follows:

- iSYS, LLC ("iSYS"): iSYS specializes in providing the U.S. government and its agencies mobile telecommunications expense management (MTEM) services and forensic informatics, and information assurance services. Operates in our Wireless Mobility Management and Consulting Services and Products segments.

- Operational Research Consultants, Inc. ("ORC"): ORC specializes in providing the U.S. government and its agencies, as well as commercial businesses, with compliant information and identity assurance management solutions consisting of identity proofing and credentialing through its internally-developed proprietary Public Key Infrastructure (PKI) technologies. Operates in our Cyber Security Solutions and Consulting Services and Products segments.

- Advanced Research Concepts Corporation ("ARCC"): ARCC was formed in January 2010 and acquired certain assets of Vuance, Inc. ARCC provides state governments and commercial businesses with secure critical response management solutions designed to improve coordination within emergency services and critical infrastructure agencies. ARCC operates within our Cyber Security Solutions segment.

- WidePoint IL, Inc. and WP NBIL, Inc.: WP NBIL operates in conjunction with WidePoint IL and provides IT architecture and planning, software implementation and IT outsourcing services to the U.S. government or as a subcontractor through large commercial businesses. WidePoint IL operates within our Consulting Services and Products segment.

- Protexx Technology Corporation d/b/a Protexx: Protexx was formed in July 2008 and acquired certain assets of Protexx Inc. Protexx specializes in identity assurance and mobile and wireless data protection services. Protexx is a development stage company. Protexx operates as a branded offering within our Cyber Security Solutions segment.

Acquisition Activity

On January 29, 2010, we completed the asset purchase and assumption of certain liabilities from Vuance, Inc, including acquisition of their Government Services Division. These assets are now housed in our wholly-owned subsidiary Advanced Response Concepts Corporation. ARCC develops and markets leading-edge secure critical response management solutions designed to improve coordination between emergency services organizations and critical infrastructure agencies.

2. Significant Accounting Policies

Basis of Presentation

The unaudited condensed consolidated financial statements as of June 30, 2011 and for the three and six months ended June 30, 2011 and 2010, respectively, included herein have been prepared by the Company, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Pursuant to such regulations, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. It is the opinion of management that all adjustments (which include normal recurring adjustments) necessary for a fair statement of financial results are reflected in the interim periods presented. The condensed consolidated balance sheet as of December 31, 2010 was derived from the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010. The results of operations for the three and six months ended June 30, 2011 are not indicative of the operating results for the full year.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and acquired entities since their respective dates of acquisition. All significant inter-company amounts were eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The more significant areas requiring use of estimates and judgment relate to revenue recognition, accounts receivable valuation reserves, realizability of intangible assets, realizability of deferred income tax assets and the evaluation of contingencies and litigation. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results could differ from those estimates.

Significant Customers

For the three months and six months ended June 30, 2011 and 2010, respectively, customer concentrations as a percentage of our consolidated revenues are set forth in the table below.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
Customer Name	2011 (%)	2010 (%)	2011 (%)	2010 (%)

	Revenue		Revenue		Revenue		Revenue	
Transportation Security Administration (“TSA”)	27	%	20	%	25	%	22	%
Department of Homeland Security (“DHS”)	28	%	18	%	28	%	19	%
Washington Headquarters Services (“WHS”)	3	%	16	%	3	%	17	%

Concentrations of Credit Risk

Financial instruments, which consist of cash and cash equivalents and accounts receivable, potentially subject the Company to credit risk. As of June 30, 2011 and December 31, 2010, respectively, two customers represented a large percentage of our accounts receivable and unbilled accounts receivable as set forth in the table below:

	As of June 30, 2011 (%)		As of December 31, 2010 (%)	
Customer Name	Receivables		Receivables	
DHS	31	%	24	%
TSA	20	%	30	%

Fair Value of Financial Instruments

The Company’s financial instruments include cash equivalents, accounts receivable, notes receivable, accounts payable, short-term debt and other financial instruments associated with the issuance of the common stock. The carrying values of cash equivalents, accounts receivable, notes receivable, and accounts payable approximate their fair value because of the short maturity of these instruments. The carrying amounts of the Company’s bank borrowings under its credit facility approximate fair value because the interest rates are reset periodically to reflect current market rates.

Accounts Receivable

The majority of the Company's accounts receivable is due from the federal government and established private sector companies in the following industries: manufacturing, customer product goods, direct marketing, healthcare, and financial services. Credit is extended based on evaluation of a customer’s financial condition and, generally, collateral is not required. Accounts receivable are usually due within 30 to 60 days and are stated at amounts due from customers net of an allowance for doubtful accounts if deemed necessary. Customer account balances outstanding longer than the contractual payment terms are reviewed for collectability and after 90 days are considered past due unless arrangements were made at the time of the transaction that specified different payment terms.

The Company determines its allowance for doubtful accounts by considering a number of factors, including the length of time trade accounts receivable are past due, the Company’s previous loss history, the customer’s current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

The Company has not historically maintained a bad debt reserve for our federal government or commercial customers as we have not witnessed any material or recurring bad debt charges and the nature and size of the contracts has not necessitated the Company’s establishment of such a bad debt reserve. Upon specific review and our determination that a bad debt reserve may be required, we will reserve such amount if we view the account as potentially uncollectable.

Unbilled Accounts Receivable

Unbilled accounts receivable on time-and-materials contracts represent costs incurred and gross profit recognized near the period-end but not billed until the following period. Unbilled accounts receivable on fixed-price contracts consist of amounts incurred that are not yet billable under contract terms. At June 30, 2011 and December 31, 2010, unbilled accounts receivable totaled approximately $1,319,000 and $3,060,000, respectively.

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Revenue Recognition

A material portion of the Company's revenue arrangements are derived from cost-plus-fixed-fee, cost-plus-award-fee, firm fixed-price or time-and-materials contracts with federal and state governments and their agencies. Customer orders are generally submitted through task orders or purchase requisitions under a master contract or under an individual purchase requisition. Tangible goods and services provided under customer contracts are generally not interdependent. The Company's revenue streams and related revenue recognition are as follows:

- Wireless Mobility Management includes mobile telecommunications expense management services and device management that are billed under a time and materials contract. Revenue is recognized when persuasive evidence of an arrangement exists, services have been rendered, the contract price is fixed or determinable and collectability is reasonably assured. The Company has a standard internal process that is used to determine whether all required criteria for revenue recognition have been met. Revenue is recognized to the extent of billable rates times hours delivered plus material and other reimbursable costs incurred to manage telecommunications carrier air and data services. The Company also charges a monthly user access and device management fee. The Company acquires telecommunication devices for the customer and recognizes revenue upon receipt by the customer of inventory and bills for services at cost plus applicable contractual fees earned. The Company also offers billing management services, which may subject the Company to credit risk as we are responsible for the payment of multiple billable arrangements by and between our customer and various carriers. The Company recognizes revenues and related costs on a gross basis as we have discretion in choosing providers, rate plans, and devices in providing the services to our customers. Certain federal and state governments and their agencies may pay for services and/or devices in advance. These advance payments are recorded as deferred revenue and recognized as services are performed and/or devices delivered.

- Cyber Security Solutions consist of Public Key Infrastructure (PKI) identity credentialing software certificates, identity credentialing software certificate consoles, device authentication imbedded software solutions, and other software. PKI credentialing is usually controlled by the Company and revenue is recognized upon issuance and there are no undelivered elements. Pricing for certificates issued by the Company is based on third party evidence of value. Revenue is recognized from the sales of credentials upon issuance. For PKI credentialing that is controlled by the customer, revenue is recognized upon delivery of the credentials and/or consoles when there are no other additional deliverables. These certificates are delivered electronically to the end user. There is no obligation to provide post contract services in relation to certificates issued and consoles delivered. Cost of sales include general infrastructure support costs to maintain the continue issuance of credentials. For other software, which is part of an integrated solution, revenue is recognized using percentage of completion as the individual component parts have no value until the solution has been delivered.

- Consulting Services and Products include the purchase and sale of third party hardware/software and maintenance services billed under cost-reimbursable contracts. Revenue is recognized when persuasive evidence of an arrangement exists, services have been rendered, the contract price is fixed or determinable and collectability is reasonably assured. The Company has a standard internal process that is used to determine whether all required criteria for revenue recognition have been met. Revenue is recognized for the re-sale of hardware equipment and software support and maintenance upon delivery to the customer, including applicable contractual fees earned. The Company bears credit risk associated with purchases made on behalf of customers. The Company recognizes revenues and related costs on a gross basis as we have discretion in choosing providers and equipment for our customers. Further our information technology and assurance consulting services are billed under a time and materials contract. Revenue is recognized when persuasive evidence of an arrangement exists, services have been rendered, the contract price is fixed or determinable and collectability is reasonably assured. The Company has a standard internal process that is used to determine whether all required criteria for revenue recognition has been met. Revenue is recognized to the extent of billable rates times hours delivered plus material and other reimbursable

costs incurred to provide services. Hardware elements are separately procured and priced through third party vendors who deal in such equipment. Our pricing is based on Third Party Evidence of Value ("TPE") with either handling charges or additional fees included in our General Services Administration ("GSA") schedule which is similar to those offered by other hardware vendors for similar products and/or services as well as charges for handling and additional fees. The hardware elements under this arrangement procured for the solution was purchased through third party vendors. The hardware elements are recognized at the time of delivery and/or integration into the solutions.

Income Taxes

The Company accounts for income taxes in accordance with authoritative guidance which requires that deferred tax assets and liabilities be computed based on the difference between the financial statement and income tax bases of assets and liabilities using the enacted marginal tax rate. The guidance requires that the net deferred tax asset be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax asset will not be realized. The Company recognizes the impact of an uncertain tax position taken or expected to be taken on an income tax return in the financial statements at the amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized in the financial statements unless it is more likely than not of being sustained upon audit by the relevant taxing authority.

Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation and amortization. Property and equipment consisted of the following as of June 30, 2011 and December 31, 2010, respectively:

	Estimated Useful Life	June 30, 2011	December 31, 2010
Land and building	20 years	$ 677,054	$ 677,054
Computer hardware and software	3 years	1,434,359	1,355,651
Furniture and fixtures	3-5 years	276,331	126,595
Gross property and equipment		$ 2,387,744	$ 2,159,300
Less– Accumulated depreciation and amortization		(1,084,419)	(917,790)
		$ 1,303,325	$ 1,241,510

Depreciation expense is computed using the straight-line method over the estimated useful lives depending upon the classification of the property and/or equipment.

The Company capitalizes costs related to software development (including certain upgrades and enhancements that result in additional functionality) and implementation in connection with its internal use software systems. All preliminary project stage and post implementation costs (including training and maintenance) are expensed as incurred.

Software Development Costs

The Company capitalizes costs related to software and implementation in connection with its internal use software systems. For software development costs (or “internally developed intangible assets”) related to software products for sale, lease or otherwise marketed, significant development costs are capitalized from the point of demonstrated technological feasibility until the point in time that the product is available for general release to customers. Once the product is available for general release, capitalized costs are amortized based on units sold, or on a straight-line basis over a six-year period or such other such shorter period as may be required. WidePoint capitalized approximately $235,000 for the three month period ended June 30, 2011, as compared to approximately $21,000 for the three month period ended June 30, 2010. WidePoint capitalized approximately $275,000 for the six month period ended June 30, 2011, as compared to approximately $36,000 for the six month period ended June 30, 2010. WidePoint recorded approximately $34,000 of amortization expense for the three month period ended June 30, 2011, as compared to approximately $80,000 for the three month period ended June 30, 2010. WidePoint recorded approximately $80,000 of amortization expense for the six month period ended June 30, 2011, as compared to approximately $150,000 for the six month period ended June 30, 2010. Capitalized software development costs, net, included in intangibles, net, on

the Company's condensed consolidated balance sheets at June 30, 2011 and December 31, 2010, were approximately $0.4 million and $0.2 million, respectively.

Goodwill, Other Intangible Assets, and Long-Lived Assets

The Company accounts for goodwill and other indefinite-lived intangible assets in accordance with ASC Topic 350 "Intangibles". Under ASC Topic 350, goodwill and certain indefinite-lived intangible assets are not amortized but are subject to an annual impairment test each year, and between annual tests if indicators of potential impairment exist. The Company has elected to perform this review annually on December 31st of each calendar year. The Company's ORC and iSYS subsidiaries have significant goodwill recorded which relates to the Wireless Mobility Management and Cyber Security Solutions segments. We have not identified any impairment of goodwill as of June 30, 2011.

Basic and Diluted Earnings Per Share ("EPS")

Basic EPS includes no dilution and is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted EPS includes the potential dilution that could occur if securities or other contracts to issue common and restricted stock were exercised or converted into common stock. The number of incremental shares from assumed conversions of stock options, stock warrants and unvested restricted stock awards included in the calculation of diluted EPS was calculated using the treasury stock method. See Note 8 for computation of EPS.

Stock-based compensation

The Company previously adopted the provisions of ASC 718-10, "Stock Compensation" (formerly known as SFAS No. 123R), using the modified prospective application transition method. Under this method, compensation cost for the portion of awards for which the requisite service has not yet been rendered that are outstanding as of the adoption date is recognized over the remaining service period. The compensation cost for that portion of awards is based on the grant-date fair value of those awards as calculated for pro forma disclosures under ASC 718-10, as originally issued. All new awards that are modified, repurchased, or cancelled after the adoption date are accounted for under provisions of ASC 718-10. The Company recognizes share-based compensation ratably using the straight-line attribution method over the requisite service period. In addition, pursuant to ASC 718-10, the Company is required to estimate the amount of expected forfeitures when calculating share-based compensation, instead of accounting for forfeitures as they occur, which was the Company's practice prior to the adoption of ASC 718-10. See Note 7 for additional information.

The Company accounts for stock-based non-employee compensation arrangements using the fair value recognition provisions of ASC 505-50, "Equity-Based Payments to Non-Employees" (formerly known as FASB Statement 123, Accounting for Stock-Based Compensation and "Emerging Issues Task Force" EITF 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services).

3. Debt

Revolving Credit Facility

On January 2, 2008, the Company entered into a Commercial Loan Agreement with Cardinal Bank relating to a $5,000,000 revolving credit facility, which agreement was amended (as so amended, the "2009 Commercial Loan Agreement").

On August 26, 2010, the Company entered into a Debt Modification Agreement with Cardinal Bank to extend the repayment date of the Company's revolving credit facility with Cardinal Bank from September 1, 2010 to September 30, 2011.

On August 26, 2010, the Company also entered into a new Commercial Loan Agreement with Cardinal Bank (the "2010 Commercial Loan Agreement"), which agreement replaced the 2009 Commercial Loan Agreement. The 2010 Commercial Loan Agreement provides for a $5,000,000 revolving credit facility from Cardinal Bank to the Company. Advances under the new revolving credit facility will bear interest at a variable rate equal to the Wall Street Journal prime rate plus 0.5%. The Company is required to maintain certain financial covenants quarterly on materially the same terms and conditions as the 2009 Commercial Loan Agreement. As of June 30, 2011, there was no borrowing on the revolving credit facility and the Company was in full compliance with these financial covenants.

Short and Long Term Debt

On January 2, 2008, the Company entered into a $2 million four-year term note with Cardinal Bank to fund the unpaid portion of the iSYS purchase price. As amended, the term note bears interest at an annual rate of 7.5% with monthly principal and interest payments of approximately $48,000, and matures on January 1, 2012. The term note is secured under a corporate security agreement. At June 30, 2011, the Company owed approximately $335,000 in short-term debt and no long-term debt associated with the four-year term note, which represents the final amounts due under the agreement.

On December 17, 2010, the Company entered into a real estate purchase agreement to acquire iSYS's telecommunications operations and call center facility in Columbus, Ohio for approximately $677,000. In connection with such real estate purchase agreement, the Company entered into a $528,000 ten-year mortgage with Cardinal Bank to fund the unpaid portion of the purchase price. The mortgage loan bears interest at an annual rate of 6.0% with monthly principal and interest payments of approximately $3,800, and matures on December 17, 2020. The mortgage loan principal and interest payments are based on a twenty-year amortization period with the final installment payment due on the maturity date. At June 30, 2011, the Company owed approximately $522,000 under this mortgage loan with approximately $16,000 in short-term debt and the remainder in long-term debt. The mortgage loan is secured by the real estate purchased pursuant to the real estate purchase agreement.

4. Goodwill and Intangible Assets

Goodwill is to be reviewed at least annually for impairment. The Company has elected to perform this review annually on December 31st of each calendar year. We did not identify any impairment as of December 31, 2010. There were no fundamental changes in business related goodwill for the three and six month periods ended June 30, 2011 which would indicate reconsideration is necessary.

Purchased and Internally Developed Intangible Assets

The following table summarizes purchased and internally developed intangible assets subject to amortization as of June 30, 2011:

	Gross Carrying Amount	Accumulated Amortization	Remaining Weighted Average Amortization Period (in years)
Purchased Intangible Assets			
iSYS (includes customer relationships, internal use software and trade name)	$ 1,230,000	$ (796,835)	2
Protexx (Identity Security Software)	$ 506,463	$ (492,395)	0
Advanced Response Concepts Corporation (includes preliminary values for customer relationships and first responder security software)	$ 355,000	$ (100,583)	3
	$ 2,091,463	$ (1,389,813)	2
Internally Developed Intangible Assets			
ORC PKI-V Intangible (Related to internally generated software)	$ 147,298	(65,466)	2
ORC PKI-VI Intangible (Related to internally generated software)	$ 77,994	(10,832)	3
ORC PKI-VII Intangible (Related to internally generated software)	$ 235,440	—	3
	460,732	$ (76,298)	3
Total	$ 2,552,195	$ (1,466,111)	3

Intangible asset amortization expense recorded for the six months ended June 30, 2011 and 2010 was $293,438 and $423,395, respectively. Intangible asset amortization expense recorded for the three months ended June 30, 2011 and 2010 was $141,057 and $220,354, respectively. The total weighted average life of all of the intangibles is approximately 4 years.

Estimated future amortization of intangible assets for each of the five fiscal years ending December 31 is as follows:

2011	$ 189,737
2012	412,244
2013	335,327
2014	142,859
2015	5,917
Total	$ 1,086,084

There were no amounts of research and development assets acquired or any written-off during the three and six month period ended June 30, 2011 and 2010.

5. Income Taxes

The Company has adopted the provisions of ASC 740-10-15. The Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. The Company did not have any unrecognized tax benefits at December 31, 2010, and June 30, 2011, respectively, including interest and penalties. In the future, any interest and penalties related to uncertain tax positions will be recognized in income tax expense.

The Company files U.S. federal income tax returns and various state income tax returns. The Company may be subject to examination by the IRS for tax years 1995 forward. Additionally, the Company may be subject to examinations by various state taxing jurisdictions for tax years 2000 forward. The Company is currently not under examination by the IRS or any state tax jurisdiction with the exception to an ongoing examination by the State of Illinois.

The current income tax benefit for the six months ended June 30, 2011 is expected to be absorbed into the full year operations with no significant change in the annual effective rate. No tax benefit has been associated with the exercise of stock options for the six months ended June 30, 2011 and 2010, because of the existence of net operating loss carryforwards. There will be no credit to additional paid in capital for such until the associated benefit is realized through a reduction of income taxes payable. As of June 30, 2011, there were no changes in the valuation allowance as there were no events that occurred which would indicate utilization of net operating loss deductions would be further limited.

6. Stockholders’ Equity

The Company is authorized to issue 110,000,000 shares of common stock, $.001 par value per share. As of June 30, 2011, there were 62,930,873 shares of common stock outstanding. During the quarter ended June 30, 2011 there were 120,000 shares of common stock issued as a result of stock option exercises, and for the six month period ended June 30, 2011, there were 240,000 shares of common stock issued as a result of stock option exercises. There were no issuances of common stock during the three or six months ended June 30, 2010. See Note 7 for additional information regarding stock option plans.

7. Stock Options and Award Programs

The Company’s stock incentive plan is administered by the Compensation Committee and authorizes the grant or award of incentive stock options, non-qualified stock options, restricted stock awards, stock appreciation rights,

dividend equivalent rights, performance unit awards and phantom shares. The Company issues new shares of common stock upon the exercise of stock options. Any shares associated with options forfeited during the reporting period were added back to the number of shares that underlie stock options to be granted under the stock incentive plan. There have been no changes to the Company's stock option and award programs since December 31, 2010.

A summary of the stock option and restricted stock award activity under our plans during the six months ended June 30, 2011 and 2010, respectively, is presented below:

NON-VESTED

	# of Shares	Weighted average grant date fair value per share
Non-vested at January 1, 2011	976,253	$ 0.44
Granted	-	-
Vested	(138,753)	$ 0.09
Forfeited	(75,000)	$ 0.38
Non-vested at March 31, 2011	762,500	$ 0.50
Granted	-	-
Vested	(12,500)	$ 0.48
Forfeited	(160,000)	$ 0.38
Non-vested at June 30, 2011	590,000	$ 0.54
Non-vested at January 1, 2010	1,125,004	$ 0.39
Granted	75,000	0.41
Vested	(120,001)	$ 0.05
Forfeited	-	-
Non-vested at March 31, 2010	1,170,003	$ 0.43
Granted	-	-
Vested	(31,250)	$ 0.44
Forfeited	-	-
Non-vested at June 30, 2010	1,138,753	$ 0.43

OUTSTANDING AND EXERCISABLE

	# of Shares	Weighted average exercise price per share
Total outstanding at January 1, 2011	3,587,000	$ 0.62
Issued	-	-
Cancelled	(75,000)	$ 0.83
Exercised	(120,000)	$ 1.22
Total outstanding at March 31, 2011	3,392,000	$ 0.59
Total exercisable at March 31, 2011	2,629,500	$ 0.50
Issued	-	-
Cancelled	(160,000)	$ 0.83
Exercised	(120,000)	$ 0.54
Total outstanding at June 30, 2011	3,112,000	$ 0.58

Total exercisable June 30, 2011	2,522,000	$	0.49
Total outstanding at January 1, 2010	4,517,411	$	0.54
Issued	75,000		0.65
Cancelled	(1,000)	$	1.35
Exercised	-		-
Total outstanding at March 31, 2010	4,591,411	$	0.54
Total exercisable at March 31, 2010	3,421,408	$	0.44
Issued	-		-
Cancelled	(7,611)	$	0.45
Exercised	-		-
Total outstanding at June 30, 2010	4,583,800	$	0.54
Total exercisable at June 30, 2010	3,445,047	$	0.44

The aggregate remaining contractual lives in years for the options outstanding and exercisable on June 30, 2011 were 3.33 and 2.81, respectively. In comparison, the aggregate remaining contractual lives in years for the options outstanding and exercisable on June 30, 2010, were 4.18 and 3.44, respectively.

Aggregate intrinsic value represents total pretax intrinsic value (the difference between WidePoint's closing stock price on June 30, 2011, and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2011. The intrinsic value will change based on the fair market value of WidePoint's stock. The total intrinsic values of options outstanding and exercisable as of June 30, 2011, were $925,810 and $923,310, respectively. The total intrinsic value of options exercised for the second quarter of fiscal 2011 was approximately $72,000. The Company issues new shares of common stock upon the exercise of stock options.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option pricing model, which uses the assumptions of no dividend yield, risk free interest rates and expected life in years of approximately 3 years. The option awards are for the period from 1999 through 2010. Expected volatilities are based on the historical volatility of our common stock. The expected term of options granted is based on analyses of historical employee termination rates and option exercises. The risk-free interest rates are based on the U.S. Treasury yield for a period consistent with the expected term of the option in effect at the time of the grant.

The amount of compensation expense recognized under ASC 718-10 during the three and six month periods ended June 30, 2011 and 2010, respectively, under our plans was comprised of the following:

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
General and Administrative Expense	$ (10,039)	$ 27,565	$ (3,635)	$ 56,745
Stock options based compensation before taxes	(10,039)	27,565	(3,635)	56,745
Total net Stock options based compensation expense	$ (10,039)	$ 27,565	$ (3,635)	$ 56,745
Net Stock options -based compensation expenses per basic and diluted common share	nil	nil	nil	nil

The benefit realized in Stock options based compensation in the quarter and six month period ended June 30, 2011, respectively, was the result of forfeitures of granted unvested stock options which were cancelled during the period. The resulting benefit occurred as the value attributed to the forfeited shares which were greater than the sum of the stock options based compensation recognized during the respective periods. Share base compensation represents both stock options based expense and stock grant expense. During the quarter and six months ended June 30, 2011 we recognized stock grant expense of $21,786 and $43,572, respectively. We recognized no stock grant expense for the quarter and six months ended June 30, 2010.

No tax benefit has been associated with the exercise of stock options for the three months ended June 30, 2011 and 2010, respectively, because of the existence of net operating loss carryforwards. There will be no credit to additional paid in capital for such until the associated benefit is realized through a reduction of income taxes payable.

At June 30, 2011, the Company had approximately $108,000 of total unamortized compensation expense, net of estimated forfeitures, related to stock option plans that will be recognized over the weighted average remaining period of 3.33 years.

8. Earnings Per Common Share (EPS)

The computations of basic and diluted EPS were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2011	2010	2011	2010
Basic EPS computation:				
Net income	$184,808	$412,682	$(132,552)	$651,980
Weighted average number of common shares	62,916,422	61,375,333	62,857,309	61,375,333
Basic EPS	$0.00	$0.01	$(0.00)	$0.01
Diluted EPS				
Net income	$184,808	$412,682	$(132,552)	$651,980
Weighted average number of common shares	62,916,422	61,375,333	62,857,309	61,375,333
Incremental shares from assumed conversions of stock Options	1,226,285	1,923,822	-	1,788,491
Adjusted weighted average number of common shares	64,142,707	63,299,155	62,857,309	63,163,824
Diluted EPS	$0.00	$0.01	$(0.00)	$0.01

9. Segment reporting

Segments are defined by authoritative guidance as components of a company in which separate financial information is available and is evaluated by the chief operating decision maker, or a decision making group, in deciding how to allocate resources and in assessing performance. Management evaluates segment performance primarily based on revenue and segment operating income.

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The Company operates as three segments, which include Wireless Mobility Management, Cyber Security Solutions, and IT Consulting Services and Products.

Segment operating income consists of the revenues generated by a segment, less the direct costs of revenue and selling, general and administrative costs that are incurred directly by the segment. Unallocated corporate costs include costs related to administrative functions that are performed in a centralized manner that are not attributable to a particular segment. These administrative function costs include costs for corporate office support, all office facility costs, costs relating to accounting and finance, human resources, legal, marketing, information technology and company-wide business development functions, as well as costs related to overall corporate management.

The following tables set forth selected segment and consolidated operating results and other operating data for the periods indicated. Management does not analyze assets for decision making purposes as it relates to the segments below. Accordingly, information is not available for long-lived assets or total assets.

Three Months Ended June 30, 2011

	Wireless	Cyber	Consulting	Corp	Consol
Revenue	$6,158,197	$2,294,973	$1,512,708	-	$9,965,878
Operating income including amortization and depreciation expense	570,994	495,652	(71,159)	(611,858)	383,629
Interest income (expense), net				(16,823)	(16,823)
Pretax income					366,806
Income tax benefit				(152,375)	(152,375)
Net income					$214,431

Three Months Ended June 30, 2010

	Wireless	Cyber	Consulting	Corp	Consol
Revenue	$6,885,987	$2,486,820	$3,079,313	-	$12,452,120
Operating income including amortization and depreciation expense	567,288	596,061	54,803	(706,853)	511,299
Interest income (expense), net				(20,562)	(20,562)
Pretax income					490,737
Income tax benefit				(78,055)	(78,055)
Net income					$412,682

Six Months Ended June 30, 2011

	Wireless	Cyber	Consulting	Corp	Consol
Revenue	$11,765,783	$3,551,222	$5,177,998	-	$20,495,003
Operating income including amortization and depreciation expense	925,404	572,937	(394,373)	(1,225,287)	(121,299)
Interest income (expense), net				(33,186)	(33,186)
Other income (expense), net				1,143	1,143
Pretax income				-	(153,342)
Income tax benefit				50,413	50,413
Net loss					$(102,929)

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Six Months Ended June 30, 2010

	Wireless	Cyber	Consulting	Corp	Consol
Revenue	$13,805,799	$3,912,327	$5,897,050	-	$23,615,176
Operating income including amortization and depreciation expense	1,246,532	881,427	162,217	(1,479,594)	810,582
Interest income (expense), net				(41,325)	(41,325)
Pretax income					769,257
Income tax expense				(117,277)	(117,277)
Net income					$651,980

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

"Forward-Looking" Information

The following discussion and analysis of the financial condition and results of operations of the Company should be read in conjunction with the financial statements and the notes thereto which appear elsewhere in this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

The information set forth below contains statements that the Company believes to be "forward-looking statements" within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that is not a statement of historical fact, including, without limitation, statements regarding the Company's business strategy and plans and objectives of management for future operations or that may predict, forecast, indicate or imply future results, performance or achievements. The words "estimate," "project," "intend," "forecast," "anticipate," "plan," "planning," "expect," "believe, likely," "should," "could," "would," "may" or the negative of such words or words or expressions of similar meaning a intended to identify forward-looking statements. These forward-looking statements are not guarantees of future performance, and all such forward-looking statements involve risks and uncertainties, many of which are beyond the Company's ability to control. Actual results may differ materially from those expressed or implied by such forward-looking statements as a result of various factors. All forward-looking statements and other information in this Quarterly Report on Form 10-Q speak only as of the date of this report. We do not undertake, and we disclaim, any obligation to update any forward-looking statements or to announce revisions to any of the forward-looking statements. Certain factors that could cause results to differ materially from those projected in the forward-looking statements are set forth below. Readers are cautioned not to put undue reliance on forward-looking statements. The Company disclaims any intent or obligation to update publicly these forward-looking statements, whether as a result of new information, future events or otherwise.

Business Overview

WidePoint Corporation is a technology-based provider of products and services to both the government sector and commercial markets. WidePoint was incorporated in Delaware on May 30, 1997. We have grown through the merger with and acquisition of highly specialized regional IT consulting companies. Our staff consists of business process and computer specialists who help our government and civilian customers augment and expand their resident technologic skills and competencies, drive technical innovation, and help develop and maintain a competitive edge in today's rapidly changing technological environment in business. Our organization emphasizes an intense commitment to our people, our customers, and the quality of our solutions offerings. As a services organization, our customers are our primary focus.

Our expertise lies in the following three business segments: Wireless Mobility Management; Cyber Security Solutions; and Consulting Services and Products. These business segments offer unique solutions in wireless mobility, cyber security and other associated IT consulting services and products in which we provide specific subject matter expertise in IT architecture and planning, software implementation services, IT outsourcing, and forensic informatics. For additional information related to our three business segments, see Note 9 to our consolidated financial statements in this Quarterly Report on Form 10-Q.

WidePoint has six operational entities, including one development stage entity, which specialize in providing the following products and services:

- ORC specializes in cyber security solutions with a focus on IT integration and secure authentication processes and software, and providing services to the federal government. ORC has been at the forefront of implementing Public Key Infrastructure (PKI) technologies. PKI technology uses a class of algorithms in which a user can receive two electronic keys, consisting of a public key and a private key, to encrypt any information and/or communication being transmitted to or from the user within a computer network and between different computer networks. We believe PKI technology has emerged as the technology of choice to enable security services within and between different computer systems utilized by various agencies and departments of the federal government.

- iSYS specializes in wireless mobility solutions, characterized by comprehensive wireless environment managed services contracts to a number of large US federal agencies. It also specializes in forensic informatics, and Identity Assurance development services, predominantly to various agencies and departments of the federal government.

- WidePoint IL (in conjunction with WP NBIL) specializes in IT consulting services predominantly in the Midwestern regional area and cross-sells various services of our other operating subsidiaries.

- ARCC specializes in providing identity assurance and priority resource management solutions, crime scene management and information protection, and other activities related thereto; and the development, maintenance, enhancement and provision of software, services, products and operations for identity management and information protection, which are offered primarily to state and local government agency markets.

- Protexx, which is a development stage company, specializes in identity assurance, and encrypted mobile and wireless data-in motion protection products and services.

We rely upon a large portion of our revenues from the federal government directly, or as a subcontractor. Our revenues and operating results may vary significantly from quarter-to-quarter, due to revenues earned on contracts, the number of billable days in a quarter, the timing of the pass-through of other direct costs, the commencement and completion of contracts during any particular quarter, the schedule of the government agencies for awarding contracts, the term of each contract that we have been awarded and general economic conditions. Because a significant portion

of our expenses, such as personnel and facilities costs, are fixed in the short term, successful contract performance and variation in the volume of activity as well as in the number of contracts commenced or completed during any quarter may cause significant variations in operating results from quarter to quarter.

The federal government's fiscal year ends September 30th. If a budget for the next fiscal year has not been approved by that date, our clients may have to suspend engagements that we are working on until a budget has been approved. Such suspensions may cause us to realize lower revenues in the fourth calendar quarter (i.e., the first quarter of the government's fiscal year). Also, Congressional Budget "Continuing Resolutions", which provide for funding of Federal Agencies at prior year spending levels may impact new awards and cause us to realize lower revenues until such time as the Federal Budget process for the fiscal period has been completed. The federal government's 2010 – 2011 budget was enacted in April 2011. During the first quarter of 2011, the federal government operated under multiple continuing resolutions for budget purposes. While our federal government clients did not have to suspend payments to the Company for the three months ending March 31, 2011, we did witness a substantial slowdown in contract awards and potential new orders as a result of delays associated with funding tied to the various continuing resolutions. Furthermore, the United States Federal Government on August 2, 2011 was required to increase its "debt ceiling" to continue to pay its obligations. As an indirect result of this debt ceiling increase, the United States Congress enacted future budget reducing legislation that may impact spending levels within government agencies that may affect the Company's short term revenue building opportunities.

Further, a change in senior government officials may negatively affect the rate at which the federal government purchases the services that we offer. As a result of the factors above, period-to-period comparisons of our revenues and operating results may not be meaningful. These comparisons are not indicators of future performance and no assurances can be given that quarterly results will not fluctuate, causing a possible material adverse effect on our operating results and financial condition.

Most of WidePoint's current costs consist primarily of the salaries and benefits paid to WidePoint's technical, marketing and administrative personnel as well as vendor-related costs in connection with our Wireless Mobility Management segment. As a result of our plan to expand WidePoint's operations through a combination of internal growth initiatives and merger and acquisition opportunities, WidePoint expects such costs to increase. WidePoint's profitability also depends upon both the volume of services performed and the Company's ability to manage costs. As a significant portion of the Company's cost is labor related, WidePoint must effectively manage these costs to achieve and grow its profitability. The Company must also manage our telephony airtime plans and other vendor related offerings under our Wireless Mobility Management segment provided to our customers as they also represent a significant portion of our costs. To date, the Company has attempted to maximize its operating margins through efficiencies achieved by the use of its proprietary methodologies, and by offsetting increases in consultant salaries with increases in consultant fees received from its clients. The uncertainties relating to the ability to achieve and maintain profitability, obtain additional funding to partially fund the Company's growth strategy and provide the necessary investment to continue to upgrade its management reporting systems to meet the continuing demands of the present regulatory changes affect the comparability of the information reflected in the financial information presented above.

Results of Operations

Three Months Ended June 30, 2011 as Compared to Three Months Ended June 30, 2010

Revenues, net. Revenues for the three month period ended June 30, 2011, were approximately $10.0 million as compared to approximately $12.5 million for the three month period ended June 30, 2010. The decrease in revenues was primarily attributable to decreases in revenues in each of our operating segments as described below:

- Our Wireless Mobility Management segment recorded revenue of approximately $6.2 million for the quarter ended June 30, 2011 versus approximately $6.9 million for the quarter ended June 30, 2010. This 10.6% reduction in revenue was predominantly the result of a reduction in billable calling minutes and billable services provided to Washington Headquarter Services ("WHS") that was not fully offset by increases in work attributable to new contract

awards that we started in the first quarter of 2011. Short-term, we may witness a reduction or variability in revenue growth as the revenue mix in this segment experiences a reduction of billable calling minutes as compared to managed fees as we shift our attention to expanding the fee portion of our sales mix. We are presently pursuing several significant service contract award opportunities at a number of federal agencies and are also initiating a new strategy to expand into state and local municipalities and commercial enterprises by utilizing intermediary sales channels to potentially expand our reach beyond the federal sector and help to support the long-term growth of this segment. The recent budget delays and Federal Government debt ceiling debates have resulted in some contract awards or projects being delayed. We anticipate further growth in the third quarter of 2011 as we continue to add new clients to our current roster of customers. As we continue to market our services we also anticipate we will continue to add units under management from new agency awards along with the possibility of additional awards from states, local municipalities, and other commercial opportunities.

- Our Cyber Security Solutions segment recorded revenue of approximately $2.3 million for the three month period ended June 30, 2011 versus approximately $2.5 million for the three month period ended June 30, 2010. This 7.7% decrease in revenue was primarily a result of revenues that were delayed as a result of the delivery of work moving from the second quarter of 2011 into the third quarter of 2011, and more importantly, with the delay of anticipated awards in the contract finalization process associated with the delays attributable to the U.S. Budget and Federal debt ceiling debate referred to earlier. We anticipate that this segment should demonstrate revenue growth in the future as various federal agency mandates continue to be implemented in order to strengthen the requirements for greater levels of identity assurance and to better protect the federal information technology infrastructure within federal agencies. We have entered into a number of strategic alliances with partners that facilitates access to various federal agencies and their related technology infrastructures in order to take advantage of these identity management improvement mandates. We believe these new partnerships should widen our sales reach in the future.

- Our IT Consulting Services and Products segment recorded revenue of approximately $1.5 million for the three month period ended June 30, 2011 versus $3.1 million for the three month period ended June 30, 2010. This 50.9% decrease was materially due to a decrease in our Federal Government related consulting and reselling activities in the second quarter of 2011. We anticipate long-term that this segment should grow at a moderate rate but given the nature and variability of the products and services we offer within this segment, performance and the continuity of growth may prove erratic from period to period.

Cost of sales. Cost of sales for the three month period ended June 30, 2011, was approximately $7.3 million (or 73% of revenues), as compared to cost of sales of approximately $9.5 million (or 76% of revenues) for the three month period ended June 30, 2010. This decrease in cost of sales was primarily attributable to a higher percentage revenue mix in cyber security-based services which tends to provide higher margins as well as a lower percentage mix of consulting services revenues which tend to provide lower margins. We anticipate improvements in our costs of sales as our Cyber Security Solutions segment adds economies of scale and expands in relation to our Consulting Services and Products segment. At times, the fluctuation in our Consulting Services and Products segment revenue mix may cause variability in our cost of sales.

Gross profit. Gross profit for the three month period ended June 30, 2011 was approximately $2.7 million (or 27% of revenues), as compared to gross profit of approximately $2.9 million (or 24% of revenues) for the three month period ended June 30, 2010. The percentage of gross profit was higher in the second quarter as result of higher margins associated with a higher mix in revenues from of our Cyber Security Solutions segment which tends to have higher margins and a lower mix of consulting services revenues which tend to have lower margins. We anticipate gross profit as a percentage of revenues to increase as cost of sales as a percentage of revenues decreases due to a greater mix of higher margin services. We believe as revenues expand in the future there will be periods of variability in margin growth associated with changes in our segments revenue mix.

Sales and marketing. Sales and marketing expense for the three month period ended June 30, 2011, was approximately $385,000 (or 4% of revenues), as compared to approximately $488,000 (or 4% of revenues) for the three month period ended June 30, 2010. The absolute dollar amount of sales and marketing decreased as we optimized and aligned our bid and proposal and marketing efforts. We believe that with our niche capabilities and our selective investment in sales and marketing will support our ability to expand our revenues.

General and administrative. General and administrative expenses for the three month period ended June 30, 2011, were approximately $1.9 million (or 19% of revenues), as compared to approximately $1.9 million (or 15% of revenues) for the three month period ended June 30, 2010. The slight increase in general and administrative expenses over those for the three months ended June 30, 2010, was primarily attributable to increases in non-recurring administrative legal expenses. We believe that our general and administrative costs on a percentage of revenue basis will level out or decrease in future financial reporting periods.

Depreciation. Depreciation expense for the three month period ended June 30, 2011, was approximately $59,000, as compared to approximately $49,000 or the three month period ended June 30, 2010. The increase in depreciation expense was primarily attributable to an increased pool of depreciable assets. We do not anticipate any material changes within depreciation expense in the short-term. However, within our Wireless Mobility Management and Cyber Security Solutions segments, there may be a need from time to time to increase the purchase of equipment in support of new revenue streams that may then raise our depreciation expenses.

Interest income. Interest income for the three month period ended June 30, 2011, was approximately $3,000, as compared to approximately $2,000, for the three month period ended June 30, 2010. This decrease in interest income for the three month period ended June 30, 2011, was primarily attributable to lesser amountsof invested cash and cash equivalents combined with lower short-term interest rates that were available to the Company on investments in interest bearing accounts. We do not anticipate any material changes in trends in our interest income for the near-term as a result of continuing low short-term interest rates presently payable by financial institutions.

Interest expense. Interest expense for the three month period ended June 30, 2011, was approximately $19,000, as compared to approximately $23,000 for the three month period ended June 30, 2010. This decrease in interest expense for the three month period ended June 30, 2011, was primarily attributable to lesser expenses associated with the debt held by the Company. We anticipate our interest expense will continue to decrease as the Company continues to pay down the principal on its term note held by Cardinal Bank.

Income taxes. Income tax expense for the three month period ended June 30, 2011 was approximately $152,000, as compared to an income tax expense of approximately $78,000 for the three month period ended June 30, 2010. The income tax expense incurred in the second quarter of 2011 was partially the result of the reduction in the income tax benefit realized in the first quarter of 2011. In the fourth quarter of fiscal year 2010, the Company analyzed its ability to utilize net operating losses recorded as deferred tax assets and based on this analysis determined that it was more likely than not that the Company would be able to utilize a substantial portion of its federal net operating losses in future periods and recognized a benefit which continued through the three months ended June 30, 2011. The Company incurred a deferred income tax expense of approximately $39,000 for the three month period ended June 30, 2010, as a result of the recognition of a deferred tax liability attributable to the differences in our treatment of the amortization of goodwill for tax purposes versus book purposes as it relates to our acquisition of iSYS in January 2008.

Net income. As a result of the factors above, the net income for the three month period ended June 30, 2011 was approximately $214,000 as compared to the net income of approximately $413,000 for the three month period ended June 30, 2010.

Six Months Ended June 30, 2011 as Compared to Six Months Ended June 30, 2010

Revenues, net. Revenues for the six month period ended June 30, 2011 were approximately $20.5 million as compared to approximately $23.6 million for the three month period ended June 30, 2010. The decrease in revenues was primarily attributable to decreases as described below in revenue in each of our operating segments:

- Our Wireless Mobility Management segment experienced decreased revenue of approximately 14.8% to approximately $11.8 million for the six months ended June 30, 2011 from approximately $13.8 million for the six months ended June 30, 2010. The decreased revenue performance was predominately the result of a reduction in billable calling minutes and billable services provided to WHS that was not fully offset by increases in work attributable to new contract awards that we started in the first half of 2011. Short-term we may witness a reduction or variability in revenue growth as the revenue mix in this segment experiences a reduction of billable calling minutes as compared to managed fees as we shift our attention to expanding the fee portion of our sales mix. We are presently pursuing several significant service contract award opportunities at a number of federal agencies and are also initiating a strategy to expand into state and local municipalities and commercial enterprises by utilizing intermediary supply channels to potentially expand our reach beyond the federal sector and help to support the long-term growth of this segment.

- Our Cyber Security Solutions segment experienced decreased revenue of approximately 9.2% to approximately $3.6 million for the six month period ended June 30, 2011 from approximately $3.9 million for the six month period

ended June 30, 2010. This decrease was primarily a result of delays in contract awards associated with Federal Government budget delays and continuing resolutions, which we witnessed during the first half of 2011. We have entered into a number of affiliations with partners who support the end user base, which facilitate access to these various federal agencies and the related technology infrastructure in order to take advantage of these identity management improvement mandates. We believe these new partnerships should widen our sales reach, which we anticipate should support the long-term growth of this segment.

- Our IT Consulting Services and Products segment experienced decreased revenue of approximately 12.2% to approximately $5.2 million during the six month period ended June 30, 2011 from approximately $5.9 million for the six month period ended June 30, 2010. This decreased revenue performance primarily resulted from delays in contract awards associated with Federal Government budget delays and continuing resolutions, which we witnessed during the first half of 2011. We anticipate that this segment should realize modest growth but given the nature and variability of the products and services we offer within this segment, the growth may be volatile from period to period.

Cost of sales. Cost of sales for the six month period ended June 30, 2011 was approximately $16.0 million (or 78% of revenues), as compared to cost of sales of approximately $18.2 million (or 77% of revenues), for the six month period ended June 30, 2010. This decrease in cost of sales was primarily attributable to a decrease in revenues. The slight increase in our cost of sales as a percentage of revenues was primarily attributable to margin improvements in the second quarter of 2011 that did not fully offset the margin weakness we experienced in the first quarter of 2011 as a result of a greater than normal consulting services segment mix that occurred during the first quarter of 2011. Our Wireless Mobility Management and Cyber Security Solutions segments realized greater margins from the benefit of economies of scale with our direct cost centers realizing greater efficiencies. Our IT Consulting Services and Products segment realized greater margins as a result of a larger mix of higher margin consulting services versus a lesser amount of lower margin software reselling that was realized during the quarter. We anticipate improvements in our costs of sales on a percentage basis as our Wireless Mobility Management and Cyber Security Solutions segments add economies of scale, which may be partially offset at times by the fluctuation in our IT Consulting Services and Products segment revenue mix.

Gross profit. Gross profit for the six month period ended June 30, 2011 was approximately $4.5 million (or 22% of revenues), as compared to gross profit of approximately $5.5 million (or 23% of revenues) for the six month period ended June 30, 2010. The percentage of gross profit was lower in the first half of 2011 as compared to the first half of 2010 as a result of lower margins associated with a greater mix of revenues from our IT Consulting Services and Products segment in our first quarter of 2011. We anticipate gross profit as a percentage of revenues should continue to increase as cost of sales as a percentage of revenues decreases due to a greater mix of higher margin services. We believe as revenues expand in the future there will be periods of variability in margin growth associated with changes in our product mix.

Sales and marketing. Sales and marketing expense for the six month period ended June 30, 2011 was approximately $815,000 (or 4% of revenues), as compared to approximately $831,000 (or 4% of revenues) for the six month period ended June 30, 2010. The dollar amount of sales and marketing decreased slightly as we optimized and aligned our bid and proposal efforts and marketing efforts. We believe that with our niche capabilities and the investment within our sales and marketing will support our ability to expand our revenues.

General and administrative. General and administrative expenses for the six month period ended June 30, 2011 were approximately $3.7 million (or 18% of revenues), as compared to approximately $3.7 million (or 16% of revenues) for the six month period ended June 30, 2010. The slight increase in general and administrative expenses was primarily attributable to increases in non-recurring administrative legal expenses. We anticipate that our general and administrative costs may rise slightly in the future as our support costs rise to facilitate our expectations of a greater revenue base as we continue our efforts to comply with pending additional financial compliance requirements. We believe that our general and administrative costs on a percentage of revenue basis will level out or decrease in future financial reporting periods.

Depreciation. Depreciation expense for the six month period ended June 30, 2011 was approximately $106,000 (or less than 1% of revenues), as compared to approximately $98,000 of such expenses (or less than 1% of revenues) for the six month period ended June 30, 2010. The increase in depreciation expense was primarily attributable to an

increased pool of depreciable assets. We do not anticipate any material changes within depreciation expense in the short-term. However, within our Wireless Mobility Management and Cyber Security Solutions segments, there may be a need from time to time to increase the purchase of equipment in support of new revenue streams that may then raise our depreciation expenses.

Interest income. Interest income for the six month period ended June 30, 2011 was approximately $6,700 (or less than 1% of revenues), as compared to approximately $9,000 (or less than 1% of revenues) for the six month period ended June 30, 2010. This decrease in interest income was primarily attributable to lesser amounts of invested cash and cash equivalents, and combined with lower short-term interest rates that were available to the Company on investments in interest bearing accounts. We do not anticipate any material changes in trends in our interest income for the near-term as a result of continuing low short-term interest rates presently payable by financial institutions.

Interest expense. Interest expense for the six month period ended June 30, 2011 was approximately $40,000 (or less than 1% of revenues), as compared to approximately $50,000 (or less than 1% of revenues) for the six month period ended June 30, 2010. This decrease in interest expense was primarily attributable to lesser expenses associated with the debt instruments held by the Company. We anticipate our interest expense will continue to decrease as the Company continues to pay down the principal on its term note held by Cardinal Bank.

Income taxes. Income tax benefit for the six month period ended June 30, 2011 was approximately $50,000, compared to an income tax expense of approximately $117,000 for the six month period ended June 30, 2010. The Company incurred a deferred income tax benefit of approximately $80,000 for the six month period ended June 30, 2011, as compared to a deferred income tax expense of approximately $78,000 for the six month period ended June 30, 2010, as a result of the recognition of a deferred tax liability attributable to the differences in our treatment of the amortization of goodwill for tax purposes versus book purposes as it relates to our acquisition of iSYS in January 2008. As goodwill is amortized for tax purposes but not book purposes and is considered a permanent asset rather than a temporary asset, the related deferred tax liability cannot be reversed until some indeterminate future period when the goodwill either becomes impaired and/or is disposed of.

Net loss. As a result of the factors above, the net loss for the six month period ended June 30, 2011 was approximately $103,000, as compared to the net income of approximately $652,000 for the six months ended June 30, 2010.

Liquidity and Capital Resources

The Company has, since inception, financed its operations and capital expenditures through the sale of preferred and common stock, seller notes (notes that we have executed with sellers of businesses that the Company purchased in order to defer the payment of all or a portion of the applicable purchase price), convertible notes, convertible exchangeable debentures, senior secured loans and the proceeds from the exercise of the warrants related to a convertible exchangeable debenture. During 2010 and through the period ended June 30, 2011, operations were primarily financed with working capital principally with additional contributions from stock option and warrant exercises. The Company has excess liquidity available from its 2010 Commercial Loan Agreement of approximately $5.0 million. We must continue to maintain certain financial covenants in order to continue to have access to this line of credit.

Net cash provided by operating activities for the six months ended June 30, 2011, was approximately $0.2 million, as compared to net cash used in operating activities of $2.8 million for the six months ended June 30, 2010. This increase in net cash provided by operating activities for the six months ended June 30, 2011 was primarily a result of a decrease in accounts receivable during the first half of 2011 as a result of the slow down in billings related to new contract awards which were delayed to as a result of budget and debt ceiling congressional debates. Net cash used in investing activities for the six months ended June 30, 2011, was approximately $505,000, as compared to $438,000 in cash used in investing activities for the six months ended June 30, 2010. The increase in net cash used in investing activities was primarily attributable to greater amounts invested between the comparative periods with leasehold improvements occurring in the first half of 2011 and the asset acquisition of the government business assets of Vuance, Inc. by the Company in the first quarter of 2010. Net cash used in financing activities amounted to approximately $164,000 in the six months ended June 30, 2011, as compared to net cash used in financing activities of approximately $399,000 in the six months ended June 30, 2010. This decrease in net cash used in financing activities primarily related to lesser amounts of options exercises during the six month period ended June 30, 2011 as compared to the six months period ended June 30, 2010.

As of June 30, 2011, the Company had a net working capital of approximately $6.0 million. The Company’s primary source of liquidity consists of approximately $5.4 million in cash and cash equivalents and approximately $6.1 million

of accounts receivable and unbilled accounts receivable. Current liabilities include approximately $5.8 million in accounts payable and accrued expenses.

The Company's business environment is characterized by rapid technological change, periods of high growth and contraction and is influenced by material events such as mergers and acquisitions, with each of the foregoing able to substantially change the Company's outlook.

The Company has embarked upon several new initiatives to expand revenue growth, which has included both acquisitions and organic growth. The Company requires substantial working capital to fund the future growth of its business, particularly to finance accounts receivable, sales and marketing efforts, and capital expenditures.

Currently there are no material commitments for capital expenditures and software development costs. Future capital requirements will depend on many factors, including the rate of revenue growth, if any, the timing and extent of spending for new product and service development, technological changes and market acceptance of the Company's services.

Management believes that its current cash position is sufficient to meet capital expenditure and working capital requirements for the near term. However, the growth and technological change of the market make it difficult to predict future liquidity requirements with certainty. Over the longer term, the Company must successfully execute its plans to increase revenue and income streams that will generate significant positive cash flows if it is to sustain adequate liquidity without impairing growth or requiring the infusion of additional funds from external sources. Additionally, a major expansion, such as that which occurred with the acquisition of iSYS or any other potential new subsidiaries, might require external financing that could include additional debt or equity capital. There can be no assurance that additional financing, if required, will be available on acceptable terms, if at all, for future acquisitions and/or growth initiatives. The Company presently has an unused credit facility for $5 million that will expire on September 30, 2011. We are presently completing the renewal of this credit facility with Cardinal Bank and expect that it will be renewed prior to the expiration of the present credit facility.

Off-Balance Sheet Arrangements

The Company has no existing off-balance sheet arrangements as defined under SEC regulations.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to provide reasonable assurance that material information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that the information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. We performed an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the existence of the material weaknesses discussed below in "Material Weakness in Internal Control Over Financial Reporting," our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of the end of the period covered by this report.

We do not expect that our disclosure controls and procedures will prevent all errors and all instances of fraud. Disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Further, the design of disclosure controls and procedures must reflect the fact that there are resource constraints, and the benefits must be considered relative to their costs. Because of the inherent limitations in all disclosure controls and procedures, no evaluation of disclosure controls and procedures can provide absolute assurance that we have detected all our control deficiencies and instances of fraud, if any. The design of disclosure controls and procedures also is based partly on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed

in achieving its stated goals under all potential future conditions.

Material Weakness in Internal Control Over Financial Reporting

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2010. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on this assessment, management concluded that our internal control over financial reporting was not effective as of December 31, 2010 due to the existence of the following material weaknesses:

Inadequate segregation of duties within an account or process. Management has determined that it continued to not have appropriate segregation of duties within our internal controls that would ensure the consistent application of procedures in our financial reporting process by existing personnel. This control deficiency could result in a misstatement of substantially all of our financial statement accounts and disclosures that would result in a material misstatement to the annual or interim financial statements.

Inadequate Policies & Procedures. Management has determined that its existing policies and procedures continued to be limited and/or inadequate in scope to provide staff with guidance or framework for accounting and disclosing financial transactions. This deficiency could result in unintended, misleading entries being made in the financial system and precluding sufficient disclosure of complex transactions.

Lack of sufficient subject matter expertise. Management has determined that it lacks certain subject matter expertise relating to accounting for complex transactions and the disclosure of complex transactions related to accounting for income taxes. Our financial staff currently lacks sufficient training or experience in accounting for complex transactions and the required disclosure therein.

Remediation Plan for Material Weaknesses

The material weaknesses described above in "Material Weaknesses in Internal Control Over Financial Reporting" comprise control deficiencies that we discovered during the financial close process for the December 31, 2010 fiscal period.

Management formulated a remediation plan in the first quarter of 2011 that will be implemented in our fiscal year 2011, which includes: (i) developing a set of policies and procedures to address inadequacies described above; and (ii) augmenting and allowing for additional training and education for select members of our financial staff. In addition, efforts will be made to segregate the data initiation and preparation processes from the data entry process in order to ensure that different employees review data as compared to those who enter data into the financial system.

We believe that these measures, if effectively implemented and maintained, will remediate the material weaknesses discussed above.

Changes in Internal Control Over Financial Reporting

We are currently undertaking the measures discussed above to remediate the material weaknesses discussed under “Material Weaknesses in Internal Control Over Financial Reporting” above. Those measures, described under “Remediation Plan for Material Weaknesses,” were commenced during the first quarter of 2011, will continue to be implemented during our fiscal year 2011, and will materially affect, or are reasonably likely to materially affect, our internal control over financial reporting.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, because of changes in conditions, effectiveness of internal controls over financial reporting may vary over time. Our system contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

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PART II – OTHER INFORMATION

ITEM 6. EXHIBITS.

EXHIBIT NO.	DESCRIPTION
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herewith).
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herewith).
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herewith).
101.	Interactive Data Files
101.INS**+	XBRL Instance Document
101.SCH**+	XBRL Taxonomy Extension Schema Document
101.CAL**+	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF**+	XBRL Taxonomy Definition Linkbase Document
101.LAB**+	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**+	XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

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

WIDEPOINT CORPORATION

Date: August 15, 2011

/s/ STEVE L. KOMAR
Steve L. Komar
President and Chief Executive Officer

Date: August 15, 2011

/s/ JAMES T. MCCUBBIN
James T. McCubbin
Vice President – Principal Financial
and Accounting Officer

Other comprehensive income (loss), net of tax								
						5.1		5.1
Total comprehensive income								
						227.1		
Share-based compensation								
						19.1		19.1
Common stock issued under employee stock plans								
	2.0		33.4					33.4
Common stock issued on acquisition								
	16.9		636.2					636.2
Tax benefits from exercise of options								
						2.3		2.3
Repurchase of common stock								
						(0.1)	(3.6)	(3.6)

BALANCE, December 31, 2009

133.0 $0.4 $1,686.9 $1,640.1 $1.9 (9.6) $(306.2) $3,023.1

Comprehensive income:

Net income attributable to common shareholders

184.4 184.4

Other comprehensive income (loss), net of tax

(4.4) (4.4)

Total comprehensive income

180.0

Share-based compensation				
	23.5			23.5
Common stock issued under employee stock plans				
2.5	54.7			54.7
Tax benefits from exercise of options				
	6.7			6.7
Repurchase of common stock				
		(0.1)	(6.3)	(6.3)

BALANCE, December 31, 2010

135.5 $0.4 $1,771.8 $1,824.5 $(2.5) (9.7) $(312.5) $3,281.7

Comprehensive income:

Net income attributable to common shareholders

260.9 260.9

Other comprehensive income (loss), net of tax

(74.0) (74.0)

Total comprehensive income

186.9

Share-based compensation

39.8 39.8

Common stock issued under employee stock plans

1.6 54.8 54.8

Tax benefits from exercise of options

14.6 14.6

Repurchase of common stock

(0.3) (14.2) (14.2)

BALANCE, December 31, 2011								
137.1	$0.4	$1,881.0	$2,085.4	$(76.5)	(10.0)	$(326.7)	$3,563.6	

See accompanying Notes to Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 Description of Business

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

Acquisition of Specifar

On May 25, 2011, Watson purchased all of the outstanding equity of Paomar PLC (Paomar). Paomar is a company incorporated under the laws of Cyprus and owner of 100 percent of the shares of Specifar Commercial Industrial Pharmaceutical, Chemical and Construction Exploitations Societe Anonyme (ABEE) (Specifar), a company organized under the laws of Greece. Specifar develops, manufactures and markets generic pharmaceuticals. Specifar also out-licenses generic pharmaceutical products, primarily in Europe. Specifar has a commercial presence in the Greek branded-generics pharmaceuticals market and owns 100 percent of the shares of Alet Pharmaceuticals Industrial and Commercial Societe Anonyme (Alet), a company that markets branded-generic pharmaceutical products in the Greek market. Specifar maintains an internationally approved manufacturing facility located near Athens, Greece and is constructing a new facility located outside of Athens which will expand manufacturing capacity. Specifar s pipeline of products includes a generic tablet version of Nexium® (esomeprazole). Specifar s results are included in the Global Generics segment, as of the acquisition date. For additional information on the Specifar acquisition, refer to NOTE 4 Acquisitions and Divestitures .

NOTE 2 Summary of Significant Accounting Policies

Basis of Presentation

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S. (GAAP). The consolidated financial statements include the accounts of wholly owned subsidiaries, after elimination of intercompany accounts and transactions. We have revised our consolidated balance sheet as of December 31, 2010 to reclassify deferred tax assets and liabilities. This revision does not impact the consolidated statement of operations, the consolidated statement of cash flows, net working capital or debt covenants for any period and is not considered material to the previously issued financial statements. During 2011, we noted that certain deferred tax assets/deferred tax liabilities were misclassified on the balance sheet as a result of improperly applying the jurisdictional netting rules as of December 31, 2010. We have therefore revised our balance sheet as of December 31, 2010 by decreasing current deferred tax assets by $12.7 million and decreasing non-current deferred tax assets by $128.0 million, decreasing current deferred tax liabilities by $12.7 million and decreasing long-term deferred tax liabilities by $128.0 million.

Our consolidated financial statements include the financial results of Specifar subsequent to the Acquisition Date.

Use of Estimates

Management is required to make certain estimates and assumptions in order to prepare consolidated financial statements in conformity with GAAP. Such estimates and assumptions affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The Company s most significant estimates relate to the determination of sales returns and allowances (SRA) for accounts receivable and accrued liabilities, valuation of inventory balances, the determination of useful lives for intangible assets, the assessment of expected cash flows used in evaluating goodwill and other long-lived assets for impairment and recognition and measurement

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of assets acquired and liabilities assumed in business combinations at fair value. The estimation process required to prepare the Company s consolidated financial statements requires assumptions to be made about future events and conditions, and as such, is inherently subjective and uncertain. The Company s actual results could differ materially from those estimates.

Foreign Currency Translation

For most of the Company s international operations, the local currency has been determined to be the functional currency. We translate functional currency assets and liabilities to their U.S. dollar equivalents at rates in effect at the balance sheet date and record these translation adjustments as a component of accumulated other comprehensive income (loss) within stockholders equity in the consolidated balance sheets. We translate functional currency statement of income amounts to their U.S. dollar equivalents at the average rates for the period. The effects of converting non-functional currency assets and liabilities into the functional currency are recorded as general and administrative expenses in the consolidated statements of operations.

Cash and Cash Equivalents

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

Fair Value of Other Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, marketable securities, accounts and other receivables, investments, trade accounts payable, our $450.0 million aggregate principal amount of 5.000% notes due August 14, 2014 (the 2014 Notes) and $400.0 million aggregate principal amount of 6.125% notes due August 14, 2019 (the 2019 Notes) (together the Senior Notes) and our credit agreement with Bank of America, N.A., as Administrative Agent, Wells Fargo Bank, N.A., as Syndication Agent, and a syndicate of banks establishing a senior unsecured revolving credit facility (the Revolving Credit Facility). The carrying amounts of cash and cash equivalents, marketable securities, accounts and other receivables and trade accounts payable are representative of their respective fair values due to their relatively short maturities. The fair values of investments in companies that are publicly traded and not accounted for under the equity method are based on quoted market prices. The Company estimates the fair value of its fixed rate long-term obligations based on quoted market rates. At December 31, 2011, the fair value of our Senior Notes was approximately $107.7 million greater than the carrying value.

Inventories

Inventories consist of finished goods held for sale and distribution, raw materials and work in process. Included in inventory at December 31, 2011 and 2010 was approximately $6.8 million and $4.6 million, respectively, of inventory that was pending approval by the U.S. Food and Drug Administration (FDA), by other regulatory agencies or has not been launched due to contractual restrictions. This inventory consists of generic pharmaceutical products that are capitalized only when the bioequivalence of the product is demonstrated or the product has already received regulatory approval and is awaiting a contractual triggering event to enter the marketplace. Inventories are stated at the lower of cost (first-in, first-out method) or market (net realizable value). The Company writes down inventories to net realizable value based on forecasted demand and market conditions, which may differ from actual results.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Major renewals and improvements are capitalized, while routine maintenance and repairs are expensed as incurred. Costs associated with internally

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

developed software are accounted for in accordance with the guidance for the treatment of costs associated with computer software development that defines those costs to be capitalized and those to be expensed. The Company capitalizes interest on qualified construction projects. At the time property and equipment are retired from service, the cost and accumulated depreciation is removed from the respective accounts.

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

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

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

Investments

The Company s equity investments are accounted for under the equity method when the Company can exert significant influence and ownership does not exceed 50%. The Company records equity method investments at cost and adjust for the appropriate share of investee net earnings or losses. Investments in which the Company owns less than a 20% interest and cannot exert significant influence are accounted for using the cost method if the fair value of such investments is not readily determinable.

Marketable Securities

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

Goodwill and Intangible Assets with Indefinite-Lives

We test goodwill and intangible assets with indefinite-lives for impairment annually at the end of the second quarter by comparing the fair value of each of the Company s reporting units to the respective carrying value of the reporting units. Additionally, we perform impairment testing when events occur that could potentially reduce the fair value of a reporting unit below its carrying amount. The Company s reporting units have been identified by Watson as Global Generics, Global Brands and Distribution. The carrying value of each reporting unit is determined by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units.

Goodwill is considered impaired if the carrying amount of the net assets exceeds the fair value of the reporting unit. Impairment, if any, would be recorded in operating income and this could result in a material reduction in net income and earnings per share. During the second quarter of 2011, the Company performed its annual impairment assessment of goodwill, acquired in-process research and development (IPR&D) intangibles and trade name intangibles assets with indefinite-lives. The Company determined there was no

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

impairment associated with goodwill or trade name intangibles. The Company recorded a $7.5 million impairment charge related to certain IPR&D assets acquired in the Arrow acquisition. No impairments were recognized during the Company s annual impairment assessment in the second quarter 2010.

IPR&D intangible assets represent the value assigned to acquired R&D projects that, as of the date acquired, represent the right to develop, use, sell and/or offer for sale a product or other intellectual property that we have acquired with respect to products and/or processes that have not been completed or approved. The IPR&D intangible assets are subject to impairment testing until completion or abandonment of each project. Impairment testing requires the development of significant estimates and assumptions involving the determination of estimated net cash flows for each year for each project or product (including net revenues, cost of sales, R&D costs, selling and marketing costs), the appropriate discount rate to select in order to measure the risk inherent in each future cash flow stream, the assessment of each asset s life cycle, competitive trends impacting the asset and each cash flow stream as well as other factors. The major risks and uncertainties associated with the timely and successful completion of the IPR&D projects include legal risk and regulatory risk. Changes in these assumptions or uncertainties could result in future impairment charges. No assurances can be given that the underlying assumptions used to prepare the discounted cash flow analysis will not change or the timely completion of each project to commercial success will occur. For these and other reasons, actual results may vary significantly from estimated results. Due to changes in market conditions in certain international locations and forecasted performance of certain products not yet launched, the Company performed off-cycle impairment reviews and recorded impairment charges related to certain acquired IPR&D assets of $95.3 million and $28.6 million during the fourth quarter of 2011 and 2010, respectively. (Refer to Note 8 Goodwill, Product Rights and Other Intangibles for additional details.)

Upon successful completion of each project and launch of the product, the Company makes a determination of the useful life of the intangible, transfers the amount to currently marketed products (CMP) and amortizes the asset over its estimated useful life.

Contingent Consideration

Contingent consideration is recorded at the acquisition date estimated fair value of the contingent payment for all acquisitions. The fair value of the contingent consideration is remeasured at each reporting period with any adjustments in fair value included in our consolidated statement of operations. (Refer to Note 15 Fair Value Measurements for additional details regarding the fair value of contingent consideration.)

Revenue Recognition

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

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Provisions for Sales Returns and Allowances

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

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

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

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

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

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

Consistent with industry practice, the Company maintains a return policy that allows our customers to return product for credit. In accordance with our return goods policy, credit for customer returns of product is applied against outstanding account activity or by check. Product exchanges are not permitted. Customer returns of product are not resalable unless the return is due to a shipping error. Our estimate of the provision for returns is based upon historical experience and current trends of actual customer returns. Additionally, we consider other

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factors when estimating our current period return provision, including levels of inventory in our distribution channel as well as significant market changes which may impact future expected returns, and make adjustments to our current period provision for returns when it appears product returns may differ from our original estimates.

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

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

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

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

Net revenues and accounts receivable balances in the Company s consolidated financial statements are presented net of SRA estimates. In addition, certain SRA balances are included in accounts payable and accrued liabilities. Accounts receivable are presented net of SRA balances of $556.3 million and $320.5 million at December 31, 2011 and 2010, respectively. Accounts payable and accrued liabilities include $250.5 million and $106.5 million at December 31, 2011 and 2010, respectively, for certain rebates and other amounts due to indirect customers.

The following table summarizes the activity in the Company s major categories of SRA (in millions):

	Chargebacks	Rebates	Returns and Other Allowances	Cash Discounts	Total
Balance at December 31, 2008	$ 120.6	$ 125.8	$ 69.5	$ 12.3	$ 328.2
Add: Arrow Acquisition	5.3	37.0	11.3	1.5	55.1
Provision related to sales in 2009	1,169.0	415.1	183.8	72.8	1,840.7
Credits and payments	(1,177.5)	(389.5)	(167.1)	(71.3)	(1,805.4)
Balance at December 31, 2009	117.4	188.4	97.5	15.3	418.6
Provision related to sales in 2010	1,175.5	755.0	206.5	90.5	2,227.5
Credits and payments	(1,192.1)	(723.5)	(214.7)	(88.8)	(2,219.1)
Balance at December 31, 2010	100.8	219.9	89.3	17.0	427.0
Provision related to sales in 2011	1,308.1	1,113.2	306.6	120.5	2,848.4
Credits and payments	(1,248.0)	(844.1)	(273.9)	(102.6)	(2,468.6)
Balance at December 31, 2011	$ 160.9	$ 489.0	$ 122.0	$ 34.9	$ 806.8

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Shipping and Handling Costs

The Company records shipping and handling costs in selling and marketing expenses. These expenses were $72.9 million, $66.5 million and $51.9 million in 2011, 2010 and 2009, respectively.

Concentration of Major Customers and Suppliers

For the year ended December 31, 2011, the Company s three largest customers accounted for 16%, 14%, and 8%, individually, of the Company s net revenues. For the year ended December 31, 2010, the Company s three largest customers accounted for 14%, 11%, and 6%, individually, of the Company s net revenues. For the year ended December 31, 2009, the Company s three largest customers accounted for 13%, 11%, and 9%, individually, of the Company s net revenues. No other individual customers accounted for more than 10% of net revenues.

Our accounts receivable primarily arise from product sales in North America and Europe and primarily represent amounts due from wholesalers, distributors, chain drug stores and service providers in the health care and pharmaceutical industries, public hospitals and other government entities. Approximately 68% and 52% of the gross accounts receivable balance consists of amounts due from our four largest customers at December 31, 2011 and 2010, respectively. The Company performs ongoing credit evaluations of its customers and maintains an allowance for potential uncollectible accounts. Actual losses from uncollectible accounts have been minimal.

Concentrations of credit risk with respect to accounts receivable are limited due to the wide variety of customers and markets using our products, as well as their dispersion across many different geographic areas. We monitor economic conditions, including volatility associated with international economies, and related impacts on the relevant financial markets and our business, especially in light of sovereign credit issues. While the credit and economic conditions within Greece have deteriorated, our net accounts receivable balances from product sales in Greece are not material. We continue to monitor these conditions, including the length of time that it takes to collect on our accounts receivable outstanding in Greece.

Certain of the Company s finished products and raw materials are obtained from single source suppliers. Although the Company seeks to identify more than one source for its various finished products and raw materials, loss of a single source supplier could have an adverse effect on the Company s results of operations, financial condition and cash flows. Third-party manufactured products accounted for approximately 49%, 33% and 38% of our Global Generics and Global Brands product net revenues in 2011, 2010 and 2009, respectively.

Research and Development Activities

R&D activities are expensed as incurred and consist of self-funded R&D costs and the costs associated with work performed under collaborative R&D agreements. R&D expenses include direct and allocated expenses. R&D expenses incurred under collaborative agreements were approximately $21.5 million, $11.1 million and $6.8 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Income Taxes

Income taxes are accounted for using an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement and tax bases of assets and liabilities at the applicable tax rates. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The

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Company evaluates the realizability of its deferred tax assets by assessing its valuation allowance and by adjusting the amount of such allowance, if necessary. The factors used to assess the likelihood of realization include the Company s forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Failure to achieve forecasted taxable income in applicable tax jurisdictions could affect the ultimate realization of deferred tax assets and could result in an increase in the Company s effective tax rate on future earnings.

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

Comprehensive Income

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company s stockholders. Other comprehensive income refers to revenues, expenses, gains and losses that, under GAAP, are included in comprehensive income, but excluded from net income as these amounts are recorded directly as an adjustment to stockholders equity. Watson s other comprehensive income (loss) is composed of unrealized gains (losses) on certain holdings of publicly traded equity securities, net of realized gains (losses) included in net income and foreign currency translation adjustments.

Earnings Per Share (EPS)

Basic EPS is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted EPS is based on the treasury stock method and includes the effect from potential issuance of common stock, such as shares issuable pursuant to the exercise of stock options, assuming the exercise of all in-the-money stock options. Common share equivalents have been excluded where their inclusion would be anti-dilutive.

A reconciliation of the numerators and denominators of basic and diluted EPS consisted of the following (in millions, except per share amounts):

	Years Ended December 31,		
	2011	2010	2009
EPS basic			
Net income attributable to common shareholders	$ 260.9	$ 184.4	$ 222.0
Basic weighted average common shares outstanding	124.5	122.4	105.0
EPS basic	$ 2.10	$ 1.51	$ 2.11
EPS assuming dilution			
Net income attributable to common shareholders	$ 260.9	$ 184.4	$ 222.0
Add: Interest expense on CODES, net of tax			5.5
Net income, adjusted	$ 260.9	$ 184.4	$ 227.5
Basic weighted average common shares outstanding	124.5	122.4	105.0
Effect of dilutive securities:			
Conversion of CODES			10.1

Dilutive stock awards	2.0	1.8	1.3
Diluted weighted average common shares outstanding	126.5	124.2	116.4
EPS diluted	$ 2.06	$ 1.48	$ 1.96

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Stock awards to purchase 0.1 million, 1.1 million and 3.5 million common shares in 2011, 2010 and 2009, respectively, were outstanding but not included in the computation of diluted EPS because the awards were anti-dilutive.

Share-based Compensation

The Company issues non-vested shares in the form of restricted stock and restricted stock units under its long-term equity incentives program. Prior to 2008, we awarded stock options with an exercise price equal to the closing price of our common stock on the day the award was granted. Non-vested shares granted to employees and directors are valued at the market price of the shares on the date of grant. Share-based compensation expense recognized during a period is based on the value of the portion of share-based awards that are expected to vest with employees. That is, share-based compensation expense is reduced for estimated future forfeitures. These estimates are revised in future periods if actual forfeitures differ from the estimates. Changes in forfeiture estimates impact compensation expense in the period in which the change in estimate occurs.

Recent Accounting Pronouncements

In May 2011, the FASB issued new guidance that results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards (IFRS). The new guidance changes some fair value measurement principles and disclosure requirements under U.S. GAAP. Among the changes, the new guidance states that the concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities). Additionally, the new guidance extends the prohibition of applying a blockage factor (that is, premium or discount related to size of the entity s holdings) to all fair value measurements. A fair value measurement that is not a Level 1 measurement may include premiums or discounts other than blockage factors. The new guidance is effective for interim and annual periods beginning on or after December 15, 2011, with early adoption prohibited. The adoption of this new guidance is not expected to have a material impact on the Company s consolidated financial statements.

In June 2011, the FASB issued a final standard requiring entities to present net income and other comprehensive income in either a single continuous statement or in two separate, but consecutive, statements of net income and other comprehensive income. The new standard eliminates the option to present items of other comprehensive income in the statement of changes in equity. The new requirements do not change which components of comprehensive income are recognized in net income or other comprehensive income, or when an item of other comprehensive income must be reclassified to net income. Also, earnings per share computations do not change. The new requirements are effective for interim and annual periods beginning after December 15, 2011, with early adoption permitted. Full retrospective application is required. The Company adopted this standard for the annual period ended December 31, 2011 with retroactive application to the annual periods ended December 31, 2010 and 2009. The Company elected to present net income and other comprehensive income in two separate, but consecutive, statements of net income and other comprehensive income. As this standard related only to the presentation of other comprehensive income, the adoption of this accounting standard did not have an impact on the Company s consolidated financial statements.

In September 2011, the FASB issued a revised standard changing the goodwill impairment guidance. The revised standard provides entities with the option to first assess qualitative factors to determine whether performing the two-step goodwill impairment test is necessary. If an entity believes, as a result of its qualitative assessment, that it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount, the two-step quantitative impairment test will be required. Otherwise, no further testing will be required. Entities can choose to perform the qualitative assessment on none, some, or all of its reporting units. The revised standard is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after

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December 15, 2011. However, an entity can choose to early adopt the revised standard provided that the entity has not yet issued its financial statements for the period that includes its annual test date. The Company completed its most recent annual goodwill impairment test during the second quarter 2011 by applying the two-step test and determined that there was no impairment associated with goodwill.

NOTE 3 Share-Based Compensation

As indicated above, the Company recognizes compensation expense for all share-based compensation awards made to employees and directors based on market price of the shares on the date of grant. A summary of the Company s share-based compensation plans is presented below.

Equity Award Plans

The Company has adopted several equity award plans, all of which have been approved by the Company s shareholders that authorize the granting of options, restricted stock and other forms of equity awards of the Company s common shares subject to certain conditions. At December 31, 2011, the Company had reserved 8.0 million of its common shares for issuance of share-based compensation awards under the Company s equity award plans.

Option award plans require options to be granted at the fair value of the shares underlying the options at the date of the grant and generally become exercisable over periods ranging from three to five years and expire in ten years. Beginning in 2005, the Compensation Committee of the Board of Directors of the Company (the Board) authorized and issued restricted stock and restricted stock units to the Company s employees, including its

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

Share-Based Compensation

Share-based compensation expense recognized in the Company s results of operations for the years ended December 31, 2011, 2010 and 2009 was $39.8 million, $23.5 million and $19.1 million, respectively. Share-based compensation capitalized to inventory was $3.6 million, $3.6 million and $2.7 million for the years ended December 31, 2011, 2010 and 2009, respectively.

NOTE 4 Acquisitions and Divestitures

Acquisition of Specifar

On May 25, 2011, Watson and each of the shareholders (together, the Sellers) of Paomar PLC (Paomar) entered into a Stock Purchase Agreement (the Stock Purchase Agreement) pursuant to which Watson purchased all of the outstanding equity of Paomar for cash and certain contingent consideration (the Specifar Acquisition). Paomar is a company incorporated under the laws of Cyprus and owner of 100 percent of the shares of Specifar Commercial Industrial Pharmaceutical, Chemical and Construction Exploitations Societe Anonyme (ABEE) (Specifar), a company organized under the laws of Greece. Specifar owns 100 percent of

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the shares of Alet Pharmaceuticals Industrial and Commercial Societe Anonyme (Alet). In accordance with the terms of the Stock Purchase Agreement, the Company acquired all the outstanding equity of Paomar for the following consideration:

The payment of cash totaling 400.0 million, or $561.7 million at closing, subject to a net working capital adjustment of 1.5 million, or approximately $2.2 million.

Certain contingent consideration (not to exceed an aggregate total of 40.0 million) based on the gross profits on sales of the generic tablet version of Nexium® (esomeprazole) developed by Specifar during its first five years of sales in countries including major markets in Europe, Asia and Latin America, as well as in Canada. For additional information on the contingent payment, refer to Note 11 Fair Value Measurements .

Through the acquisition, Watson gains a generic pharmaceuticals product development company that develops and out-licenses generic pharmaceutical products primarily in Europe. In addition, the acquisition enhances the Company s commercial presence in key European markets by providing a portfolio of products and provides a commercial presence in the branded-generic Greek pharmaceuticals market, including the Specifar and Alet brands of products. Specifar maintains an internationally approved manufacturing facility located near Athens, Greece and is constructing a new facility located outside of Athens, which will expand manufacturing capacity. Specifar s pipeline of products includes a generic tablet version of Nexium® (esomeprazole). Watson funded the transaction using cash on hand and borrowings from the Company s 2006 Credit Facility. Specifar results are included in the Global Generics segment subsequent to the acquisition date.

Recognition and Measurement of Assets Acquired and Liabilities Assumed at Fair Value

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

The following table summarizes the final fair values of the tangible and identifiable intangible assets acquired and liabilities assumed at acquisition date, with the excess being allocated to goodwill (in millions):

	Amount
Cash and cash equivalents	$ 0.6
Accounts receivable	20.6
Inventories	27.1
Other current assets	9.3
Property, plant & equipment	65.1
IPR&D intangible assets	164.3
Intangible assets	265.1
Goodwill	195.1
Other assets	5.6
Current liabilties	(28.4)
Long-term deferred tax and other tax liabilities	(94.6)
Long-term debt	(27.9)
Other long-term liabilities	(42.4)
Net assets acquired	$ 559.5

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In June 2011, the Company paid and retired $28.8 million in long-term debt assumed in the Specifar Acquisition.

Inventories

The fair value of inventories acquired includes a step-up in the value of inventories of approximately $10.0 million, which was fully-amortized to cost of sales during 2011.

IPR&D and Intangible Assets

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

The fair value of the IPR&D and identifiable intangible assets was determined using the income approach, which is a valuation technique that provides an estimate of the fair value of an asset based on market participant expectations of the cash flows an asset would generate over its remaining useful life. Some of the more significant assumptions inherent in the development of those assets valuations include the estimated net cash flows for each year for each project or product (including net revenues, cost of sales, research and development costs, selling and marketing costs and working capital/asset contributory asset charges), the appropriate discount rate to select in order to measure the risk inherent in each future cash flow stream, the assessment of each asset s life cycle, competitive trends impacting the asset and each cash flow stream as well as other factors. The discount rate used to arrive at the present value of IPR&D projects as of the acquisition date was approximately 17.0% to reflect the internal rate of return and incremental commercial uncertainty in the projections as the products have not yet received regulatory approval. The major risks and uncertainties associated with the timely and successful completion of the IPR&D projects include development, legal and regulatory risk. No assurances can be given that the underlying assumptions used to prepare the discounted cash flow analysis will not change or the timely completion of each project to commercial success will occur. For these and other reasons, actual results may vary significantly from estimated results.

Intangible assets represent currently marketed products and have an estimated weighted average useful life of seven (7) years. IPR&D intangible assets represent products that are expected to be approved for marketing over the next one to three years.

Goodwill Allocation

Among the primary reasons the Company entered into the Specifar Acquisition and factors that contributed to a purchase price allocation resulting in the recognition of goodwill were a history of operating margins and profitability, a strong R&D organization and expanded commercial footprint on a global basis, which will enable Watson to expand its product offerings. The goodwill recognized from the Specifar Acquisition is not deductible for tax purposes. All goodwill from the Specifar Acquisition was assigned to the Global Generics segment.

Contingent Consideration

The Company s purchase price allocation determined the fair value of the contingent consideration obligation to be $35.5 million based on a probability-weighted income approach derived from revenue estimates and post-tax gross profit levels and a probability assessment with respect to the likelihood of achieving the various earn-out criteria. The fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement as defined in fair value measurement accounting. The resultant probability-weighted cash flows were discounted using an effective annual interest rate of 8.5%. At each reporting date, the Company adjusts the contingent consideration obligation to estimated fair value and records changes in fair value as income or expense in our consolidated statement of operations. Changes in the fair value of the contingent consideration obligations may result from changes in discount periods and rates, changes in the

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timing and amount of revenue estimates and changes in probability assumptions with respect to the likelihood of achieving the various earn-out criteria. Accretion expense related to the increase in the net present value of the contingent liability is included in interest expense for the period. During the year ended December 31, 2011, the Company recorded in interest expense $1.9 million of interest accretion related to the esomeprazole contingent consideration.

Long-Term Deferred Tax Liabilities and Other Tax Liabilities

Long-term deferred tax liabilities and other tax liabilities result from purchase accounting adjustments for the inventory fair value step-up and identifiable IPR&D and intangible assets fair value adjustments. These adjustments create excess book basis over the tax basis which is multiplied by the statutory tax rate for the jurisdiction in which the deferred taxes exist.

Acquisition-Related Expenses

Included in general and administrative expenses for the year ended December 31, 2011 is acquisition costs totaling $6.5 million for advisory, legal and regulatory costs incurred in connection with the Specifar Acquisition.

Unaudited Pro Forma Results of Operations

The following table presents the unaudited pro forma consolidated operating results for the Company, as though the Specifar Acquisition had occurred as of the beginning of the prior annual reporting period. The unaudited pro forma results reflect certain adjustments related to past operating performance, acquisition costs and acquisition accounting adjustments, such as increased depreciation and amortization expense based on the fair valuation of assets acquired, the impact of acquisition financing in place at January 1, 2010 and the related tax effects. The pro forma results do not include any anticipated synergies which may be achievable subsequent to the acquisition date. Accordingly, such pro forma amounts are not necessarily indicative of the results that actually would have occurred had the acquisition been completed on the dates indicated, nor are they indicative of the future operating results of the combined company (in millions, except per share amounts):

	Year Ended December 31,	
(Unaudited)	**2011**	**2010**
Net revenues	$ 4,630.7	$ 3,675.9
Net income attributable to common shareholders	$ 269.8	$ 165.1
Earnings per share:		
Basic	$ 2.17	$ 1.34
Diluted	$ 2.13	$ 1.32

Acquisition of Crinone® and Progesterone Vaginal Gel 8% Assets from Columbia Laboratories, Inc. (Columbia)

On July 2, 2010, the Company completed the acquisition of the U.S. rights to Columbia products Crinone® and progesterone vaginal gel 8% (progesterone gel) and acquired 11.2 million shares of Columbia s common stock, representing approximately a 13% ownership share, for initial cash consideration of $62.0 million and additional payments up to $45.5 million contingent upon the successful completion of certain clinical and regulatory milestones and certain other contingent obligations based on future sales of $19.3 million. As of December 31, 2011, the Company paid Columbia $5.0 million of the contingent obligation based upon the successful submission of a New Drug Application (NDA) to the U.S. Food and Drug Administration (FDA) for progesterone gel. On January 20, 2012, the Advisory Committee for Reproductive Health Drugs of the FDA (the Advisory Committee) voted to not recommend approval of the progesterone gel NDA and stated that more information was needed to support approval. While the FDA will consider recommendations of the Advisory Committee, FDA will make the final decision regarding the approval of the product. The FDA is expected to take

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action on the NDA by February 26, 2012. While we will continue to seek FDA approval of the product, we have reduced the value of our investment in the progesterone gel business and expected future contingent consideration to its estimated fair value as of December 31, 2011. Refer to NOTE 10 Other Long-Term Liabilities for additional information on contingent consideration.

The transaction was accounted for using the purchase method of accounting under existing U.S. GAAP with assets acquired and liabilities assumed recorded at their fair values as of the acquisition date. The purchase price for the Columbia acquisition was allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at the acquisition date as follows (in millions):

	Amount
Investments	$ 11.5
IPR&D intangible assets	75.8
Intangible assets	39.5
Long-term deferred tax assets	24.3
Contingent consideration obligations	(64.8)
Long-term deferred tax liabilities	(24.3)
Net assets acquired	$ 62.0

Pro forma results of operations have not been presented because the effect of the acquisition was not material.

Acquisition of Equity Interest in Moksha8 Pharmaceuticals, Inc. (Moksha8)

On October 4, 2010, the Company entered into an agreement with Moksha8 to expand into markets in Brazil and Mexico. The Company made an initial investment of $30.0 million in cash in Moksha8 in exchange for an approximate 22% ownership share in Moksha8. The Company accounts for the Moksha8 investment under the equity method.

Refer to NOTE 17 Subsequent Events for additional information on acquisitions.

NOTE 5 Other Income

Other income consisted of the following (in millions):

	Years Ended December 31,		
	2011	2010	2009
Gain (loss) on sale of securities	$ 0.8	$ 25.6	$ (1.1)
Earnings (losses) on equity method investments	(4.5)	1.6	10.8
Loss on early extinguishment of debt		(0.5)	(2.0)
Other income (loss)	3.2	1.0	0.2
	$ (0.5)	$ 27.7	$ 7.9

Gain (loss) on sale of securities

In March 2010, we completed the sale of our outstanding shares of Scinopharm for net proceeds of approximately $94.0 million, which resulted in a gain of $23.3 million.

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NOTE 6 Balance Sheet Components

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

	December 31, 2011	2010
Inventories:		
Raw materials	$ 219.2	$ 178.4
Work-in-process	55.7	38.4
Finished goods	655.0	465.6
	929.9	682.4
Less: Inventory reserves	40.5	51.4
Inventories, net	$ 889.4	$ 631.0
Property and equipment:		
Machinery and equipment	$ 597.2	$ 570.4
Buildings and improvements	382.2	385.7
Research and laboratory equipment	108.7	106.9
Leasehold improvements	89.5	90.0
Furniture and fixtures	51.7	46.2
Land and land improvements	47.1	33.9
Construction in progress	131.1	32.5
Total property and equipment, at cost	1,407.5	1,265.6
Less accumulated depreciation	(693.8)	(623.3)
Total property and equipment, net	$ 713.7	$ 642.3
Accounts payable and accrued expenses:		
Trade accounts payable	$ 755.9	$ 215.2
Proposed legal settlements	28.8	129.9
Accrued payroll and related benefits	121.4	88.7
Accrued third-party rebates	221.6	83.0
Royalties and sales agent payables	119.9	35.5
Current portion of contingent consideration obligations	128.3	28.9
Accrued indirect returns	28.9	23.5
Interest payable	17.8	17.6
Accrued severence, retention and other shutdown costs	7.2	20.0
Other accrued expenses	105.6	98.8
Total accounts payable and accrued expenses	$ 1,535.4	$ 741.1

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7 Investments in Marketable Securities and Other Investments

Investments in marketable securities and other investments consisted of the following (in millions):

	December 31, 2011	2010
Marketable securities:		
U.S. Treasury and agency securities maturing within one year	$ 4.9	$ 4.8
U.S. Treasury and agency securities maturing within two years	10.0	5.5
Equity securities		0.8
Total marketable securities	$ 14.9	$ 11.1
Investments and other assets:		
Equity method investments	$ 28.8	$ 63.2
Cost method and other long-term investments	0.3	0.3
Other assets	42.2	21.0
Total investments and other assets	$ 71.3	$ 84.5

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

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

At December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury and agency securities	$ 14.8	$ 0.1	$	$ 14.9
Equity securities current				
Current	14.8	0.1		14.9
Equity securities non-current				
Total	$ 14.8	$ 0.1	$	$ 14.9

At December 31, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				

U.S. Treasury and agency securities		$ 10.3	$	$	$ 10.3
Equity securities	current		0.8		0.8
Current		10.3	0.8		11.1
Equity securities	non-current		0.1		0.1
Total		$ 10.3	$ 0.9	$	$ 11.2

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Current Investments

The Company invests in U.S. Treasury and agency securities. These investments are included in marketable securities on the Company s Consolidated Balance Sheets at December 31, 2011 and 2010. Current investments are classified as available-for-sale and are recorded at fair value based on quoted market prices.

Investment in Equity Method Investments

The Company s equity method investments at December 31, 2011 consist of Columbia, Moksha8, and certain equity method investments in privately held companies acquired as part of Arrow Acquisition. (Refer to NOTE 4 Acquisition and Divestitures for additional information on Columbia and Moksha8.)

In December 2011, the Company recorded a $7.6 million other-than-temporary impairment charge related to its equity method investment in Columbia due to the Advisory Committee s January 20, 2012 vote to not recommend approval of the progesterone gel NDA.

On March 24, 2010, the Company sold its entire holdings of common shares in the equity of Scinopharm to Uni-President Enterprises Corporation. (Refer to NOTE 4 Acquisition and Divestitures for additional information on Scinopharm).

The Company recorded net (losses) earnings from equity method investments of ($4.5) million, $1.6 million and $10.8 million in 2011, 2010 and 2009, respectively.

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

Cost Method Investments

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

Other Assets

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

NOTE 8 Goodwill, Product Rights and Other Intangibles

Goodwill for the Company s reporting units consisted of the following (in millions):

	December 31,	
	2011	**2010**
Global Brands segment	$ 371.6	$ 371.6
Global Generics segment	1,250.4	1,070.2
Distribution segment	86.3	86.3
Total goodwill	$ 1,708.3	$ 1,528.1

The increase in Global Generics segment goodwill in 2011 is primarily due to goodwill of $195.1 million recognized in connection with the Specifar acquisition. (Refer to NOTE 4 Acquisitions and Divestitures for additional details.)

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	December 31, 2011	2010
Intangibles with definite lives:		
Product rights and other related intangibles	$ 2,582.5	$ 2,049.7
Core technology	52.5	52.5
Customer relationships	49.1	49.1
	2,684.1	2,151.3
Less accumulated amortization	(1,566.0)	(1,211.1)
	1,118.1	940.2
Intangibles with indefinite lives:		
IPR&D	419.3	615.6
Trade Name	76.2	76.2
	495.5	691.8
Total product rights and related intangibles, net	$ 1,613.6	$ 1,632.0

In May 2011, the Company acquired intangible assets in connection with the Specifar Acquisition of $429.4 million, including $265.1 million relating to CMP and $164.3 relating to IPR&D intangibles. CMP intangibles have been included in product rights and other related intangibles and will be amortized over a weighted average useful life.

In July 2010, the Company acquired intangible assets in connection with the acquisition of the U.S rights to certain Columbia products of $115.3 million, including $39.5 million relating to CMP and $75.8 million relating to IPR&D intangibles. CMP intangibles have been included in product rights and other related intangibles and will be amortized using a weighted average useful life.

During 2011 and 2010 approximately $250.4 million and $142.3 million of IPR&D intangibles were transferred to product rights and other related intangibles as products received regulatory approval. Amortization of these intangibles commenced upon product launch using a weighted average useful life.

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

Due to changes in market conditions in certain international locations and forecasted performance of certain products not yet launched, the Company performed off-cycle impairment reviews and recorded impairment charges related to certain acquired IPR&D assets during 2011 and 2010. During 2011 and 2010, the Company recorded aggregate impairment charges of $102.8 million and $28.6 million, respectively, related to certain IPR&D assets acquired. The impairment charges in 2011 include $75.8 million related to IPR&D intangibles acquired in our acquisition of the progesterone gel business from Columbia and $27.0 million of IPR&D intangibles acquired in the Arrow Acquisition. In 2010, the Company recorded an impairment charge of $28.6 million related to IPR&D intangibles acquired in the Arrow Acquisition. These impairment charges result from the Company s current estimates of the fair value of these IPR&D assets, based on updated forecasts, compared to their assigned fair values on the acquisition date. The fair value of acquired identifiable intangible assets generally is determined using an income

approach, based on a forecast of all expected future net cash flows related to the asset which are adjusted to present value using appropriate discount rates. Forecasts used to determine fair values of IPR&D assets are based on appropriate assumptions which include, among other factors,

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the impact of changes to the development programs, the current competitive environment, the regulatory timeframes impacting future product launch dates and the risk associated with these assets.

Assuming no additions, disposals or adjustments are made to the carrying values and/or useful lives of the intangible assets, annual amortization expense on product rights and related over the next five years is estimated to be as follows (in millions):

	Amount
2012	$ 358.7
2013	257.0
2014	235.7
2015	158.5
2016	72.5

The above amortization expense is an estimate. Actual amounts may change from such estimated amounts due to fluctuations in foreign currency exchange rates, additional intangible asset acquisitions, potential impairments, accelerated amortization or other events.

NOTE 9 Long-Term Debt

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

	December 31,	
	2011	2010
Senior Notes,		
$450.0 million 5.000% notes due August 14, 2014 (the 2014 Notes)	$ 450.0	$ 450.0
$400.0 million 6.125% notes due August 14, 2019 (the 2019 Notes) together the Senior Notes	400.0	400.0
	850.0	850.0
Less: Unamortized discount	(1.7)	(2.1)
Senior Notes, net	848.3	847.9
Mandatorily Redeemable Preferred Stock	183.2	166.4
Other notes payable	1.5	1.8
	1,033.0	1,016.1
Less: Current portion	184.5	
Total long-term debt	$ 848.5	$ 1,016.1

Senior Notes

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

Net proceeds from the offering of Senior Notes in 2009 were used to repay certain amounts under the 2006 Credit Facility and to redeem other debt with the remaining net proceeds being used to fund a portion of the cash consideration for the Arrow Acquisition.

Revolving Credit Facility

On September 16, 2011 (the Closing Date), the Company entered into a credit agreement (the Revolving Credit Agreement) with Bank of America, N.A., as Administrative Agent, Wells Fargo Bank, N.A., as Syndication Agent, and a syndicate of banks establishing a senior unsecured revolving credit facility (the Revolving Credit Facility). The Revolving Credit Facility provides an aggregate principal amount of $500.0 million in senior unsecured revolving loans. The revolving loans may be borrowed, repaid and re-borrowed for a term of five (5) years and, subject to certain minimum amounts, may be prepaid in whole or in part without premiums or penalties. Amounts borrowed under the Revolving Credit Facility may be used to finance working capital and other general corporate purposes. On the Closing Date, the Company borrowed $125.0 million under the Revolving Credit Facility and used cash on hand to repay the then amount outstanding, and to terminate, the Company s 2006 Revolving Facility dated as of November 3, 2006 (as amended on July 1, 2009) among the Company, Canadian Imperial Bank of Commerce as Administrative Agent, Wachovia Capital Markets, LLC as Syndication Agent and a syndicate of banks.

Committed borrowings under the Revolving Credit Facility bear interest at the Company s choice of a per annum rate equal to either a base rate or Eurocurrency rate, plus an applicable margin. The base rate is the higher of (a) the Federal Funds Rate plus 0.50%, (b) prime rate as publicly announced by the Administrative Agent, or (c) one-month London Interbank Offered Rate plus 1.00%. The applicable margin is a percentage determined in accordance with a pricing grid based on the Company s credit rating and is initially set at 0.25% for base rate loans and 1.25% for Eurocurrency rate loans. Additionally, to maintain availability of funds, the Company pays an unused commitment fee, which according to the pricing grid is initially set at 0.15% of the unused portion of the Revolving Credit Facility. The Company is subject to, and, at December 31, 2011, was in compliance with, all financial and operational covenants under the terms of the Revolving Credit Facility. The Revolving Credit Facility also imposes certain customary restrictions including, but not limited to, limits on the incurrence of debt or liens upon the assets of the Company or its subsidiaries, investments and restricted payments. There was no outstanding balance under the Revolving Credit Facility at December 30, 2011.

2006 Credit Facility

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

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and a $650.0 million senior term loan facility (Term Facility). The 2006 Credit Facility had a five-year term and was scheduled to mature in November 2011. In May 2011, the Company borrowed $250.0 million under the 2006 Revolving Facility to partially fund the Specifar acquisition as discussed in Note 3 ACQUISITIONS and DIVESTITURES . On September 16, 2011, concurrent with executing the Revolving Credit Facility, the Company repaid the then amount outstanding and terminated the 2006 Revolving Facility.

Mandatorily Redeemable Preferred Stock

In connection with the Arrow Acquisition, on December 2, 2009, pursuant to the Purchase Agreement, Watson issued 200,000 shares of newly designed non-voting Series A Preferred Stock of Watson, having a stated value of $1,000 per share (the Stated Value), or an aggregate stated value of $200.0 million, which have been placed in an indemnity escrow account for a period of three years. The fair value of the Mandatorily Redeemable Preferred Stock was estimated to be $150.0 million at Acquisition Date based on the mandatory redemption value of $200.0 million on December 2, 2012 using a discount rate of 9.63% per annum.

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

Dividends

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

Liquidation Preference

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

Mandatory Redemption

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

Change in Control Redemption

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

Voting Rights

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

At December 31, 2011, the fair value of the Mandatorily Redeemable Preferred Stock was $183.2 million and was reported as short-term debt. At December 31, 2010, the fair value of the Mandatorily Redeemable

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Preferred Stock was $166.4 million and was reported as long-term debt. Accretion expense has been classified as interest expense. At December 31, 2011 and 2010, the unamortized accretion expense was $16.8 million and $33.6 million, respectively.

Fair Value of Outstanding Debt

As of December 31, 2011, the fair value of our Senior Notes was $107.7 million greater than the carrying value. Generally changes in market interest rates affect the fair value of fixed-rate debt, but do not impact earnings or cash flows. Accordingly, we believe the effect, if any, of reasonably possible near-term changes in the fair value of our debt would not be material on our financial condition, results of operations or cash flows.

Annual Debt Maturities

At December 31, 2011, annual maturities of long-term debt were as follows (in millions):

2013	0.2
2014	450.0
2019	400.0

Amounts represent total anticipated cash payments on our Senior Notes, Mandatorily Redeemable Preferred Stock and other current and long-term debt assuming existing debt maturity schedules. Any early settlement of our Senior Notes through redemption or repurchase privileges, as defined under the terms of the Senior Notes, would change the timing of principal amounts due under the Company s long-term debt obligations.

NOTE 10 Other Long-Term Liabilities

Other long-term liabilities consisted of the following (in millions):

	December 31,	
	2011	**2010**
Atorvastatin contingent consideration liability	$ 128.5	$ 123.1
Columbia contingent consideration liability	8.6	75.4
Specifar contingent consideration liability	34.4	
Other contingent consideration liabilities	10.1	
Other long-term liabilities	19.4	13.5
	201.0	212.0
Less: Current portion included in accounts payable and accrued expenses	128.3	28.9
Total other long-term liabilities	$ 72.7	$ 183.1

The Company determines the acquisition date fair value of contingent consideration obligations based on a probability-weighted income approach derived from revenue estimates and a probability assessment with respect to the likelihood of achieving contingent obligations including contingent payments such as milestone obligations, royalty obligations and contract earn-out criteria, where applicable. The fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement as defined in fair value measurement accounting. The resultant probability-weighted cash flows are discounted using an appropriate effective annual interest rate to reflect the internal rate of return and incremental commercial uncertainty, major risks and uncertainties associated with the successful

completion of the projects triggering the contingent obligation. At each reporting date, the Company revalues the contingent consideration obligation to

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

estimated fair value and records changes in fair value as income or expense in our consolidated statement of operations. Changes in the fair value of the contingent consideration obligations may result from changes in discount periods and rates, changes in the timing and amount of revenue estimates and changes in probability assumptions with respect to the likelihood of achieving the various contingent consideration obligations. Accretion expense related to the increase in the net present value of the contingent liability is included in interest expense for the period.

Atorvastatin Contingent Consideration Liability

In accordance with the acquisition agreement, the Arrow Group selling shareholders have the right to receive certain contingent payments based on the after-tax gross profits, as defined by the agreement, on sales of atorvastatin within the U.S. (the Territory) from product launch date up to and including May 31, 2013 (the Contingent Payment Period). The determination of contingent payment amounts is dependent upon the existence of generic competition within the Territory and after-tax gross profits earned, as defined in the acquisition agreement. Should there be no competing generic product launched in the Territory during the Contingent Payment Period, payment of contingent consideration will be calculated as 50% of the after-tax gross profits, as defined in the acquisition agreement. Should there be a competing product to atorvastatin launched in the Territory during the Contingent Payment Period, the contingent consideration will be calculated as either 85% of the after-tax gross profits or 15% of the after-tax gross profits, as defined in the acquisition agreement, with total contingent payments being limited to $250.0 million during the Contingent Payment Period.

At December 31, 2011, the fair value of the atorvastatin contingent liability was $128.5 million of which $2.9 million was classified in other long-term liabilities and $125.6 million classified in accounts payable and accrued expenses. At December 31, 2010, the fair value of the atorvastatin contingent liability was $123.1 million and was classified in other long-term liabilities.

Columbia Contingent Consideration Liability

On July 2, 2010, the Company completed the acquisition of the U.S. rights to Columbia products Crinone® and progesterone gel for initial cash consideration of $62.0 million and acquired certain assets and assumed certain contingent consideration obligations. The fair value determinations of Columbia s contingent payment obligations on the acquisition date were based on, among other factors, estimates of expected future cash flows, estimates of appropriate discount rates used to present value expected future cash flow streams, the timing of approvals for IPR&D projects and the timing of related product launch dates and other factors. Contingent consideration obligations primarily relate to anticipated future milestones and other payments due Columbia based upon sales in accordance with the terms of the Columbia acquisition agreement. On January 20, 2012, the Advisory Committee for Reproductive Health Drugs of the FDA voted to not recommend approval of the progesterone gel NDA and stated that more information was needed to support approval. While the FDA will consider recommendations of the Committee, FDA will make the final decision regarding the approval of the product. The FDA is expected to take action on the NDA by February 26, 2012. While we will continue to seek FDA approval of the product, we have reduced the value of the expected future contingent consideration of the progesterone gel business to its estimated fair value as of December 31, 2011.

At December 31, 2011 the fair value of the Columbia contingent liability related to Crinone® was $8.6 million of which $5.9 million was classified in other long-term liabilities and $2.7 million classified in accounts payable and accrued expenses. At December 31, 2010, the fair value of the Columbia contingent liabilities related to Crinone® and progesterone gel was $75.4 million of which $46.5 million was classified in other long-term liabilities and $28.9 million classified in accounts payable and accrued expenses.

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Specifar Contingent Consideration

On May 25, 2011, the Company acquired all the outstanding equity of Paomar for cash totaling 400.0 million, or $561.7 million at closing, subject to a net working capital adjustment of 1.5 million, or approximately $2.2 million and certain contingent consideration (not to exceed an aggregate total of 40.0 million) based on the gross profits on sales of the generic tablet version of Nexium® (esomeprazole) developed by Specifar during its first five years of sales in countries including major markets in Europe, Asia and Latin America, as well as in Canada. The Company s purchase price allocation determined the fair value of the Specifar contingent consideration obligation to be $35.5 million based on a probability-weighted income approach derived from revenue estimates and post-tax gross profit levels and a probability assessment with respect to the likelihood of achieving the various earn-out criteria.

At December 31, 2011 the fair value of the Specifar contingent liability was $34.4 million and was classified in other long-term liabilities.

NOTE 11 Income Taxes

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

	Years Ended December 31,		
	2011	2010	2009
Income before income taxes:			
U.S.	$ 731.4	$ 391.6	$ 366.5
Foreign	(275.4)	(141.0)	(3.9)
Income before income taxes	$ 456.0	$ 250.6	$ 362.6

The Company s provision for income taxes consisted of the following (in millions):

	Years Ended December 31,		
	2011	2010	2009
Current provision:			
Federal	$ 301.2	$ 161.4	$ 133.0
State	10.8	14.9	20.2
Foreign	11.8	9.3	6.4
Total current provision	323.8	185.6	159.6
Deferred (benefit) provision:			
Federal	(53.2)	(54.1)	(7.8)
State	(3.9)	(10.2)	(5.5)
Foreign	(69.8)	(54.0)	(5.7)
Total deferred (benefit) provision	(126.9)	(118.3)	(19.0)
Total provision for income taxes	$ 196.9	$ 67.3	$ 140.6

The exercise of certain stock options resulted in a tax benefit and has been reflected as a reduction of income taxes payable and an increase to additional paid-in capital. Such benefits recorded were $14.6 million, $6.7 million and $2.3 million for the years ended December 31, 2011, 2010, and 2009, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Years Ended December 31,		
	2011	2010	2009
Federal income tax at statutory rates	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	2.4%	1.6%	2.9%
Foreign rate differential	7.4%	(0.8)%	(0.1)%
Non-deductible expenses	2.9%	5.7%	0.8%
R&D credit and U.S. manufacturing deduction	(3.7)%	(3.7)%	(1.7)%
Charitable contributions	(0.4)%	(1.0)%	(0.1)%
Favorable tax audit outcome	(1.4)%	(7.8)%	0.0%
Valuation allowance	1.4%	(1.4)%	(0.5)%
Transaction costs	0.2%	0.0%	1.6%
Sale of subsidiary	0.0%	(2.1)%	0.0%
Other	(0.6)%	1.4%	0.9%
Effective income tax rate	43.2%	26.9%	38.8%

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

	December 31,	
	2011	2010
Benefits from net operating loss and tax credit carryforwards	$ 101.3	$ 94.2
Differences in financial statement and tax accounting for:		
Inventories, receivables and accruals	163.9	145.6
Property, equipment and intangible assets	(288.1)	(305.7)
Deferred revenue	9.9	12.9
Deferred interest expense	(76.3)	(76.3)
Share-based compensation	19.4	12.8
Other	18.3	4.3
Total deferred tax liability, gross	(51.6)	(112.2)
Less: Valuation allowance	(37.8)	(29.7)
Total deferred tax liability, net	$ (89.4)	$ (141.9)

The Company had the following carryforward tax attributes at December 31, 2011:

$79.2 million state tax net operating loss (NOL) which begin to expire in 2012;

$162.5 million foreign tax NOLs which begin to expire in 2012; and

Tax credits of $58.2 million in foreign jurisdictions which are not subject to expiration.

A valuation allowance has been established due to the uncertainty of realizing certain net operating losses ($28.0 million) and deferred tax assets relating to some impaired investments ($9.8 million).

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred income taxes have not been provided on the undistributed earnings of certain of the Company s foreign subsidiaries of approximately $108.8 and $89.3 million as of December 31, 2011 and 2010, respectively. These amounts have been indefinitely reinvested. It is not practicable to calculate the deferred taxes associated with these earnings; however, foreign tax credits would likely be available to reduce federal income taxes in the event of distribution.

Accounting for Uncertainty in Income Taxes

At December 31, 2011, 2010 and 2009, the liability for income tax associated with uncertain tax positions was $71.2 million, $68.0 million and $72.2 million, respectively. As of December 31, 2011, the net amount of $65.2 million, if recognized, would favorably affect the Company s effective tax rate. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in millions):

	December 31,		
	2011	2010	2009
Balance at the beginning of the year	$ 68.0	$ 72.2	$ 61.3
Increases for current year tax positions	8.5	5.9	6.9
Increases for prior year tax positions	11.0	20.1	12.7
Decreases for prior year tax positions	(14.9)	(27.5)	(3.9)
Settlements	(1.2)	(2.3)	(4.4)
Lapse of applicable statue of limitations	(0.2)	(0.4)	(0.4)
Balance at the end of the year	$ 71.2	$ 68.0	$ 72.2

The Company s continuing practice is to recognize interest and penalties related to uncertain tax positions in tax expense. During the years ended December 31, 2011, 2010 and 2009, the company recognized approximately $2.1 million, ($2.3) million and $1.4 million in interest and penalties, respectively. At December 31, 2011, 2010 and 2009 the Company had accrued $4.2 million (net of tax benefit of $2.6 million), $2.4 million (net of tax benefit of $1.8 million) and $5.1 million (net of tax benefit of $3.1 million) of interest and penalties related to uncertain tax positions, respectively.

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

In the fourth quarter of 2010, the IRS began examining the Company s 2007, 2008, and 2009 tax years. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, the Company has accrued for amounts it believes are the probable outcomes. As a result of the ongoing IRS exam, the potential completion and/or settlement of other examinations in state and foreign jurisdictions, and the future completion of the Company s assessment of the uncertain tax positions of the Arrow Group, the quantification of all those potential changes cannot be estimated at this time.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 12 Stockholders Equity

Preferred stock

In 1992, the Company authorized 2.5 million shares of no par preferred stock. The Board has the authority to fix the rights, preferences, privileges and restrictions, including but not limited to, dividend rates, conversion and voting rights, terms and prices of redemptions and liquidation preferences without vote or action by the stockholders. On December 2, 2009 the Company issued 200,000 shares of Mandatorily Redeemable Preferred Stock. The Mandatorily Redeemable Preferred Stock is redeemable in cash on December 2, 2012 and is accordingly, included within short-term debt at December 31, 2011 and long-term debt at December 31, 2010 in the consolidated balance sheet (for additional information on the Mandatorily Redeemable Preferred Stock refer to NOTE 9 Long-Term Debt).

Stock option plans

The Company has adopted several stock option plans, all of which have been approved by the Company s shareholders that authorize the granting of options to purchase the Company s common shares subject to certain conditions. At December 31, 2011, the Company had reserved 8.0 million of its common shares for issuance upon exercise of options granted or to be granted under these plans and for restricted stock grants (see discussion below). The option award plans require options to be granted at the fair value of the shares underlying the options at the date of the grant and generally become exercisable over periods ranging from three to five years and expire in ten years. No additional options have been granted under any of these plans.

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

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding, December 31, 2010	3.1	$ 36.63		
Granted				
Exercised	(1.3)	42.41		
Cancelled	(0.1)	53.81		
Outstanding, December 31, 2011	1.7	$ 31.74	3.4	$ 57.4
Vested and expected to vest at December 31, 2011	1.7	$ 31.74	3.4	$ 57.1
Options exercisable at December 31, 2011	1.6	$ 31.83	3.2	$ 52.9

As of December 31, 2011, the Company had $0.1 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 0.7 years. Total intrinsic value of options exercised for the year ended December 31, 2011 and 2010 was $24.3 million and $18.4 million, respectively.

Restricted Stock Plan

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

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

that entitle the holder to shares of common stock subject to certain terms. Watson s restricted stock and restricted stock unit awards generally have restrictions lapse over a one- to four-year period. Restrictions generally lapse for non-employee directors after one year. Restrictions generally lapse for employees over a two- to four-year period. Certain restricted stock units are performance-based awards issued at a target number, subject to adjustments up or down based upon achievement of certain financial targets. The fair value of restricted stock grants is based on the fair market value of our common stock on the respective grant dates. Restricted stock compensation is being amortized and charged to operations over the same period as the restrictions are lapse for the Participants.

A summary of the changes in restricted stock grants during the year ended December 31, 2011 is presented below (shares and aggregate intrinsic value in millions):

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Restricted shares outstanding at December 31, 2010	2.3	$ 34.33	1.6	$ 79.6
Granted	1.0	57.52		58.9
Vested	(0.6)	30.79		(19.9)
Cancelled	(0.2)	39.74		(7.8)
Restricted shares outstanding at December 31, 2011	2.5	$ 44.37	1.5	$ 110.8

As of December 31, 2011, the Company had $44.6 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 1.5 years.

Stock Repurchases

During the years ended December 31, 2011 and 2010, the Company repurchased approximately 0.3 million and 0.1 million shares, respectively, of its common stock surrendered to the Company to satisfy tax withholding obligations in connection with the exercise and sale of stock options or vesting of restricted stock issued to employees for total consideration of $14.2 million and $6.3 million, respectively.

Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) at December 31, 2011 consisted of unrealized gains on securities of $0.1 million and foreign currency translation adjustments of ($76.6) million. Accumulated other comprehensive income (loss) at December 31, 2010 consists of unrealized gains on securities of $9.2 million and foreign currency translation adjustments of ($11.7) million.

NOTE 13 Segments

Watson has three segments: Global Generics, Global Brands and Distribution. The Global Generics segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Global Brands segment includes patent-protected products and certain trademarked off-patent products that Watson sells and markets as brand pharmaceutical products. The Distribution segment mainly distributes generic pharmaceutical products manufactured by third parties, as well as by Watson, primarily to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians offices. The Distribution segment operating results exclude sales by Anda of products developed, acquired, or licensed by Watson s Global Generics and Global Brands segments.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The accounting policies of the operating segments are the same as those described in NOTE 2 Summary of Significant Accounting Policies. The other revenue classification consists primarily of milestone payments, commission revenue, royalties and revenues from research, development and licensing fees and also includes co-promotion revenue and revenue (including the amortization of deferred revenue) relating to our obligation to manufacture and supply products to third parties. The Company evaluates segment performance based on segment contribution. Segment contribution represents segment net revenues less cost of sales (excludes amortization), direct R&D expenses and selling and marketing expenses. The Company does not report total assets, capital expenditures, corporate general and administrative expenses, amortization, gains or losses on asset sales or disposals and impairments by segment as such information has not been accounted for at the segment level, nor has such information been used by management at the segment level.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Segment net revenues, segment operating expenses and segment contribution information for the Company s Global Generics, Global Brands and Distribution segments consisted of the following (in millions):

	Years Ended December 31,		
	2011	2010	2009
Global Generics Segment			
Product sales	$ 3,320.2	$ 2,268.9	$ 1,641.8
Other revenue	47.0	69.5	26.4
Net revenues	3,367.2	2,338.4	1,668.2
Operating expenses:			
Cost of sales(1)	1,817.8	1,198.9	947.1
Research and development	227.7	194.6	140.4
Selling and marketing	156.0	111.9	53.8
Global Generics Contribution	**$ 1,165.7**	**$ 833.0**	**$ 526.9**
Contribution margin	34.6%	35.6%	31.6%
Global Brands Segment			
Product sales	$ 364.9	$ 316.3	$ 393.7
Other revenue	76.1	81.5	67.3
Net revenues	441.0	397.8	461.0
Operating expenses:			
Cost of sales(1)	94.4	88.4	89.3
Research and development	67.7	101.5	56.9
Selling and marketing	168.6	137.8	144.5
Global Brands Contribution	**$ 110.3**	**$ 70.1**	**$ 170.3**
Contribution margin	25.0%	17.6%	36.9%
Distribution Segment			
Product sales	$ 776.2	$ 830.7	$ 663.8
Other revenue			
Net revenues	776.2	830.7	663.8
Operating expenses:			
Cost of sales(1)	652.7	711.2	560.4
Research and development			
Selling and marketing	77.2	70.3	64.8
Distribution Contribution	**$ 46.3**	**$ 49.2**	**$ 38.6**
Contribution margin	6.0%	5.9%	5.8%
Total Segment Contribution	**$ 1,322.3**	**$ 952.3**	**$ 735.8**
Corporate general and administrative	353.1	436.1	257.1

Amortization	354.3	180.0	92.6
Loss on asset sales and impairments	78.7	30.8	2.2
Operating income	$ 536.2	$ 305.4	$ 383.9

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

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s net product sales are represented by the sale of products in the following geographic areas for the years ended December 31 (in millions):

	2011	2010	2009
United States	$ 3,960.6	$ 2,990.1	$ 2,642.2
International	500.7	425.8	57.1
	$ 4,461.3	$ 3,415.9	$ 2,699.3

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

	2011	2010	2009
Central nervous system	$ 1,517.4	$ 907.6	$ 836.7
Cardiovascular	977.2	594.6	269.4
Hormones and synthetic substitutes	724.7	682.3	609.8
Anti-infective agents	197.9	161.5	133.7
Urology	140.5	127.3	111.4
Other	903.6	942.6	738.3
	$ 4,461.3	$ 3,415.9	$ 2,699.3

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14 Business Restructuring Charges

Activity related to our business restructuring and facility rationalization activities primarily consisted of restructuring activities involving facilities at Carmel, New York; Corona, California; Groveport, Ohio; Mississauga, Canada and Melbourne, Australia for the year ended December 31, 2011 as follows (in millions):

	Accrual Balance at December 31, 2010	Charged to Expense	Cash Payments	Non-cash Adjustments	Accrual Balance at December 31, 2011
Cost of sales					
Severance and retention	$ 12.9	$ 1.1	$ (6.1)	$	$ 7.9
Product transfer costs	1.4	3.2	(4.3)		0.3
Facility decommission costs	1.6	1.1	(1.5)		1.2
Accelerated depreciation		3.8		(3.8)	
	15.9	9.2	(11.9)	(3.8)	9.4
Operating expenses					
R&D	3.1	3.9	(3.2)		3.8
Accelerated depreciation R&D		1.0		(1.0)	
Selling, general and administrative	1.0	1.7	(1.8)		0.9
Accelerated depreciation S,G&A		0.3		(0.3)	
	4.1	6.9	(5.0)	(1.3)	4.7
Total restructuring activity	$ 20.0	$ 16.1	$ (16.9)	$ (5.1)	$ 14.1

Activity related to our business restructuring and facility rationalization activities primarily consisted of restructuring activities involving facilities at Carmel, New York, Mississauga, Canada and Melbourne, Australia for the year ended December 31, 2010 as follows (in millions):

	Accrual Balance at December 31, 2009	Charged to Expense	Cash Payments	Non-cash Adjustments	Accrual Balance at December 31, 2010
Cost of sales					
Severance and retention	$ 13.1	$ 5.9	$ (6.1)	$	$ 12.9
Product transfer costs	1.0	3.3	(2.9)		1.4
Facility decommission costs	0.2	10.7	(9.3)		1.6
Accelerated depreciation		10.4		(10.4)	
	14.3	30.3	(18.3)	(10.4)	15.9
Operating expenses					

R&D	0.8	8.1	(5.8)		3.1
Accelerated depreciation - R&D		1.4		(1.4)	
Selling, general and administrative	0.8	1.7	(1.5)		1.0
	1.6	11.2	(7.3)	(1.4)	4.1
Total restructuring activity	$ 15.9	$ 41.5	$ (25.6)	$ (11.8)	$ 20.0

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

Over the past several years, we have announced steps to improve our operating cost structure and achieve operating excellence and efficiencies through our Global Supply Chain Initiative (GSCI). Product manufacturing ceased in Carmel, New York by December 31, 2010 and we closed the facility in early 2011. During 2010, the Company announced additional measures to reduce our cost structure by announcing the planned closure of our Canadian manufacturing facility and the discontinuation of R&D activities in Canada and Australia. In January 2011, the Company announced the planned discontinuation of R&D activities in Corona, California, which was completed at the end of 2011. In July 2011, the Company announced the planned closure of the Groveport, Ohio distribution center in the second quarter of 2012. The transfer of development activities to the remaining R&D sites are expected to be completed by late 2012. During the year ended December 31, 2011, 2010 and 2009, the Company recognized restructuring charges of $16.1 million, $41.5 million and $32.6 million, respectively.

NOTE 15 Fair Value Measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants. Fair values determined based on Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined based on Level 2 inputs utilize observable quoted prices for similar assets and liabilities in active markets and observable quoted prices for identical or similar assets in markets that are not very active. Fair values determined based on Level 3 inputs utilize unobservable inputs and include valuations of assets or liabilities for which there is little, if any, market activity. A financial asset or liability s classification within the above hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

Assets and liabilities measured at fair value or disclosed at fair value on a recurring basis as at December 31, 2011 and 2010 consisted of the following (in millions):

		Fair Value Measurements as at December 31, 2011 Using:		
	Total	Level 1	Level 2	Level 3
Assets:				
Marketable securities	14.9	$ 14.9	$	$
Investments				
Liabilities:				
Contingent consideration	181.6			181.6

		Fair Value Measurements as at December 31, 2010 Using:		
	Total	Level 1	Level 2	Level 3
Assets:				
Marketable securities	$ 11.1	$ 11.1	$	$
Investments	23.1	23.1		
Liabilities:				
Contingent consideration	198.5			198.5

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

The fair value measurement of the contingent consideration obligations is determined using Level 3 inputs. The fair value of contingent consideration obligations is based on a probability-weighted income approach. The measurement is based upon unobservable inputs supported by little or no market activity based on our own assumptions. Changes in the fair value of the contingent consideration obligations are recorded in our consolidated statement of operations. For the year ended December 31, 2011, charges (credits) of ($7.2) million, ($7.7) million, ($49.0) million and $12.8 million have been included in cost of sales, research and development expenses, loss on asset sales and impairments and interest expense, respectively, in the accompanying condensed consolidated statement of operations.

The table below provides a summary of the changes in fair value, including net transfers in and/or out, of all financial assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the years ended December 31, 2011 and 2010 (in millions):

	Balance at December 31, 2010	Net transfers in to (out of) Level 3	Purchases and settlements, net	Net accretion and fair value adjustments	Foreign currency translation	Balance at December 31, 2011
Liabilities:						
Contingent consideration obligations	$198.5	$	$37.2	$(51.1)	$(3.0)	$181.6

	Balance at December 31, 2009	Net transfers in to (out of) Level 3	Purchases and settlements, net	Net accretion and fair value adjustments	Foreign currency translation	Balance at December 31, 2010
Liabilities:						
Contingent consideration obligations	$111.0	$	$64.8	$22.7	$	$198.5

NOTE 16 Commitments and Contingencies

Facility and Equipment Leases

The Company has operating leases for certain facilities and equipment. The terms of the operating leases for the Company s facilities require the Company to pay property taxes, normal maintenance expenses and maintain minimum insurance coverage. Total rental expense for operating leases in 2011, 2010 and 2009 was $32.4 million, $26.0 million and $20.0 million, respectively.

At December 31, 2011, future minimum lease payments under all non-cancelable operating leases are approximately $22.3 million in 2012, $17.6 million in 2013, $16.4 million in 2014, $16.2 million in 2015, $14.9 million in 2016 and $90.9 million thereafter.

Employee Retirement Plans

The Company maintains certain defined contribution retirement plans covering substantially all U.S.-based employees. The Company contributes to the plans based upon the employee contributions. Watson s contributions to these retirement plans were $15.7 million, $9.5 million and $11.0 million in the years ended December 31, 2011, 2010 and 2009, respectively. The Company does not sponsor any defined benefit retirement plans or postretirement benefit plans.

Legal Matters

Watson and its affiliates are involved in various disputes, governmental and/or regulatory inspection, inquires, investigations and proceedings, and litigation matters that arise from time to time in the ordinary course

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of business. The process of resolving matters through litigation or other means inherently uncertain and it is possible that an unfavorable resolution of these matters will adversely affect the Company, its results of operations, financial condition and cash flows. The Company s regular practice is to expense legal fees as services are rendered in connection with legal matters, and to accrue for liabilities when losses are probable and reasonably estimable.

Cipro® Litigation. Beginning in July 2000, a number of suits were filed against Watson, The Rugby Group, Inc. (Rugby) and other company affiliates in various state and federal courts alleging claims under various federal and state competition and consumer protection laws. Several plaintiffs have filed amended complaints and motions seeking class certification. Approximately 42 cases have been filed against Watson, Rugby and other Watson entities. Twenty-two of these actions have been consolidated in the U.S. District Court for the Eastern District of New York (*In re: Ciprofloxacin Hydrochloride Antitrust Litigation, MDL Docket No. 001383*). On May 20, 2003, the court hearing the consolidated action granted Watson s motion to dismiss and made rulings limiting the theories under which plaintiffs can seek recovery against Rugby and the other defendants. On March 31, 2005, the court hearing the consolidated action granted summary judgment in favor of the defendants on all of plaintiffs claims and denied the plaintiffs motions for class certification. On May 7, 2005, three groups of plaintiffs from the consolidated action (the direct purchaser plaintiffs, the indirect purchaser plaintiffs and plaintiffs Rite Aid and CVS) filed notices of appeal in the United States Court of Appeals for the Second Circuit, appealing, among other things, the May 20, 2003 order dismissing Watson and the March 31, 2005 order granting summary judgment in favor of the defendants. On November 7, 2007, the U.S. Court of Appeals for the Second Circuit ordered the appeal by the indirect purchaser plaintiffs transferred to the United States Court of Appeals for the Federal Circuit. On October 15, 2008, the United States Court of Appeals for the Federal Circuit affirmed the dismissal of the indirect purchasers claims, and on December 22, 2008, denied the indirect purchaser plaintiffs petition for rehearing and rehearing en banc. On June 22, 2009, the Supreme Court denied the indirect purchaser plaintiffs petition for writ of certiorari. On April 29, 2010, the United States Court of Appeals for the Second Circuit affirmed the ruling of the District Court granting summary judgment in favor of the defendants, and on September 7, 2010, denied the appellants petition for rehearing en banc. On March 7, 2011, the Supreme Court denied the direct purchaser plaintiffs petition for writ of certiorari. Other actions are pending in various state courts, including California, Kansas, Tennessee, and Florida. The actions generally allege that the defendants engaged in unlawful, anticompetitive conduct in connection with alleged agreements, entered into prior to Watson s acquisition of Rugby from Sanofi Aventis (Sanofi), related to the development, manufacture and sale of the drug substance ciprofloxacin hydrochloride, the generic version of Bayer s brand drug, Cipro®. The actions generally seek declaratory judgment, damages, injunctive relief, restitution and other relief on behalf of certain purported classes of individuals and other entities. In the action pending in Kansas, the court has administratively terminated the matter pending the outcome of the appeals in the consolidated case. In the action pending in the California Superior Court for the County of San Diego (*In re: Cipro Cases I & II, JCCP Proceeding Nos. 4154 & 4220*), on July 21, 2004, the California Court of Appeal ruled that the majority of the plaintiffs would be permitted to pursue their claims as a class. On August 31, 2009, the California Superior Court granted defendants motion for summary judgment, and final judgment was entered on September 24, 2009. On November 19, 2009, the plaintiffs filed a notice of appeal. On October 31, 2011, the California Court of Appeal affirmed the Superior Court s judgment. On December 13, 2011, the plaintiffs filed a petition for review in the California Supreme Court. The petition has been fully briefed and remains pending. In addition to the pending actions, Watson understands that various state and federal agencies are investigating the allegations made in these actions. Sanofi has agreed to defend and indemnify Watson and its affiliates in connection with the claims and investigations arising from the conduct and agreements allegedly undertaken by Rugby and its affiliates prior to Watson s acquisition of Rugby, and is currently controlling the defense of these actions.

Governmental Reimbursement Investigations and Drug Pricing Litigation. In November 1999, Schein Pharmaceutical, Inc., now known as Watson Pharma, Inc. (Watson Pharma) was informed by the U.S.

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Beginning in July 2002, the Company and certain of its subsidiaries, as well as numerous other pharmaceutical companies, were named as defendants in various state and federal court actions alleging improper or fraudulent reporting practices related to the reporting of average wholesale prices and wholesale acquisition costs of certain products, and that the defendants committed other improper acts in order to increase prices and market shares. Some of these actions have been consolidated in the U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 145*). The consolidated amended Class Action complaint in that case alleges that the defendants acts improperly inflated the reimbursement amounts of certain drugs paid by various public and private plans and programs. Certain defendants, including the Company, have entered into a settlement agreement resolving all claims against them in the Consolidated Class Action (the Track Two Settlement). The total amount of the settlement for all of the settling defendants is $125 million. The amount to be paid by each settling defendant is confidential. On July 2, 2008, the United States District Court for the District of Massachusetts preliminarily approved the Track Two settlement. On December 8, 2011, the Court entered a final order and judgment granting final approval of the Track Two Settlement. The settlement is not expected to materially adversely affect the Company s business, results of operations, financial condition and cash flows.

The Company and certain of its subsidiaries also are named as defendants in various lawsuits filed by numerous states and qui tam relators, including Texas, Kansas, Nevada, Montana, Massachusetts, Wisconsin, Kentucky, Alabama, Illinois, Mississippi, Florida, Arizona, Missouri, Alaska, Idaho, South Carolina, Hawaii, Utah, Iowa, Oklahoma and Louisiana captioned as follows: *State of Nevada v. American Home Products, et al., Civil Action No. 02-CV-12086-PBS, United States District Court for the District of Massachusetts; State of Montana v. Abbott Laboratories, et al., Civil Action No. 02-CV-12084-PBS, United States District Court for the District of Massachusetts; Commonwealth of Massachusetts v. Mylan Laboratories, et al., Civil Action No. 03-CV-11865-PBS, United States District Court for the District of Massachusetts; State of Wisconsin v. Abbott Laboratories, et al., Case No. 04-cv-1709, Wisconsin Circuit Court for Dane County; Commonwealth of Kentucky v. Alpharma, Inc., et al., Case Number 04-CI-1487, Kentucky Circuit Court for Franklin County; State of Alabama v. Abbott Laboratories, Inc. et al., Civil Action No. CV05-219, Alabama Circuit Court for Montgomery County; State of Illinois v. Abbott Laboratories, Inc. et al., Civil Action No. 05-CH-02474, Illinois Circuit Court for Cook County; State of Mississippi v. Abbott Laboratories, Inc. et al., Civil Action No. G2005-2021 S/2, Mississippi Chancery Court of Hinds County; State of Florida ex rel. Ven-A-Care, Civil Action No 98-3032G, Florida Circuit Court in Leon County (the Florida Ven-A-Care Action); State of Arizona ex rel. Terry Goddard, No. CV 2005-18711, Arizona Superior Court for Maricopa County; State of Missouri ex rel. Jeremiah W. (Jay) Nixon v. Mylan Laboratories, et al, Case No. 054-2486, Missouri Circuit Court of St. Louis;*

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

State of Alaska v. Alpharma Branded Products Division Inc., et al., In the Superior Court for the State of Alaska Third Judicial District at Anchorage, C.A. No. 3AN-06-12026 CI; State of Idaho v. Alpharma USPD Inc. et al., In the District Court of the Fourth Judicial District of the State of Idaho, in and for the County of Ada, C.A. No. CV0C-0701847; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7152; State of South Carolina and Henry D. McMaster v. Watson Pharmaceuticals (New Jersey), Inc., In the Court of Common Pleas for the Fifth Judicial Circuit, State of South Carolina, County of Richland, C.A. No. 2006-CP-40-7155; State of Hawaii v. Abbott Laboratories, Inc. et al., In the Circuit Court of the First Circuit, State of Hawaii, C.A. No. 06-1-0720-04 EEH; State of Utah v. Actavis U.S., Inc., et al., In the Third Judicial District Court of Salt Lake County, Civil No. 07-0913719; State of Iowa v. Abbott Laboratories, Inc., et al., In the U.S. District Court for the Southern District of Iowa, Central Division, Case No. 07-CV-00461 (the Iowa AG Action); State of Texas ex rel. Ven-A-Care of the Florida Keys, Inc. v. Alpharma Inc., et al, Case No. 08-001565, in the District Court of Travis County, Texas (the Texas Ven-A-Care Action); United States of America ex rel. Ven-A-Care of the Florida Keys, Inc. v. Actavis Mid-Atlantic LLC, Civil Action No. 08-10852, in the U.S. District Court for the District of Massachusetts (the Federal Ven-A-Care Action); State of Kansas ex rel. Steve Six v. Watson Pharmaceuticals, Inc. and Watson Pharma, Inc., Case Number: 08CV2228, District Court of Wyandotte County, Kansas, Civil Court Department; State of Oklahoma, ex rel., W.A. Drew Edmondson, Attorney General of Oklahoma v. Abbott Laboratories, Inc., et al., Case No. CJ-2010-474, District Court of Pottawatomie County, Oklahoma, and State of Louisiana V. Abbott Laboratories, Inc., et al., Case No. 596144, Parish of East Baton Rouge, 19th Judicial District. In December of 2010, the State of Utah served the Company with a Civil Investigative Demand seeking additional information relating to the Company s pricing practices. On December 20, 2011, the District Court for the Third Judicial District for Salt Lake County, Utah, entered an order staying the proceedings on the Civil Investigative Demand until thirty days following resolution of a pending appeal in a related matter.

On August 4, 2004, the City of New York filed an action against the Company and numerous other pharmaceutical defendants alleging similar claims. The case has been consolidated with similar cases filed by forty one individual New York counties. (*City of New York v. Abbott Laboratories, Inc., et al., Civil Action No. 01-CV-12257-PBS, United States District Court for the District of Massachusetts*) (hereinafter the Consolidated NY Counties Actions), as well as by four additional New York counties, with three of these cases pending in New York state courts.

In December of 2010, the Company reached an agreement in principle to settle the following pending actions: the Texas Ven-a-Care Action, the Florida Ven-a-Care Action, the Iowa AG Action, and the Consolidated New York Counties Action (the State Ven-A-Care Settlement). In addition, at the same time the Company reached an agreement in principle to settle claims pending in the Federal Ven-A-Care Action relative to the Texas, Florida, Iowa and New York Medicaid programs (the Federal Ven-A-Care Settlement, and collectively with the State Ven-A-Care Settlement, the December 2010 Ven-A-Care Settlement). The total amount paid by the Company under the terms of the December 2010 Ven-A-Care Settlement was $79.0 million. The December 2010 Ven-A-Care Settlement was finalized in September 2011 and the Texas Ven-A-Care Action, the Florida Ven-a-Care Action, the Iowa AG Action and the Consolidated New York Counties Action have each been dismissed with prejudice. In May of 2011, the Company reached an agreement-in-principle to settle all remaining claims in the Federal Ven-A-Care Action (*i.e.,* all claims not settled in connection with the December 2010 Ven-A-Care Settlement) (the May 2011 Ven-A-Care Settlement), except for those claims related to Alabama, Alaska, Kentucky, Idaho, Illinois, South Carolina, Utah and Wisconsin. The May 2011 Ven-A-Care Settlement was finalized in December 2011 and the Federal Ven-A-Care action has been dismissed with prejudice. The total amount paid by the Company under the terms of the May 2011 Ven-A-Care Settlement is $27.0 million. The December 2010 Ven-A-Care Settlement and the May 2011 Ven-A-Care Settlement resolved all of the claims brought against the Company by the qui-tam relator seeking to recover on behalf of the United

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States, other than such claims pending with respect to Alabama, Alaska, Kentucky, Idaho, Illinois, South Carolina, Utah, and Wisconsin.

The cases against the Company on behalf of Arizona, Hawaii and Massachusetts have been settled. In October 2011 the Company reached an agreement in principle to settle the case brought on behalf of Oklahoma. The settlement is subject to the parties negotiating and executing a definitive settlement agreement. The amount of the settlement is not expected to be material to the Company. The case against the Company on behalf of Alabama was tried in 2009. The jury was unable to reach a verdict, and the court declared a mistrial and ordered the case to be retried. A new trial date has not been scheduled. The case against the Company on behalf of Kentucky was tried in November 2011. The jury reached a verdict in the Company s favor on each of Kentucky s claims against the Company. Kentucky has filed post-trial motions for relief from the jury verdict. A hearing on Kentucky s post-trial motions is set for May 8, 2012. The case against the Company on behalf of Alaska was settled in principle in December 2011. The amount to be paid by the Company under the terms of the settlement in principle is not material to the Company. The case against the Company on behalf of Idaho is scheduled for trial in March 2012. The case against the Company on behalf of Mississippi is scheduled for trial in September of 2012. The case against the Company on behalf of Kansas is scheduled for trial in January 2014.

Following the payments of the December 2010 and May 2011 Ven-A-Care Settlements, the Company has a remaining accrual of $23.9 million liability reserve on its balance sheet in connection with the remaining drug pricing actions. With regard to the remaining drug pricing actions, the Company believes that it has meritorious defenses and intends to vigorously defend itself in those actions. The Company continually monitors the status of these actions and may settle or otherwise resolve some or all of these matters on terms that the Company deems to be in its best interests. However, the Company can give no assurance that it will be able to settle the remaining actions on terms it deems reasonable, or that such settlements or adverse judgments in the remaining actions, if entered, will not exceed the amounts of the liability reserves. Additional actions by other states, cities and/or counties are anticipated. These actions and/or the actions described above, if successful, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Medicaid Drug Reimbursement Litigation. In December 2009, the Company learned that numerous pharmaceutical companies, including certain subsidiaries of the Company, have been named as defendants in a qui tam action pending in the United States District Court for the District of Massachusetts (*United States of America ex rel. Constance A. Conrad v. Actavis Mid-Atlantic, LLC, f/k/a Biovail Pharmaceuticals, LLC, et. al., USDC Case No. 02-CV-11738-NG).* The seventh amended complaint, which was served on certain of the Company s subsidiaries in December 2009, alleges that the defendants falsely reported to the United States that certain pharmaceutical products were eligible for Medicaid reimbursement and thereby allegedly caused false claims for payment to be made through the Medicaid program. In July 2011, the plaintiff served a tenth amended complaint that unseals the action in its entirety and continues to allege the previously asserted claims against certain subsidiaries of the Company. The Company s subsidiaries named in the action together with all other named defendants filed a Joint Motion to Dismiss the Tenth Amended Complaint on December 9, 2011. Additional actions alleging similar claims could be asserted. The Company believes that it has meritorious defenses to the claims and intends to vigorously defend itself in the action. However, this action or similar actions, if successful, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

FDA Matters. In May 2002, Watson reached an agreement with the FDA on the terms of a consent decree with respect to its Corona, California manufacturing facility. The court approved the consent decree on May 13, 2002 (*United States of America v. Watson Laboratories, Inc., and Allen Y. Chao*, United States District Court for the Central District of California, EDCV-02-412-VAP). The consent decree with the FDA does not require any fine, a facility shutdown, product recalls or any reduction in production or service at the Company s Corona facility. The consent decree applies only to the Corona facility and not other manufacturing sites. On July 9,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2008, the court entered an order dismissing Allen Y. Chao, the Company s former President and Chief Executive Officer, from the action and from the consent decree. The decree requires Watson to ensure that its Corona, California facility complies with the FDA s current Good Manufacturing Practices (cGMP) regulations.

Pursuant to the agreement, Watson hired an independent expert to conduct inspections of the Corona facility at least once each year. In each year since 2002, the independent expert has reported its opinion to the FDA that, based on the findings of the audit of the facility, the FDA s applicable cGMP requirements, applicable FDA regulatory guidance, and the collective knowledge, education, qualifications and experience of the expert s auditors and reviewers, the systems at Watson s Corona facility audited and evaluated by the expert are in compliance with the FDA s cGMP regulations. However, the FDA is not required to accept or agree with the independent expert s opinion. The FDA has conducted periodic inspections of the Corona facility since the entry of the consent decree. The FDA s most recent general cGMP inspection was conducted from August 2, 2010 through August 13, 2010. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. The FDA also conducted a pharmacovigilence inspection at the Corona facility in August and September of 2011. At the conclusion of the inspection the auditor issued an FDA Form 483 with five observations and stated that he would recommend no further actions by FDA in connection with the inspection. However, if in the future, the FDA determines that, with respect to its Corona facility, Watson has failed to comply with the consent decree or FDA regulations, including cGMPs, or has failed to adequately address the FDA s inspectional observations, the consent decree allows the FDA to order Watson to take a variety of actions to remedy the deficiencies. These actions could include ceasing manufacturing and related operations at the Corona facility, and recalling affected products. Such actions, if taken by the FDA, could have a material adverse effect on the Company, its results of operations, financial position and cash flows.

Androgel®Antitrust Litigation. On January 29, 2009, the U.S. Federal Trade Commission and the State of California filed a lawsuit in the United States District Court for the Central District of California *(Federal Trade Commission, et. al. v. Watson Pharmaceuticals, Inc., et. al., USDC Case No. CV 09-00598)* alleging that the Company s September 2006 patent lawsuit settlement with Solvay Pharmaceuticals, Inc., related to AndroGel® 1% (testosterone gel) CIII is unlawful. The complaint generally alleged that the Company improperly delayed its launch of a generic version of Androgel® in exchange for Solvay s agreement to permit the Company to co-promote Androgel® for consideration in excess of the fair value of the services provided by the Company, in violation of federal and state antitrust and consumer protection laws. The complaint sought equitable relief and civil penalties. On February 2 and 3, 2009, three separate lawsuits alleging similar claims were filed in the United States District Court for the Central District of California by various private plaintiffs purporting to represent certain classes of similarly situated claimants *(Meijer, Inc., et. al., v. Unimed Pharmaceuticals, Inc., et. al., USDC Case No. EDCV 09-0215); (Rochester Drug Co-Operative, Inc. v. Unimed Pharmaceuticals Inc., et. al., Case No. EDCV 09-0226); (Louisiana Wholesale Drug Co. Inc. v. Unimed Pharmaceuticals Inc., et. al, Case No. EDCV 09-0228)*. On April 8, 2009, the Court transferred the government and private cases to the United States District Court for the Northern District of Georgia. On April 21, 2009 the State of California voluntarily dismissed its lawsuit against the Company without prejudice. The Federal Trade Commission and the private plaintiffs in the Northern District of Georgia filed amended complaints on May 28, 2009. The private plaintiffs amended their complaints to include allegations concerning conduct before the U.S. Patent and Trademark Office, conduct in connection with the listing of Solvay s patent in the Food and Drug Administration s Orange Book, and sham litigation. Additional actions alleging similar claims have been filed in various courts by other private plaintiffs purporting to represent certain classes of similarly situated direct or indirect purchasers of Androgel® (*Stephen L. LaFrance Pharm., Inc. d/b/a SAJ Dist. v. Unimed Pharms., Inc., et al., D. NJ Civ. No. 09-1507*); (Fraternal *Order of Police, Fort Lauderdale Lodge 31, Insurance Trust Fund v. Unimed Pharms. Inc., et al.,D. NJ Civ. No. 09-1856*); (*Scurto v. Unimed Pharms., Inc., et al., D. NJ Civ. No. 09-1900*); (*United Food and Commercial Workers Unions and Employers Midwest Health Benefits Fund v. Unimed Pharms., Inc., et al., D. MN Civ. No. 09-1168*); (*Rite Aid Corp. et al. v. Unimed Pharms., Inc. et al., M.D. PA Civ. No. 09-1153); (Walgreen Co., et al. v. Unimed Pharms.,LLC, et al., MD. PA Civ. No. 09-1240*); (*Supervalu, Inc. v. Unimed*

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pharms., LLC, et al, ND. GA Civ. No. 10-1024); (*LeGrand v. Unimed Pharms., Inc., et al*., ND. GA Civ. No. 10-2883); (*Jabo s Pharmacy Inc. v. Solvay Pharmaceuticals, Inc., et al* ., Cocke County, TN Circuit Court Case No. 31,837). On April 20, 2009, the Company was dismissed without prejudice from the *Stephen L. LaFrance* action pending in the District of New Jersey. On October 5, 2009, the Judicial Panel on Multidistrict Litigation transferred all actions then pending outside of the United States District Court for the Northern District of Georgia to that district for consolidated pre-trial proceedings (*In re: AndroGel® Antitrust Litigation (No. II), MDL Docket No. 2084*), and all currently-pending related actions are presently before that court. On February 22, 2010, the judge presiding over all the consolidated litigations related to Androgel® then pending in the United States District Court for the Northern District of Georgia granted the Company s motions to dismiss the complaints, except the portion of the private plaintiffs complaints that include allegations concerning sham litigation. On July 20, 2010, the plaintiff in the *Fraternal Order of Police* action filed an amended complaint adding allegations concerning conduct before the U.S. Patent and Trademark Office, conduct in connection with the listing of Solvay s patent in the Food and Drug Administration s Orange Book, and sham litigation similar to the claims raised in the direct purchaser actions. On October 28, 2010, the judge presiding over MDL 2084 entered an order pursuant to which the *LeGrand* action, filed on September 10, 2010, was consolidated for pretrial purposes with the other indirect purchaser class action as part of MDL 2084 and made subject to the Court s February 22, 2010 order on the motion to dismiss. Discovery in the private actions is ongoing. Final judgment in favor of the defendants was entered in the Federal Trade Commission s action on April 21, 2010. On June 10, 2010, the Federal Trade Commission filed a notice of appeal to the Eleventh Circuit Court of Appeals, appealing the district court s dismissal of its complaint. The appeal is pending.

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

Hormone Replacement Therapy Litigation. Beginning in early 2004, a number of product liability suits were filed against the Company and certain Company affiliates, as well as numerous other pharmaceutical companies, for personal injuries allegedly arising out of the use of hormone replacement therapy products, including but not limited to estropipate and estradiol. Breast cancer is the injury predominately alleged in these cases, but stroke is claimed in two cases and ovarian cancer in claimed in one case. Approximately 63 cases remain pending against Watson and/or its affiliates in state and federal courts representing claims by approximately 63 plaintiffs. The majority of the cases have been transferred to and consolidated in the United States District Court for the Eastern District of Arkansas (*In re: Prempro Products Liability Litigation, MDL Docket No. 1507*). Discovery in these cases is ongoing. The Company believes it has substantial meritorious defenses to these cases and maintains product liability insurance against such cases. However, litigation is inherently uncertain and the Company cannot predict the outcome of this litigation. These actions, if successful, or if insurance does not provide sufficient coverage against such claims, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Fentanyl Transdermal System Litigation. Beginning in 2009, a number of product liability suits were filed against the Company and certain Company affiliates, as well as other manufacturers and distributors of fentanyl transdermal system products, for personal injuries or deaths allegedly arising out of the use of the fentanyl transdermal system products. Approximately 66 cases are pending against the Company and/or its affiliates in state and federal courts, representing claims by approximately 178 plaintiffs. Discovery is ongoing. The Company believes it has substantial meritorious defenses to these cases and maintains product liability insurance against such cases. However, litigation is inherently uncertain and the Company cannot predict the outcome of this litigation. These actions, if successful, or if insurance does not provide sufficient coverage against such claims, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Metoclopramide Litigation. Beginning in 2009, a number of product liability suits were filed against the Company and certain Company affiliates, as well as other manufacturers and distributors of metoclopramide, for personal injuries allegedly arising out of the use of metoclopramide. Approximately 1,150 cases are pending against the Company and/or its affiliates in state and federal courts, representing claims by approximately 5,100 plaintiffs. These cases are generally in their preliminary stages and discovery is ongoing. The Company believes that it will be defended in and indemnified for the majority of these claims by Pliva, Inc., an affiliate of Teva Pharmaceutical Industries, Ltd., from whom the Company purchased its metoclopramide product line in late 2008. Further, the Company believes that it has substantial meritorious defenses to these cases and maintains product liability insurance against such cases. However, litigation is inherently uncertain and the Company cannot predict the outcome of this litigation. These actions, if successful, or if our indemnification arrangements or insurance do not provide sufficient coverage against such claims, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Medical West Ballas Pharmacy, LTD, et al. v. Anda, Inc., (Circuit Court of the County of St. Louis, State of Missouri, Case No. 08SL-CC00257). In January 2008, Medical West Ballas Pharmacy, LTD, filed a purported class action complaint against the Company alleging conversion and alleged violations of the Telephone Consumer Protection Act (TCPA) and Missouri Consumer Fraud and Deceptive Business Practices Act. In April 2008, plaintiff filed an amended complaint substituting Anda, Inc., a subsidiary of the Company, as the defendant. The amended complaint alleges that by sending unsolicited facsimile advertisements, Anda misappropriated the class members paper, toner, ink and employee time when they received the alleged unsolicited faxes, and that the alleged unsolicited facsimile advertisements were sent to the plaintiff in violation of the TCPA and Missouri Consumer Fraud and Deceptive Business Practices Act. The TCPA allows recovery of minimum statutory damages of $500 per violation, which can be trebled if the violations are found to be willful. The complaint seeks to assert class action claims on behalf of the plaintiff and other similarly situated third parties. In April 2008, Anda filed an answer to the amended complaint, denying the allegations. In November 2009, the court granted plaintiff s motion to expand the proposed class of plaintiffs from individuals for which Anda lacked evidence of express permission or an established business relationship to All persons who on or after four years prior to the filing of this action, were sent telephone facsimile messages advertising pharmaceutical drugs and products by or on behalf of Defendant. In November 2010, the plaintiff filed a second amended complaint further expanding the definition and scope of the proposed class of plaintiffs. On November 30, 2010, Anda filed a petition with the Federal Communications Commission (FCC), asking the FCC to clarify the statutory basis for its regulation requiring opt-out language on faxes sent with express permission of the recipient. The FCC s ruling on Anda s petition may determine whether fax recipients who expressly agree to receive faxes may assert claims for receipt of such faxes pursuant to the TCPA. On December 2, 2010, Anda filed a motion to dismiss claims the plaintiff is seeking to assert on behalf of putative class members who expressly consented or agreed to receive faxes from Defendant, or in the alternative, to stay the court proceedings pending resolution of Anda s petition to the FCC. On April 11, 2011, the court denied the motion. On May 19, 2011, the plaintiff s filed their motion for class certification. Anda filed its opposition to the motion on July 13, 2011. The hearing on the class certification motion is scheduled for March 21, 2012. No trial date has been set. Anda believes it has substantial meritorious defenses to the action, including but not limited to its receipt of consent to receive facsimile advertisements from many of the putative class members, and intends to defend the action vigorously. However, this action, if successful, could have an adverse effect on the Company s business, results of operations, financial condition and cash flows.

Drospirenone/Ethinyl Estradiol Tablets (Generic version of Yasmin®). On April 17, 2008, Bayer Schering Pharma AG sued the Company in the United States District Court for the Southern District of New York, alleging that sales of the Company s drospirenone/ethinyl estradiol tablets, a generic version of Bayer s Yasmin® tablets, infringes Bayer s U.S. Patent No. 5,569,652 (*Bayer Schering Pharma AG v. Watson Pharmaceuticals, Inc., et. al., Case No. 08cv3710*). The complaint sought damages and injunctive relief. On September 28, 2010,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the district court granted the Company s motion for judgment on the pleadings and dismissed the case with prejudice. Final judgment was entered on January 7, 2011. On January 21, 2011, Bayer filed a Notice of Appeal with the United States Court of Appeals for the Federal Circuit. Oral argument was held on December 7, 2011 and a decision is pending. The Company believes it has substantial meritorious defenses to the case. However, the Company has sold and is continuing to sell its generic version of Yasmin®. Therefore, an adverse ruling on the appeal or a subsequent final determination that the Company has infringed the patent in suit could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Levonorgestrel/Ethinyl Estradiol Tablets (Generic version of Seasonique®). On March 6, 2008, Duramed (now known as Teva Women s Health) sued the Company in the United States District Court for the District of Nevada, alleging that sales of the Company s levonorgestrel/ethinyl estradiol tablets, a generic version of Duramed s Seasonique® tablets, would infringe Duramed s U.S. Patent No. 7,320,969 (*Duramed v. Watson Pharmaceuticals, Inc., et. al., Case No. 08cv00116*). The complaint sought damages and injunctive relief. On March 31, 2010, the District Court granted Duramed s motion for summary judgment that the asserted claims are not invalid as obvious. Watson appealed and on March 25, 2011, the U.S. Court of Appeals for the Federal Circuit reversed the District Court and remanded the case for a determination of whether the asserted claims are obvious. On June 9, 2011, Duramed moved for a preliminary injunction to prevent the Company from launching its product until after a trial on the merits. On June 16, 2011, the court denied Duramed s motion. Duramed appealed and also requested temporary injunctive relief during the pendency of its appeal *(Duramed v. Watson Laboratories, Case No. 3011-1438).* On July 27, 2011, the U.S. Court of Appeals for the Federal Circuit denied Duramed s request for temporary relief. Watson launched its generic product on July 28, 2011. On November 10, 2011, the U.S. Court of Appeals for the Federal Circuit affirmed the District Court s denial of Duramed s preliminary injunction motion. On August 5, 2011, Duramed filed a motion in the District Court to amend its complaint to add a claim for damages as a result of Watson s launch of its generic product. On November 18, 2011, Watson moved for summary judgment. No trial date has been set. The Company believes it has substantial meritorious defenses to the case. However, the Company has sold and is continuing to sell its generic version of Seasonique®. Therefore, an adverse ruling in the case or a subsequent final appellate determination that the patent in suit is valid, and that the Company has infringed the patent in suit, could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Drospirenone/Ethinyl Estradiol Tablets (Generic version of Yaz®). On November 5, 2007, Bayer Schering Pharma AG sued the Company in the United States District Court for the District of Nevada, alleging that sales of the Company s drospirenone/ethinyl estradiol tablets, a generic version of Bayer s Yaz® tablets, would infringe numerous Bayer patents. (*Bayer Schering Pharma AG v. Watson Pharmaceuticals, Inc., et. al., Case No. 07cv1472*) The complaint sought damages and injunctive relief and included claims related to U.S. Patent No. 5,787,531, U.S. Patent No. RE 37,564, and U.S. Patent No. RE 37,838. Watson filed an amended answer and counterclaims for a Declaratory Judgment of invalidity and/or non-infringment of U.S. Patent Nos. 5,798,338, 6,933,395, 6,958,326, 7,163,931 and RE 38,253. Thereafter, the U.S. Court of Appeals for the Federal Circuit ruled that U.S. Patent No. 5,787,531 was invalid and the claims related to that patent were dismissed. The District Court subsequently entered a consent judgment that the Company does not infringe U.S. Patent Nos. 5,798,338, 6,933,395, 6,958,326, and 7,163,931, and dismissed with prejudice Bayer s claims related to U.S. Patent Nos. RE 37,838 and RE 38,253. The only patent still in dispute in the Nevada lawsuit is U.S. Patent No. RE 37,564. The Company has filed a motion for summary judgment that Bayer s U.S. Patent No. RE 37, 564 is invalid as obvious. The motion remains pending.

In a separate case, on September 18, 2008, Bayer sued the Company in the United States District Court for Southern District of New York, alleging that sales of the Company s drospirenone/ethinyl estradiol tablets, a generic version of Bayer s Yaz® tablets, would infringe U.S. Patent No. 5,569,652. On March 23, 2011, per stipulation by the parties, the District Court entered judgment in favor of the Company on its counterclaim for non-infringement of U.S. Patent No. 5,569,652, based on the Court s September 28, 2010 Memorandum Opinion

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WATSON PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and Order in the Yasmin case (*Case No. 08cv3710*, discussed above). The appeal of this case was consolidated with the appeal of the Yasmin case, and remains pending. On January 7, 2012, the Company commenced sales of its generic version of Bayer s Yaz® tablets. The Company believes it has substantial meritorious defenses to the case. However, the Company has sold and is continuing to sell its generic version of Yaz®. Therefore, an adverse ruling in the Nevada lawsuit or a subsequent final determination that the Company has infringed the patents in suit, or an adverse ruling in the case pending on appeal at the Federal Circuit, could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Quinine Sulfate Litigation. Beginning in 2008, a number of product liability suits were filed against the Company and certain Company affiliates, as well as other manufacturers and distributors of quinine sulfate, for personal injuries allegedly arising out of the use of quinine sulfate. Approximately 18 cases, representing claims by approximately 38 plaintiffs, are pending against the Company and/or its affiliates in various state courts in California and have been consolidated for pre-trial discovery. In December 2011, the Company reached an agreement in principle to settle all of the outstanding claims, subject to execution of definitive settlement agreements. The amount to be paid by the Company under the terms of the settlement in principle is not material to the Company. The Company believes that it has substantial meritorious defenses to these cases and maintains product liability insurance against such cases. However, litigation is inherently uncertain. Although the cases have been settled in principle, if the settlement is not consummated, these actions, if successful, or if insurance does not provide sufficient coverage against such claims, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

Alendronate Litigation. Beginning in 2010, a number of product liability suits were filed against the Company and certain Company affiliates, as well as other manufacturers and distributors of alendronate, for personal injuries allegedly arising out of the use of alendronate. Approximately 111 cases are pending against the Company and/or its affiliates in various state and federal courts, representing claims by approximately 128 plaintiffs. These cases are generally at their preliminary stages and discovery is ongoing. The Company believes that it will be defended in, and indemnified for, the majority of these claims by Merck & Co., the New Drug Application holder and manufacturer of the product sold by the Company during most of 2008. Several claims have also been asserted against Cobalt Laboratories, which the Company acquired in 2009 as part of its acquisition of the Arrow Group of companies, in connection with Cobalt s manufacture and sale of alendronate. Ten of the cases that have been served on the Company naming Watson and/or Cobalt have been consolidated for pre-trial proceedings as part of a multi-district litigation (MDL) matter pending in the United States District Court for the Southern District of New Jersey *(In re: Fosamax (Alendronate Sodium) Products Liability Litigation, MDL No. 2243)*. Four cases are part of a similar MDL matter pending in the United States District Court for the Southern District of New York. The remaining cases are part of a State mass tort coordinated proceeding pending in Atlantic County, New Jersey. In January 2012, the United States District Court for the Southern District of New Jersey conditionally granted the Company s motion to dismiss all of the cases pending against the Company in the New Jersey MDL matter. The court is expected to finally rule on the motion to dismiss following plaintiffs submission of any supplemental pleadings attempting to overcome the reasoning of the court s dismissal. In the state court proceeding pending in Atlantic County, responsive pleadings and discovery have been suspended with respect to the generic defendants (including the Company) pending briefing and ruling on a motion to dismiss, which the generic defendants expect to file in March 2012. The Company believes that it has substantial meritorious defenses to these cases and maintains product liability insurance against such cases. However, litigation is inherently uncertain and the Company cannot predict the outcome of this litigation. These actions, if successful, or if our indemnification arrangements or insurance do not provide sufficient coverage against such claims, could adversely affect the Company and could have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

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

NOTE 17 Subsequent Events

Acquisition of Ascent Pharmahealth Limited

On January 24, 2012, we completed the acquisition of Ascent Pharmahealth Ltd., the Australia and Southeast Asia generic pharmaceutical business of Strides Arcolab Ltd, for AU$375.0 million in cash, or approximately $393.0 million. The transaction was funded using cash on hand and borrowings from the Company s revolving credit facility. As a result of the acquisition, Watson enhances its commercial presence in Australia and we gain a selling and marketing capability in Southeast Asia through Ascent s line of branded-generic and over-the-counter products. Given the proximity of this acquisition, the initial accounting for the business combination was incomplete at the time the financial statements were issued.

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Schedule II

Watson Pharmaceuticals, Inc.

Valuation and Qualifying Accounts

Years Ended December 31, 2011, 2010 and 2009

(in millions)

	Balance at beginning of period	Charged to costs and expenses	Deductions/ Write-offs	Other*	Balance at end of period
Allowance for doubtful accounts:					
Year ended December 31, 2011	$ 12.5	$ 2.3	$ (8.3)	$ 0.3	$ 6.8
Year ended December 31, 2010	5.4	9.5	(2.4)		12.5
Year ended December 31, 2009	3.3	3.4	(3.1)	1.8	5.4
Inventory reserves:					
Year ended December 31, 2011	$ 51.4	$ 44.4	$ (56.3)	$ 1.0	$ 40.5
Year ended December 31, 2010	77.7	50.0	(76.3)		51.4
Year ended December 31, 2009	34.7	51.0	(22.4)	14.4	77.7
Tax valuation allowance:					
Year ended December 31, 2011	$ 29.7	$ 9.1	$ (1.6)	$ 0.6	$ 37.8
Year ended December 31, 2010	28.4	7.3	(6.0)		29.7
Year ended December 31, 2009	8.1	0.2		20.1	28.4

* Represents opening balances of businesses acquired in the period.

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SUPPLEMENTARY DATA (UNAUDITED)

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

	For Three Month Periods Ended			
	Dec. 31, 2011	Sept. 30, 2011	June 30, 2011	Mar. 31, 2011
Net revenues	$ 1,544.6	$ 1,081.6	$ 1,081.7	$ 876.5
Operating expenses	1,377.3	941.8	963.4	765.7
Operating income	167.3	139.8	118.3	110.8
Provision for income taxes	61.5	50.9	43.2	41.3
Net income attributable to common shareholders	$ 94.8	$ 68.1	$ 52.7	$ 45.3
Basic earnings per share	$ 0.76	$ 0.55	$ 0.42	$ 0.37
Diluted earnings per share	$ 0.75	$ 0.54	$ 0.42	$ 0.36
Market price per share:				
High	$ 72.06	$ 73.35	$ 69.04	$ 57.52
Low	$ 59.50	$ 58.84	$ 56.13	$ 50.47

	For Three Month Periods Ended			
	Dec. 31, 2010	Sept. 30, 2010	June 30, 2010	Mar. 31, 2010
Net revenues	$ 952.7	$ 882.4	$ 875.3	$ 856.5
Operating expenses	897.7	848.0	759.6	756.2
Operating income	55.0	34.4	115.7	100.3
Provision for income taxes	14.9	(12.2)	27.9	36.7
Net income	$ 18.3	$ 25.7	$ 70.6	$ 69.8
Basic earnings per share	$ 0.15	$ 0.21	$ 0.58	$ 0.57
Diluted earnings per share	$ 0.15	$ 0.21	$ 0.57	$ 0.57
Market price per share:				
High	$ 52.20	$ 45.15	$ 44.97	$ 42.50
Low	$ 42.17	$ 39.34	$ 40.50	$ 37.26

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EXHIBIT INDEX

Exhibit No.	Description
2.2	Share Purchase Agreement dated as of June 16, 2009, by and among Robin Hood Holdings Limited, Watson Pharmaceuticals, Inc., certain shareholders of Robin Hood Holdings Limited, and Anthony Selwyn Tabatznik, solely in his capacity as the Shareholders Representative, is incorporated by reference to Exhibit 2.1 to the Company s June 16, 2009 Form 8-K.
2.3	First Amendment to Share Purchase Agreement, dated as of November 26, 2009, by and among Robin Hood Holdings Limited, Arrow Pharmaceutical Holdings Ltd., Cobalt Laboratories, Inc., Arrow International Ltd., Arrow Supplies Ltd., Watson Pharmaceuticals, Inc., Watson Pharma S.À.R.L., Watson Cobalt Holdings, LLC, the shareholders of Robin Hood Holdings Limited, and Anthony Selwyn Tabatznik, solely in his capacity as Shareholders Representative, is incorporated by reference to Exhibit 2.2 to the Company s November 26, 2009 Form 8-K.
2.4	Share Purchase Agreement dated May 25, 2011 by and among Watson Pharmaceuticals, Inc. and each of the shareholders (together, the Sellers) of Paomar PLC (Paomar), is incorporated by reference to Exhibit 2.4 to the Company s May 27, 2011 Form 8-K.
2.5	Share Purchase Agreement dated January 24, 2012 by and among Watson Pharmaceuticals, Inc., Strides Pharma Limited, I-Investments Pty Ltd, Strides Arcolab Limited, Ascent Pharmahealth Limited and Dennis Bastas is incorporated by reference to Exhibit 2.1 to the Company s January 26, 2012 Form 8-K.
3.1	Articles of Incorporation of the Company and all amendments thereto are incorporated by reference to Exhibit 3.1 to the Company s June 30, 1995 Form 10-Q and to Exhibit 3.1(A) to the Company s June 30, 1996 Form 10-Q.
3.2A	Second Amended and Restated Bylaws of Watson Pharmaceuticals, Inc. are incorporated by reference to Exhibit 3.1 to the Company s March 5, 2009 Form 8-K.
3.2B	Amended and Restated Articles of Incorporation of Watson Pharmaceuticals, Inc. are incorporated by reference to Appendix A to the Company s April 1, 2011 Form DEF 14A.
3.2C	Amendment to the Second Amended and Restated Bylaws of the Company (the Bylaws), are incorporated by reference to Exhibit 5.03 to the Company s January 16, 2012 Form 8-K.
3.3	Certificate of Designations for Series A Preferred Stock is incorporated by reference to Exhibit 3.1 to the Company s November 26, 2009 Form 8-K.
4.1	Indenture between the Company and Wells Fargo Bank, N.A., as trustee, dated as of August 24, 2009, is incorporated by reference to Exhibit 4.1 to the Company s August 18, 2009 Form 8-K.
4.2	First Supplemental Indenture between the Company and Wells Fargo Bank, N.A., as trustee, dated as of August 24, 2009, including the forms of the Company s 5.000% Senior Notes due 2014 and 6.125% Senior Notes due 2019, is incorporated by reference to Exhibit 4.2 to the Company s August 18, 2009 Form 8-K.
4.3	Second Supplemental Indenture between the Company and Wells Fargo Bank, N.A., as trustee, dated as of May 7, 2010, is incorporated by reference to Exhibit 10. to the Company s March 31, 2010 10-Q.
4.4	Shareholders Agreement, dated as of December 2, 2009, by and among Watson Pharmaceuticals, Inc., Quiver Inc. and Friar Tuck Limited, is incorporated by reference to Exhibit 4.1 to the Company s November 26, 2009 Form 8-K.

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4.5	Credit Agreement, dated September 16, 2011, by and among Watson Pharmaceuticals, Inc., Bank of America, N.A., as Administrative Agent, Wells Fargo Bank, N.A., as Syndication Agent, and a syndicate of Lenders, is incorporated by reference to Exhibit 99.1 to the Company s September 19, 2011 Form 8-K.
*10.2A	Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc. is incorporated by reference to Exhibit 10.1 to the Company s June 30, 2005 Form 10-Q.
*10.2B	Second Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc. is incorporated by reference to Exhibit 10.1 to the Company s March 31, 2007 Form 10-Q.
*10.2C	Third Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc.
*10.2D	Fourth Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc. are incorporated by reference to Appendix B to the Company s April 1, 2011 Form DEF 14A.
*10.3	Key Employee Agreement entered into as of February 28, 2000, between David A. Buchen and the Company, is incorporated by reference to Exhibit 10.4 to the Company s 2000 Form 10-K.
*10.4	Amendment to Key Employment Agreement entered into as of December 31, 2008, between David A. Buchen and the Company, is incorporated by reference to Exhibit 10.9 to the Company s 2008 Form 10-K.
*10.9	2001 Incentive Award Plan Form of Notice of Grant and Signature Page for an Employee or a Consultant is incorporated by reference to Exhibit 10.15 to the Company s 2004 Form 10-K.
*10.10	2001 Incentive Award Plan Form of Notice of Grant and Signature Page for a Director is incorporated by reference to Exhibit 10.16 to Exhibit 10.16 to the Company s 2004 Form 10-K.
*10.11	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Non-Employee Director Restricted Stock Award is incorporated by reference to Exhibit 10.2 to the Company s June 30, 2005 Form 10-Q.
*10.12	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Non-Employee Director Option Grant is incorporated by reference to Exhibit 10.3 to the Company s June 30, 2005 Form 10-Q.
*10.13	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for an Employee Restricted Stock Award is incorporated by reference to Exhibit 10.4 to the Company s June 30, 2005 Form 10-Q.
*10.14	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for an Employee Stock Option Award is incorporated by reference to Exhibit 10.5 to the Company s June 30, 2005 Form 10-Q.
*10.15	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Vice-President and Above Stock Option Award is incorporated by reference to Exhibit 10.6 to the Company s June 30, 2005 Form 10-Q.
*10.16	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Vice-President and Above Restricted Stock Award is incorporated by reference to Exhibit 10.22 to the Company s 2006 Form 10-K.

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*10.17	Key Employee Agreement between Watson Pharmaceuticals, Inc. and Paul M. Bisaro, dated as of August 1, 2007, is incorporated by reference to Exhibit 10.2 to the Company s August 1, 2007 Form 8-K.
*10.18	Amendment to Watson Pharmaceuticals, Inc. Key Employee Agreement entered into as of December 22, 2008 by and between Paul M. Bisaro and the Company is incorporated by reference to Exhibit 10.27 to the Company s 2008 Form 10-K..
*10.19A	Key Employee Agreement between Anda, Inc. and Al Paonessa III, dated as of August 2, 2007 is incorporated by reference to Exhibit 10.28 to the Company s 2007 Form 10-K.
10.19B	Amendment to Key Employment Agreement entered into as of December 31, 2008, between AI Paonessa III and the Company is incorporated by reference to Exhibit 10.8 to the Company s 2008 Form 10-K.
*10.22	Key Employee Agreement entered into as of October 30, 2009 by and between R. Todd Joyce and the Company is incorporated by reference to Exhibit 10.1 to the Company s October 30, 2009 Form 8-K.
10.23A	Purchase and Collaboration Agreement, dated as of March 3, 2010, by and among Columbia Laboratories, Inc., Coventry Acquisition, Inc. and Watson Pharmaceuticals, Inc., is incorporated by reference to Exhibit 2.1 to the Company s March 5, 2010 Form 8-K.
10.23B	Letter Agreement dated February 10, 2012 Amending the Purchase and Collaboration Agreement, dated as of March 3, 2010, by and among Columbia Laboratories, Inc., Coventry Acquisition, Inc. and Watson Pharmaceuticals, Inc.
10.24	Consulting agreement between Arrow No. 7 Ltd., and Anthony Selwyn Tabatznik as of May 10, 2010, is incorporated by reference to Exhibit 10.1 to the Company s March 31, 2010 Form 10-Q.
12.1	Statement regarding the computation of the ratio of earnings to fixed charges is incorporated by reference to Exhibit 12.1 to the Company s August 17, 2009 Form S-3.
21.1	Subsidiaries of the Company.
23.1	Consent of PricewaterhouseCoopers LLP.

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31.1**	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange
31.2**	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
32.1**	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS***	XBRL Instance Document
101.SCH***	XBRL Taxonomy Extension Schema Document
101.CAL***	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF***	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB***	XBRL Taxonomy Extension Label Linkbase Document

* Compensation Plan or Agreement

** Furnished herewith and not filed for purposes of Section 18 of the Exchange Act.

*** XBRL information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), and is not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

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